Department of Insurance:

Former Executive Life Insurance Company Policyholders Have Incurred Significant Economic Losses, and Distributions of Funds Have Been Inconsistently Monitored and Reported

January 2008 Report 2005-115.2

CALIFORNIA STATE AUDITOR

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January 31, 2008 2005-115.2

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee (audit committee), the Bureau of State Audits presents its audit report concerning the Department of Insurance's (department) management of the Executive Life Insurance Company (ELIC) estate.

When the insurance commissioner (commissioner) conserved ELIC on April 11, 1991, he reported the company's assets to be $8.8 billion. Including the loss from the liquidation of ELIC's investment securities in 1992, investment income, litigation proceeds, and income from other sources, the total ELIC assets available between 1991 and 2006 were $10.2 billion. Of this amount, the commissioner has used $528 million to pay for the cost of administering the ELIC estate. The commissioner transferred $6.7 billion to Aurora National Life Assurance Company (Aurora) for use in its role as a successor insurer to ELIC. In addition, the commissioner has paid a total of $2.7 billion to policyholders and other beneficiaries of the estate. As of December 31, 2006, $325 million remained of the ELIC estate; however, in July and August 2007 the commissioner transferred $311 million to Aurora for distribution to certain policyholders and other beneficiaries.

As with any insolvency of a public company, investors and creditors risk substantial losses. This was no different in the case of the policyholders of ELIC who incurred significant losses when the commissioner obtained a court order to take over its operations to conserve the company. In August 2005 the department estimated that losses related to the original policy rights totaled $936 million. The department acknowledged that it did not include the time value of money in its August 2005 estimate; however, its analysis also did not include the financial impact caused by changes to policy terms subsequent to ELIC's insolvency. In contrast, when we calculated the economic loss to policyholders, we included several specific factors such as changes to policy terms, the time value of money, estimated original policy value, and others. Taking all of these factors into consideration, we estimated the total economic losses for policyholders to be $3.1 billion both as of August 2005 and December 31, 2006.

The commissioner has not consistently monitored, reported on, or accounted for the distribution of assets of the ELIC estate. Other than requiring special procedures as part of an audit issued in 1998 and including some of those same procedures in an examination that was still ongoing as of October 2007, the commissioner asserted that he did not obtain general rights to monitor Aurora's records. Thus, the commissioner has done little to make sure that ELIC estate funds were distributed in accordance with key agreements from 1998 to 2006. Because the commissioner did not monitor these distributions, policyholders have less assurance that the $225 million distributed during this time period was distributed in accordance with the ELIC agreements. Furthermore, some reports authorized by the California Insurance Code or required by individual trust agreements were not produced and, inconsistent accounting practices and varying availability of supporting documents hinder a complete accounting of the ELIC estate. Overall, inconsistent reporting and auditing have contributed to a lack of information available to former ELIC policyholders and other parties who have an interest in the ELIC estate.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

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Results in Brief

The Department of Insurance (department) is responsible for protecting California policyholders by regulating insurance companies (insurers), brokers, and agents operating in the State. The department's Conservation and Liquidation Office (CLO) assists the insurance commissioner (commissioner) in conserving, rehabilitating, or liquidating financially distressed or insolvent insurers. An insurer subject to a conservation or liquidation order is called an estate.

The Executive Life Insurance Company (ELIC) was a multibillion-dollar life insurance company that had its principal legal residence in California and operated in the State from 1962 to 1991. According to a 1994 report issued by the chief deputy insurance commissioner at the time, ELIC invested 55 percent to 60 percent of its portfolio in high-yield, noninvestment-grade corporate bonds, also known as junk bonds, during the 1980s. At the time, the insurance industry average for this type of investment typically ranged from 7 percent to 11 percent. In late 1989 the junk bond market experienced a significant decline in value, and in early 1991, the commissioner determined that ELIC's financial statements were grossly overstated and that the company was insolvent. On April 11, 1991, acting on a court conservation order, he took over the operation of ELIC.

On the date of conservation, the commissioner reported ELIC's assets to be $8.8 billion. Including the loss from the liquidation of ELIC's investment securities in 1992, investment income, litigation proceeds, and income from other sources, the total ELIC assets available between 1991 and 2006 were $10.2 billion. Of this amount, the commissioner has used $528 million to pay for the cost of administering the ELIC estate. As a result of the ELIC Rehabilitation Plan (rehabilitation plan) approved by the conservation court and upheld by the California Supreme Court on September 3, 1993, Aurora National Life Assurance Company (Aurora) assumed and reinsured nearly all of ELIC's policies; and the policies were revalued at approximately 78 percent of their original value. The commissioner transferred $6.7 billion to Aurora for use in its role as a successor insurer to ELIC. Of this amount, Aurora later paid $2.7 billion to policyholders who decided not to continue their insurance policies with the company by a certain date, which includes funds Aurora sent back to the estate for it to distribute to these former policyholders.

The commissioner has paid a total of $2.7 billion to policyholders and other beneficiaries of the estate, including the National Organization of Life and Health Insurance Guaranty Associations (national guaranty organization). These payments included $1.1 billion of death benefits and other payments made between the time of ELIC's conservation

Audit Highlights . . .

» When the Insurance Commissioner (commissioner) conserved the Executive Life Insurance Company (ELIC) on April 11, 1991, he reported the company's assets to be $8.8 billion. Later, losses from the liquidation of ELIC investment securities reduced this amount by $1.3 billion. Through December 31, 2006, the remaining $7.5 billion has been increased by investment income, litigation proceeds, and other income, resulting in $10.2 billion in total available assets.

» Of the $10.2 billion, the commissioner transferred $6.7 billion to Aurora National Life Assurance Company for use in its role as successor insurer to ELIC and to pay policyholders who did not continue with the company. The commissioner has paid a total of $2.7 billion to policyholders and other beneficiaries of the estate and has used $528 million for administering the ELIC estate.

» About $325 million remained in the estate as of December 31, 2006. In 2007 the commissioner transferred $311 million of these remaining funds to Aurora, most of which it reports as disbursed to policyholders and others in October 2007.

» In August 2005 the department estimated policyholder losses at $936 million, which equates to policyholders recovering 90 percent of their original policy rights. Including factors not considered by the department, we estimated policyholder economic losses of $3.1 billion as of August 2005, with policyholders recovering 86 percent of their expected ELIC account values.

» The commissioner has not consistently monitored, reported on, or accounted for the distribution of the assets of the ELIC estate.

in 1991 and its acquisition by Aurora in 1993, as well as subsequent payments resulting from the sale of assets and from litigation proceeds. Payments were made both to policyholders who continued with Aurora (opt-in policyholders) and those who did not continue with Aurora (opt-out policyholders). As of December 31, 2006, $325 million remained of the ELIC estate, and $311 million of these remaining funds were transferred to Aurora for distribution in October 2007 to opt-in policyholders and other beneficiaries.

As with any insolvency of a public company, investors and creditors risk substantial losses. This was no different in the case of the policyholders of ELIC who incurred significant losses when the commissioner, in his role as regulator, determined that ELIC's liabilities far outweighed its assets and, on April 11, 1991, obtained a court order to take over its operations to conserve the company.

In August 2005 the department estimated that losses related to original policy rights for opt-in policyholders were $279 million and that opt-out policyholders had lost $657 million, for a total estimated loss of $936 million. The department's calculation subtracts subsequent distributions and the application of $2 billion by the national guaranty organization from the September 3, 1993, policyholder shortfall. The department stated, however, that its estimate did not include the time value of money. This value is important when measuring economic loss, as a policyholder who received $100 in 2005 did not have the same opportunity to earn interest on the money that he or she would if the $100 had been paid in 1993.

When we estimated the economic loss to policyholders, we included several specific factors that the department's analysis did not include; however, we recognize that more elaborate models could be developed. Nevertheless, taking into consideration changes to policy terms, the time value of money, estimated original policy value, and other factors, we estimated the total economic losses for both opt-in and opt-out policyholders to be $3.1 billion both as of August 2005 and December 31, 2006.[1] Specifically, we estimated that as of August 2005 losses for opt-in policyholders were $1.4 billion and those for opt-out policyholders were $1.7 billion. The two models result in distinct measures to the degree that policyholders were made whole. The department's model estimates policyholders received 90 percent of their original policy rights. Our model estimates policyholders recovered 86 percent of their expected ELIC account values, measured as the estimated amount their ELIC policies would have been worth if ELIC had not become insolvent.

1 The overall losses remaining the same is partly due to $98 million distributed to opt-ins and $178 million distributed to opt-outs during 2006.

According to legal counsel for the department, neither the court-approved ELIC rehabilitation plan, the ELIC Enhancement Agreement (enhancement agreement), nor the agreements with third parties (collectively referred to in this report as the ELIC agreements[2]) give the commissioner, in his role as conservator, rehabilitator, and liquidator of the ELIC estate, the general rights to review or audit Aurora's records. The department indicated that although it lacks this general authority, through other reviews, such as examinations of Aurora conducted by the department in its role as regulator of the insurance industry, the department has gained confidence in Aurora's compliance with the ELIC agreements and thus has not needed to assert additional rights to monitor Aurora. In addition, as a result of settlement negotiations in 2005, the commissioner released Aurora from existing known and unknown claims of liability, which may further limit the commissioner's ability to monitor Aurora's compliance with the ELIC agreements prior to 2005. Despite those limitations, as part of a recent agreement negotiated by the commissioner in June 2007, the Conservation and Liquidation Office (CLO) was able to monitor Aurora's October 2007 distribution of the $311 million it had received from the ELIC estate. However, the commissioner did not monitor $225 million in distributions that occurred from 1998 through 2006, and therefore cannot provide policyholders and others the same level of assurance that the distributions Aurora made during this period were distributed in accordance with the ELIC agreements.

Our review of documents related to ELIC from the period beginning in 1990, before the commissioner conserved ELIC, through 2006 found a lack of consistent information available on ELIC estate operations and the disposition of ELIC's assets. For instance, some of the reports that are authorized by the California Insurance Code or required by individual trust agreements were not produced. Additionally, inconsistent accounting practices and inconsistent availability of supporting documents hinder a complete accounting of the ELIC estate, and limit the information available to interested stakeholders. From 1991 to 1993, the available financial information is contained in unaudited financial statements, while for 1994 through 1996, audited financial statements exist for the various trusts within the estate. However, for the 1997 to 2006 time period, audits were not consistently performed. For example, the consolidated audits performed of the ELIC estate from 1997 to 2000 are not comprehensive in that they do not include all of the entities making up the ELIC estate, and no audits were performed from 2001 to 2004. Various reports covering the 2001 to 2004 period commented on CLO accounting problems and

[2] We categorize the third-party agreements with the rehabilitation plan and enhancement agreement for ease of reference. However, unlike the rehabilitation plan and the enhancement agreement, the third-party agreements are not part of the restructuring of ELIC. Refer to Chapter 3 for additional discussion.

internal control weaknesses. Inconsistent accounting practices may have contributed to the four months it took for the CLO to provide us with information on its sources and uses of ELIC estate funds from 1997 to 2006. During this four-month period, the vice president of the CLO's estate finance group worked to verify the accuracy of the data before providing us with a financial data extract from its general ledger for the ELIC estate.

Recommendations

To increase assurance that Aurora follows key provisions in the ELIC agreements, the commissioner should seek the right to review Aurora's future distributions of ELIC estate funds and review those distributions to ensure that it adds the proper amount of interest to the funds, and distributes the funds correctly.

In order to ensure that information is available to policyholders and other parties interested in the disposition of ELIC's assets, the commissioner should, as soon as practical after the end of each year and upon the termination of any trust, complete a report that includes the assets and liabilities; the amount of all distributions, if any, made to the trust beneficiaries; and all transactions materially affecting the trust and estate.

In order to ensure that the financial information reported by the CLO is accurate, the commissioner should continue the practice of auditing the ELIC estate and any trusts that remain open on a periodic basis as recently implemented by the current chief financial officer.

In order to ensure that it accurately records distributions in its primary accounting system, and its financial reporting is correct, the CLO should periodically reconcile the distributions reported in its general ledger to its subsidiary databases.

Agency Comments

The department stated that it intends to implement all of the recommendations in our report. The department agreed with our analysis of the sources and uses of ELIC estate funds. Additionally, the department stated that the results produced by the model that estimated policyholder economic losses are reasonable, but questioned our inclusion of the accumulation of interest. However, the department disagreed with our conclusion that the commissioner has not consistently monitored, reported on, or accounted for the distribution of the assets of the ELIC estate. The department's full response begins on page 83 and our comments on the department's response begin on page 101.

Introduction

Background

Under the direction of the insurance commissioner (commissioner), the Department of Insurance (department) is responsible for regulating insurance companies, brokers, and agents operating in the State. Under the State Constitution, the commissioner is an elected position serving a maximum of two four-year terms. The California Insurance Code (insurance code) gives the commissioner broad powers to supervise the department and to perform all duties under laws regulating the business of insurance in the State. As part of its regulatory authority, the department is responsible for protecting policyholders, beneficiaries, and the public from losses due to the insolvency of insurance companies (insurers) authorized to conduct business in California. See the text box for a definition of insolvency and other related terms.

Definitions of Terms Used in This Report

Insolvency: A financial condition in which an entity is unable to meet its financial obligations and, in the case of an insurer, is unable to pay claims when they are due.

Conservation: The taking over, by the commissioner, of the operations of an insurance company licensed in California, upon a superior court's order. The commissioner then conducts a thorough examination of the company's books and records.

Rehabilitation: The eventual return of day-to-day management to the insurance company, occurring if the commissioner determines that the insurance company's identified problems can be corrected.

Liquidation: If the commissioner determines that the insurance company cannot be rehabilitated, liquidation involves closing the company and converting its assets into cash. The commissioner then applies for a court order to distribute the assets to parties with a financial interest in the estate.

Sources: Insurance code, and CLO's Web site: http://www.caclo.org.

The Conservation and Liquidation Office

The commissioner established the Conservation and Liquidation Office (CLO) in 1994 to assist him in fulfilling his responsibility to protect California residents from losses due to the insolvency of insurers.[3] Section 1011 of the insurance code authorizes the commissioner, upon obtaining a court order, to take possession of the real or personal property, books, records, and assets of an insurer and to conduct, as conservator, as much of the insurer's business as the commissioner deems necessary. Once the commissioner obtains a court order, the CLO takes a leading role in conserving, rehabilitating, or liquidating financially distressed or insolvent insurers. As of December 2007 the CLO was responsible for managing 25 insurance companies that the insurance commissioner has conserved or liquidated, which it refers to as estates.

After the CLO has liquidated the assets of an estate, the commissioner must apply for a court order to distribute the assets to policyholders, creditors, and other interested parties in the order

[3] Prior to 1994 the Conservation and Liquidation Division within the department fulfilled this responsibility.

Order of Asset Distribution

1. Administrative expenses
2. Unpaid charges due under the California Insurance Code, Section 736, for examinations made by the Department of Insurance
3. California taxes due
4. Policyholder claims given preference by the laws of the United States or of the State of California
5. Guaranty association claims
6. Creditors' claims not included above

Source: California Insurance Code, Section 1033, as of 1991.

required by the insurance code. See the text box for the sequence required in 1991, when the commissioner conserved the Executive Life Insurance Company (ELIC).

The Executive Life Insurance Company

In April 1991 the commissioner at the time obtained a court order for the conservation of ELIC.[4] Between April 1991 and September 1993, he took steps to rehabilitate and partially liquidate ELIC. In August 1993 the conservation court approved the ELIC Rehabilitation Plan (rehabilitation plan), and the California Supreme Court subsequently rejected applications for appeal, allowing the plan to take effect in September 1993. This rehabilitation plan authorized the liquidation of all of ELIC's remaining assets, provided policyholders the option to continue their policies with a successor insurer, and specified how policyholders would share in the liquidation of the company's assets.

From June 1991 to November 1993, a special deputy appointed by the commissioner was responsible for the day-to-day oversight of the company at ELIC's office building in Los Angeles. The commissioner later appointed another special deputy who managed the ELIC estate from November 1993 through July 1997. On August 1, 1997, the CLO assumed responsibility for managing the ELIC estate and continues to manage it.

Events Leading to the Conservation of ELIC

Owned by the First Executive Corporation (FEC), a Delaware holding company, ELIC was a multibillion-dollar life insurance company that maintained its principal legal residence in California and operated in the State from 1962 to 1991. ELIC offered a variety of products, some of which closely resembled financial investments rather than traditional insurance products. For example, in addition to annual-premium and single-premium whole life insurance policies, ELIC offered annuities for individuals and retirement plans; municipal guaranteed investment contracts, which were sold to municipalities as investments for bond proceeds; and pension

[4] Between the time shortly before ELIC's conservation in 1991 and October 2007, five different individuals have held the position of insurance commissioner. See Appendix A for a timeline relating to ELIC and the different individuals who served as insurance commissioner during that period.

guaranteed investment contracts, which were sold to pension funds. Even though some of ELIC's products were known as contracts, we refer to all of ELIC's customers as policyholders.

To help cover claims against it, an insurance company will invest the premiums it receives. ELIC was no different in this respect. However, according to a report issued in 1994 by the chief deputy insurance commissioner at the time (chief deputy), ELIC was unique among large insurance companies in that it typically invested 55 percent to 60 percent of its portfolio in high-yield, noninvestment-grade corporate bonds, also known as junk bonds. Bond rating agencies establish grades that rate bonds according to their investment risk. The noninvestment grade given to junk bonds falls below the four highest grades used by these rating agencies. ELIC's concentration of junk bonds was much higher than the insurance industry average at the time, which was typically 7 percent to 11 percent. Because of its investment strategy, ELIC was able to offer interest rates on its insurance products that were two to eight percentage points higher than rates earned on U.S. government treasuries, a primary type of investment in the insurance industry.

The investment firm of Drexel Burnham Lambert, Inc. (Drexel) was a major supplier to the junk bond market, and ELIC had strong business ties to Drexel. According to the former chief deputy's 1994 report, a large portion of the junk bonds ELIC purchased were underwritten by Drexel or issuers advised by Drexel, and ELIC sold its guaranteed investment contract products to many of Drexel's corporate clients. When, in late 1989, the junk bond market experienced a major decline, Drexel's business collapsed. By the spring of 1990 ELIC had to make significant adjustments to its financial statements and faced unfavorable press coverage, causing its policyholders to panic. Many policyholders who had the option to do so cashed in their policies, forcing ELIC to sell its most liquid assets for needed cash. Because a large proportion of the bonds in ELIC's portfolio were in default and the remainder had suffered serious declines in value, its assets were grossly inadequate to cover its liabilities.

The former chief deputy's report further stated that in early 1991 the commissioner began scrutinizing ELIC's holdings. Analyses of its junk bond portfolio revealed that the insurer's financial statements, which had valued the bonds at $6 billion, were greatly overstated; according to the department's analysis the portfolio's market value was closer to $3.5 billion or $4 billion. In addition, ELIC's independent auditors would not express an opinion on its parent corporation's financial statements because they had substantial doubt as to whether FEC was a going concern. Acting on a conservation court order, the commissioner took over the operations of ELIC on April 11, 1991.

Liquidation of Assets—Conserving and Liquidating the ELIC Estate

After conserving ELIC, the commissioner took steps to rehabilitate and partially liquidate the estate. He conducted a complex bidding process; obtained court approval to sell ELIC's junk bond portfolio; identified Aurora National Life Assurance Company (Aurora), a company based in the United States and established by a consortium of French companies, as a successor for ELIC's insurance business; and entered into an agreement with the National Organization of Life and Health Insurance Guaranty Associations (national guaranty organization) to augment its statutory coverage with enhanced coverage of certain policyholder losses. The text box explains the role guaranty associations play in insurance company insolvencies. Specific to the ELIC insolvency, the commissioner negotiated an ELIC Enhancement Agreement (enhancement agreement) with the national guaranty organization. Under the agreement, the national guaranty organization is the designated representative of the guaranty associations in 47 states and Puerto Rico that participated in the agreement (participating guaranty associations), and policyholders receive guaranty association benefits directly from Aurora, eliminating the need for individual policyholders to deal with their own state guaranty associations.

Role of the National Organization of Life and Health Insurance Guaranty Associations in the Insurance Industry

The National Organization of Life and Health Insurance Guaranty Associations (national guaranty organization) is a voluntary association made up of the life and health insurance guaranty associations of all 50 states, the District of Columbia, and Puerto Rico. It was founded in 1983 when the state guaranty associations determined that they needed help coordinating their efforts to protect policyholders when a multistate life or health insurance company became insolvent.

State guaranty associations provide coverage for policyholders of insurers licensed to do business in their respective state. When an insurer licensed in multiple states is declared insolvent, the national guaranty organization, on behalf of affected member state guaranty associations, provides services, such as analyzing the insurer's commitments to policyholders and ensuring that covered claims are paid.

Source: National Organization of Life and Health Insurance Guaranty Associations Web site: http://www.nolhga.com.

The commissioner also drafted a rehabilitation plan that outlined terms significant to the sale of ELIC's assets, terms and conditions for restructuring ELIC's policy obligations, and how policyholders would share in the liquidation of ELIC's assets that were not transferred to Aurora. After significant debate and modifications, the conservation court approved the rehabilitation plan, which took effect in September 1993.

The rehabilitation plan provided for the restructuring of ELIC's policies to eliminate the differential between the value of ELIC's assets and the value of its liabilities under the terms of the original insurance policies. The required restructuring reduced the value of each policy and adjusted certain policy terms such as surrender rights. The rehabilitation plan also provided each policyholder with an in-force policy as well as the option to opt in to the plan or to opt out. By opting in, a policyholder (opt-in policyholder) continued his or her insurance coverage with the new insurer, Aurora, remained eligible to recover some or all of any reduction in the policy's value through payments from the national guaranty organization, and could share proportionately in the liquidation of ELIC's remaining assets and any proceeds from litigation. The 1994 report by the former chief deputy, mentioned earlier, stated that 92 percent of the eligible policies were opted in to the rehabilitation plan by their policyholders. Policyholders who opted out (opt-out policyholders) terminated their policies in exchange for a reduced cash payment. The opt-out policyholders were eligible to share proportionately in the liquidation of ELIC's assets and litigation proceeds, but unlike the opt-ins, they were not eligible to receive benefits from the national guaranty organization to cover some of their losses.

Upon the sale of its business to Aurora, the ELIC estate transferred nearly all its investment-grade securities and operating assets to Aurora to support its liabilities under the restructured policies. The transferred assets also supported the initial cash payments to be made to the opt-out policyholders. Some assets remained in the ELIC estate after the sale. These assets, depending on their nature, were placed into three liquidating trusts: the ELIC Trust, the ELIC Real Estate Trust, and the Base Assets Trust. Over time the three trusts converted their assets to cash, which subsequently was distributed to the opt-in and opt-out policyholders and other beneficiaries. All three liquidating trusts have served their purpose and are now closed. The commissioner also established other trusts for the purposes of holding and distributing funds to policyholders: the Opt-Out Trust, the Holdback Trust, and the FEC Litigation Trust. These trusts are discussed further elsewhere in this report.

In addition to funds it has received from liquidating the assets that remained in the ELIC estate after Aurora assumed ELIC's restructured insurance policies, the department also has received proceeds from two significant legal matters. Specifically, the estate was a party to litigation against the directors and officers of FEC, Michael Milken,[5] Drexel, and others. The litigation surrounded ELIC's junk bond investments and FEC's 1991 bankruptcy. Later, in 1999, the commissioner filed a civil lawsuit against the consortium of French companies that bought ELIC's junk bond portfolio and formed Aurora to purchase ELIC's insurance policies. (This lawsuit is referred to in this report as the Altus litigation—the name of one of the defendants.) The commissioner alleged that a group of French investors illegally purchased the ELIC assets by hiding the true controlling ownership of their group, which included Credit Lyonnais, a major government-owned French bank. The alleged involvement of Credit Lyonnais violated federal

[5] Michael Milken worked at the investment bank of Drexel Burnham Lambert, Inc., and greatly expanded the use of high-yield debt (junk bonds) in corporate finance and mergers and acquisitions. As shown in the Bureau of State Audits' report 2005-115.1 issued in October 2006, Milken ultimately paid more than $200 million to the estate as a result of this litigation.

banking law, which did not allow banks to have ownership interests in insurers, and state insurance laws, which did not allow government-owned entities to have ownership interests in insurers. In 2005 some defendants, including Aurora, chose to settle with the commissioner. We discuss the litigation of both of these matters further in Chapter 1.

Currently, both the CLO and Aurora share the responsibility for distributing ELIC estate funds to policyholders and other beneficiaries. These distributions, also referred to as "enhancements" in this report, are payments from various trusts controlled by the estate after Aurora assumed ELIC's restructured insurance policies, and include funds the estate has received from liquidating ELIC's assets, as well as litigation proceeds that the estate has received. The distribution of these funds to opt-in and opt-out policyholders has the effect of reducing the losses policyholders incurred as a result of the ELIC insolvency. The CLO distributes funds to the opt-out policyholders, while Aurora typically distributes funds to the opt-in policyholders. When funds are available for distribution, the CLO calculates the relative share due the opt-in (66.1 percent) and opt-out (33.9 percent) policyholders and forwards the opt-in policyholders' share to Aurora for distribution. Most of the specific processes for how ELIC funds are distributed to policyholders are spelled out in the ELIC rehabilitation plan and the ELIC enhancement agreement, which are agreements between the commissioner, Aurora, and the national guaranty organization. Additionally, other agreements between the commissioner, Aurora, and companies that agreed to cover some policyholders' losses in return for rights to future distributions of ELIC funds also affect how funds are distributed.

The current commissioner continues to be involved in litigation surrounding the proceeds from the Altus litigation, which have delayed the ELIC estate's closing. As of November 2007 the CLO estimated that it would close the ELIC estate in late 2011.

Scope and Methodology

In the Bureau of State Audits report 2005-115.1, issued in October 2006, we responded to some of the Joint Legislative Audit Committee's (audit committee) questions regarding the ELIC estate. We determined that the estate had received $1.1 billion from two significant litigation matters and identified that the commissioner had expended more than $165 million on litigation costs to recover these proceeds. We also determined that outside counsel represented the commissioner in the ELIC estate conservation and liquidation, as well as in other litigation, and concluded that the commissioner was not obligated to use the Office of the Attorney General as counsel for these matters. Additionally, we determined that the department's outside counsel and fee agreements had reasonable terms and fees and identified policyholder funds that the CLO was holding that it might eventually transfer to the department as unclaimed property.

In addition to the questions we responded to in report 2005-115.1, the audit committee requested that we review the department's management of the ELIC estate and related litigation. The audit committee asked us to analyze the funds paid into and out of the ELIC estate since April 11, 1991, and to determine how much money policyholders have received, what percentage of policyholders have received all of the payments they would have received if ELIC had not become insolvent, and how much money policyholders will receive in the future. The audit committee also asked us to determine how the department has used the litigation proceeds that it has received, including payments made to policyholders, the national guaranty organization, and others. Additionally, the audit committee asked us to determine the percentage of the department's projected $4 billion loss to policyholders that was recovered by litigation including settlements, relating to the ELIC estate, after subtracting amounts distributed to policyholders and the national guaranty organization and others.

At the time we issued report 2005-115.1, much of the data and information we needed to answer the remaining questions resided with Aurora. Additional data and information that we needed were with the CLO, including information on the funds paid into and out of the ELIC estate since April 1991 and data on the amounts that the department had paid directly to policyholders.

To obtain the necessary data and information from Aurora, we entered into a memorandum of understanding with Aurora, Reassure America Life Insurance Company (a coinsurer under an agreement with Aurora), and the department on October 23, 2006. We subsequently obtained some of the data from Aurora on February 5, 2007, and obtained additional data on a piecemeal basis through August 2007. From Aurora we obtained the Policy Detail File that contains historical data on the restructuring of ELIC's policies. We also obtained the databases the company uses to track the funds it has paid or credited to policyholders to cover the losses they incurred as a result of the ELIC insolvency, and other data systems it uses to track various policyholder-level transactions.

The process of obtaining the data and information from Aurora was hindered by the lack of available data system documentation that would allow us to read much of the data we received. In addition, much of the data we initially received from Aurora was incomplete. Aurora periodically allowed us access to management personnel to answer some of our questions about its data from February though July 2007, and we negotiated a two-week visit to one of the company's sites from July 30, 2007, through August 10, 2007, to interview the personnel most familiar with Aurora's data systems and obtain documentation for our work.

From the CLO we obtained updated versions of its Trust Administration System Opt-Out Database, which includes information on the funds the commissioner has paid to opt-out policyholders who did not continue their policies with Aurora, and an updated version of the Trust Administration System Holdback Database, which includes information on the funds the commissioner has paid directly to opt-in policyholders to cover the losses they incurred as a result of the ELIC insolvency. We also obtained documents relating to ELIC estate financial transactions that have occurred since 1991, including a financial data extract from the CLO's general ledger.

To assess the department's management of the ELIC estate, we reviewed the laws, rules, and regulations significant to the management of the estate, and we evaluated the department's accounting, monitoring, and reporting of the disposition of ELIC funds. Additionally, we interviewed personnel at both the department and the CLO, including the chief of the department's Field Exam Division, the department's legal counsel, and the CLO's ELIC estate trust officer and chief financial officer.

To determine the funds paid into and out of the ELIC estate and/or Aurora between April 11, 1991, and December 31, 2006, we obtained reports filed by the commissioner, independently audited financial statements, as well as reports from other sources when independently audited financial documents were not available. In determining the funds paid into and out of the ELIC estate for the period when the CLO was administering the estate, we acquired a financial data extract from its general ledger. It took four months for the CLO to provide us with this data. During this time, the vice president of the CLO's estate finance group analyzed, verified, and made adjustments to the data before providing it to us, including reconciling its beginning and ending estate balances to supporting documentation, and separating transactions that were posted in groups. From all of the hardcopy and electronic financial information we obtained for the April 11, 1991, to December 31, 2006 period, we determined the total amount that the estate has received from state and federal litigation, as well as the amount it has received from the sale of assets and investments. We also determined the total amount that the commissioner has used to make distributions to policyholders and the amount that he has paid to the national guaranty organization.

To determine the ELIC funds that the estate has provided to Aurora for the purpose of reducing policyholders' losses and to pay other beneficiaries, such as the national guaranty organization, and to determine the amount that Aurora has added to these funds, we obtained audited financial statements from both Aurora and the CLO, where available. Furthermore, we obtained additional documentation provided by both Aurora and the CLO, including wire transfers, and other source documents obtained from Aurora.

To determine the amount that policyholders have received from the ELIC funds, we used data and information obtained from both Aurora and the CLO. We utilized the databases Aurora uses to track the funds it has paid or credited to policyholders to cover the losses they incurred as a result of the ELIC insolvency. We also used the CLO's Trust Administration System Opt-Out Database and Trust Administration System Holdback Database, as well as other available documentation such as wire transfer documentation and independently audited financial statements when available to determine the amount that the commissioner has paid directly to policyholders.

In our work attempting to identify all of the litigation funds paid to policyholders, the national guaranty organization, and others from the litigation proceeds that the department has received, we found that the source documentation available does not allow us to separately identify these amounts. Specifically, the audit reports of the ELIC Trust do not distinguish the use of FEC litigation proceeds from other uses of the trust funds. Because we could not separately identify these amounts, we were not able to fulfill the audit committee's request as it was stated.

In evaluating alternative methods of presenting the information, we determined that there was not an adequate method available to calculate the percentage of policyholders' losses that were recovered by litigation proceeds. Comparing the litigation proceeds in 1993 dollars to the policyholder loss at September 3, 1993, can misstate the recovery percentage, because the policyholder losses at that date do not include subsequent economic losses that policyholders incurred and do not include the effects of distributions that policyholders have received since that date, which reduced their losses. Additionally, comparing the present value of litigation proceeds received at December 31, 2006, to the policyholder losses at that date, results in a double counting of the effects of litigation proceeds that have been paid to policyholders from the ELIC estate since September 3, 1993, and can misstate the recovery percentage. Hence, given the limitations of the documentation available to determine how litigation proceeds were used, and given the shortcomings in the other methods we considered for determining the percentage of policyholder's projected losses that has been recovered, we concluded we would be unable to accurately perform the requested calculation.

To assess policyholder losses through December 31, 2006, we contracted with Hemming Morse, Incorporated (HMI), an accounting firm that concentrates its practice in the areas of forensic accounting and litigation support. In its analysis, HMI estimated policyholder losses by estimating the economic impact of the difference between the original ELIC policy terms and the new Aurora restructured policy terms. Their analysis includes consideration of the time value of money, industry average crediting rates, and distributions of funds and other credits policyholders received from ELIC Trusts and Aurora through December 31, 2006. From this information, HMI was able to estimate policyholder economic losses and the percentage of policyholders' expected account values that were recovered had ELIC not become insolvent. HMI performed a similar analysis to estimate the policyholder losses at August 22, 2005, for comparison to the department's analysis at that time. Law firms retained by the commissioner for specific legal matters have previously engaged HMI. For example, HMI was retained by a law firm that was working for the commissioner relating to the Altus litigation, and an HMI director ultimately testified as to his findings. In addition, the commissioner contracted directly with HMI in the past to assist outside counsel on a matter that went to arbitration.

To determine how much money policyholders will receive in the future, we obtained wire transfer documents related to the recent settling of an arbitration matter between the commissioner and the national guaranty organization whereby the department has allocated funds to Aurora for distribution to policyholders on October 2, 2007. We also identified undistributed ELIC funds that remain with Aurora and interviewed Aurora personnel to determine why the funds have not yet been distributed and its anticipated future use of these funds. In our work with the estate's audited financial statements and the financial database the CLO provided to us, we identified funds remaining in the estate as of December 31, 2006. We interviewed the ELIC estate trust officer to understand what the CLO intends to do with these remaining funds. We also obtained from the ELIC estate trust officer an estimate of the remaining amounts that the estate may receive from the resolution of outstanding litigation.

The United States Government Accountability Office, whose standards we follow, requires us to assess the reliability of computer-processed data. To assess whether the information we obtained from various sources was sufficiently reliable for the purposes of our audit, we conducted tests to determine its completeness and accuracy. In general, to determine accuracy we compared the information we were provided to hard-copy information we were able to obtain and examined the differences. To determine the completeness of information, we compared the data provided to us with other sources of information to ensure that all information that should have been provided to us was in fact provided. In the text box we describe the definitions of data reliability applicable to the report.

In our work we determined that the CLO's Trust Administration System Opt-Out Database was sufficiently reliable for the purposes of the audit. We were not able to determine the reliability of the remaining databases we tested due to the unavailability of documentation to substantiate the data or due to control weaknesses in the CLO accounting system during the 1997 through 2004 period. However, because the information was vital to answering audit questions and was not available from another source, we used the data in our report and noted their limitations.

Definitions of Data Reliability

Sufficiently Reliable Data: Based on audit work, an auditor can conclude that using the data would not weaken the analysis nor lead to an incorrect or unintentional message.

Not Sufficiently Reliable Data: Based on audit work, an auditor can conclude that using the data would most likely lead to an incorrect or unintentional message and the data have significant or potentially significant limitations, given the research question and intended use of the data.

Data of Undetermined Reliability: Based on audit work, an auditor can conclude that use of the data could lead to an incorrect or unintentional message and the data have significant or potentially significant limitations, given the research question and intended use of the data.

Source: Assessing the Reliability of Computer Processed Data, United States Government Accountability Office.

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Chapter 1

THE COMMISSIONER USED THE EXECUTIVE LIFE INSURANCE COMPANY'S ASSETS TO CONTINUE INSURANCE COVERAGE, REDUCE POLICYHOLDER LOSSES, AND PAY ADMINISTRATIVE COSTS

Chapter Summary

When the insurance commissioner (commissioner) conserved the Executive Life Insurance Company (ELIC) on April 11, 1991, he reported the company's assets to be $8.8 billion. Including the loss from the liquidation of ELIC investment securities in 1992, investment income, litigation proceeds, and income from other sources, the total ELIC assets available between 1991 and 2006 were $10.2 billion. The commissioner transferred $6.7 billion of this amount to Aurora National Life Assurance Company (Aurora) to act as a successor insurer per the ELIC Rehabilitation Plan (rehabilitation plan) and has distributed most of the remaining funds to policyholders and other beneficiaries. As of December 2006 $325 million remained in the ELIC estate. Of these funds, the commissioner subsequently transferred $311 million to Aurora, which Aurora reports distributing all but $7 million to former ELIC policyholders and other beneficiaries in October 2007. The estate may receive additional litigation proceeds in the future.

The Distribution of ELIC's Assets Is Nearly Complete

After conserving ELIC, the commissioner took steps to mitigate policyholders' losses, including negotiating a rehabilitation plan that provided policyholders the option to continue their insurance coverage, and specified how policyholders would share in the liquidation of ELIC's assets. The commissioner managed ELIC in conservation until 1993.[6] When the court approved the rehabilitation plan on September 3, 1993, the commissioner transferred nearly all of the company's investment-grade securities and operating assets to Aurora for it to use to continue providing services to former ELIC policyholders. As we discuss later in this chapter, Aurora subsequently distributed $2.7 billion of the $6.7 billion in ELIC assets that it received from the commissioner to the policyholders who chose not to continue with Aurora (opt-out policyholders).

[6] See Appendix A for a timeline identifying the parties responsible for managing the ELIC estate between April 1991 and December 2007.

The commissioner placed the remaining ELIC assets that were not transferred to Aurora into trusts, with the intent of distributing them to policyholders and other beneficiaries to reduce the losses they had incurred due to the ELIC insolvency.[7] Over time the assets in these trusts have been converted to cash, and the commissioner has distributed most of the funds to policyholders and other beneficiaries, such as the National Organization of Life and Health Insurance Guaranty Associations (national guaranty organization). The general purpose of these funds was to reduce policyholder losses that resulted from the ELIC insolvency and to reimburse the national guaranty organization and others for payments they had made to policyholders to reduce policyholder losses.[8] The commissioner also used some of the funds for the cost of administering the ELIC estate.

As shown in Table 1, when the commissioner conserved ELIC in 1991, he reported the book value of the company's assets to be $8.8 billion. The book value is the value of a company as reported in its accounting records. Losses from the liquidation of ELIC investment securities in 1992 contributed to a reduction in the available assets to $7.5 billion. Subsequent investment income, litigation proceeds, and other income increased the available assets by $2.7 billion, resulting in approximately $10.2 billion available for policyholders and other beneficiaries of the estate. Of this amount, the commissioner transferred $6.7 billion to Aurora as part of the rehabilitation plan, which provided policyholders the option to continue their insurance coverage with this new insurer; the commissioner paid $2.7 billion to policyholders and other beneficiaries, including the national guaranty organization; and used $528 million for the costs of administering the ELIC estate. On December 31, 2006, $325 million in ELIC assets remained. As we discuss later in this chapter, the commissioner subsequently transferred $311 million of these funds to Aurora for it to distribute to policyholders who opted to continue with Aurora (opt-in policyholders) and other beneficiaries.

On December 31, 2006, $325 million in ELIC assets remained. The commissioner subsequently transferred $311 million of these funds to Aurora for it to distribute to policyholders who opted to continue with Aurora (opt-in policyholders) and other beneficiaries.

As we previously described in the Introduction and show in Appendix A, different special deputy commissioners have managed the ELIC estate in three distinct time periods. The tables in Appendix B display the results of operations for each period and the assets available near the beginning and end of each period.

7 As shown in Table B.1, Appendix B, at the end of 1993, $670 million remained with the commissioner.

8 The national guaranty organization has received more than $428 million of the ELIC estate. Most of this amount was paid to the national guaranty organization as partial reimbursement for payments that participating guaranty associations made to reduce policyholder losses, including $352 million out of the funds that the commissioner sent to Aurora, as shown in Table 6 on page 26, and $74 million that it received directly from the commissioner, as shown in Table B.3, Appendix B. Separately, the national guaranty organization also received $1.8 million from the ELIC estate for legal and professional services.

Table 1
Changes in Available Assets, Executive Life Insurance Company Estate April 11, 1991, to December 31, 2006 (in Thousands)

Assets Available, April 11, 1991		**$8,803,945**
1992 Investment losses*		(1,343,431)
Assets after losses		**7,460,514**
Additions to Assets		
Investment income	$1,370,771	
Litigation proceeds†	1,067,605	
Premium income	280,203	
Miscellaneous‡	18,286	
Total additions		2,736,865
Total available assets		**10,197,379**
Deductions to Assets		
Transferred to Aurora§	(6,670,106)	
Paid to beneficiaries‖	(2,674,417)	
Administrative costs#	(527,782)	
Total deductions		(9,872,305)
Assets Available, December 31, 2006		**$325,074**

Sources: Unaudited financial statements for the period April 1991 through 1993, independently audited financial statements for the period 1994 through 1996, and the Conservation and Liquidation Office's (CLO) Executive Life Insurance Company (ELIC) financial database for the period 1997 through 2006.

Note: Due to the lack of availability of source documents for the period April 1991 through 1996, and due to control weaknesses in the CLO accounting system during the period 1997 through 2004, the information presented is of undetermined reliability. We include the information in our audit due to the lack of other, more reliable sources.

* 1992 investment losses represent the estimated loss from the sale of long-term investments in 1992. Gains and losses for other periods are included in investment income. The available financial statements for 1992 do not include an operating statement reporting investment losses, income, and expenses. Thus, this estimate is auditor prepared based on available information from the statement of sources and uses of cash.

† As shown in Table 2 on page 21, most of this amount represents the proceeds from two lawsuits to which the commissioner was a party representing the ELIC estate.

‡ This amount consists of various additions and deductions not otherwise classified, including $244 million in Base Assets Trust funds that Aurora transferred back to the ELIC estate in 1994; a $230 million reduction in net assets of the ELIC estate in 1994 due to a change in the method of reporting net assets between 1993 and 1994; $81.5 million in miscellaneous income; $75 million paid to Aurora in a 1998 legal settlement; and various other less material amounts.

§ As shown in Table 3 on page 22, $2.7 billion has been paid to beneficiaries and $4 billion remained with Aurora for the ongoing servicing of opt-in policies.

‖ As shown in Table 4 on page 23, $1.1 billion was paid to policyholders under normal operations prior to the transfer of assets to Aurora. Additionally, $822 million was distributed by the CLO or sent to Aurora for it to distribute to opt-in policyholders and other beneficiaries, $666 million was paid to opt-out policyholders, and $74 million was paid to the national guaranty organization.

\# As shown in Table 5 on page 25, this amount consists of legal and professional fees, salaries and wages, and the operating expenses of administering the ELIC estate.

The ELIC Estate Experienced Investment Losses in 1992 That Significantly Reduced the Assets Available to Policyholders

The 1992 investment losses shown in Table 1 reflect losses incurred due to ELIC's heavy investment in junk bonds. As we discussed in the Introduction, ELIC had a multibillion-dollar junk bond portfolio in 1991. News that the issuers of these junk bonds would not be able to meet their obligations, and subsequent defaults on these types of bonds, caused the junk bond market to crash. According to a former chief deputy commissioner, on March 3, 1992, ELIC sold the majority of its junk bonds to a consortium of French companies that we refer to in this report as Altus (one of the French companies) for $3.25 billion. This sale, approved by the conservation court in February 1992, was part of a larger bidding process for ELIC's assets that took place between May 1991 and November 1991, during which time eight separate bids were received and analyzed in court proceedings. Table B.1 in Appendix B shows a $1.3 billion investment loss for the year, a portion of which relates to the sale to Altus.

The ELIC Estate Has Received $2.7 Billion Since 1991

As shown in Table 1, the ELIC estate has received $1.4 billion in investment income since the company's conservation in 1991. Of this amount, $919 million was received during the 1991 to 1993 time period, when the commissioner was managing ELIC, before the transfer of ELIC's insurance business to Aurora. The remaining $451 million was received during the 1994 to 2006 time period. Table B.1 in Appendix B displays the investment income by time period.

The ELIC estate has received $1.1 billion in litigation proceeds, primarily from two lawsuits related to the junk bonds owned by ELIC.

In addition, the ELIC estate has received $1.1 billion in litigation proceeds, primarily from two lawsuits related to the junk bonds owned by ELIC. The first concerned alleged civil and criminal fraud in the purchase of ELIC's junk bond portfolio (the Altus litigation) and insurance business. The second concerned the failure of ELIC and the bankruptcy of its corporate parent, the First Executive Corporation (FEC). Table 2 displays the litigation proceeds by source. Table B.1 in Appendix B displays the litigation proceeds by time period. The majority of litigation proceeds were received in the 1997 to 2006 period when most of the Altus litigation was settled. As we discuss later in this chapter, the commissioner appealed part of the Altus litigation.

In response to the alleged fraudulent purchase of the ELIC junk bond portfolio and insurance business, in February 1999 the commissioner filed a civil lawsuit against Credit Lyonnais, a French bank; Altus Finance; and a number of other defendants. While the commissioner's civil lawsuit was pending, the United States

Table 2
Litigation Proceeds, Executive Life Insurance Company Estate
April 11, 1991, to December 31, 2006
(in Thousands)

SOURCE	AMOUNT
Altus litigation	$730,465
FEC litigation*	332,696
Other litigation	4,444
Total proceeds from litigation	**$1,067,605**

Sources: Independently audited financial statements for the period 1994 through 1996, and the Conservation and Liquidation Office's (CLO) Executive Life Insurance Company financial database for the period 1997 through 2006.

* In our previous report, *Department of Insurance: Its Conservation and Liquidation Office Continues to Collect and Distribute Proceeds From the Liquidation of the Executive Life Insurance Company*, report 2005-115.1, October 2006, we reported First Executive Corporation litigation proceeds of $347 million. This $14 million difference is nearly all related to the 1994 through 1996 time period. Our analysis for this period is limited because we do not have access to the information supporting the audit reports, and thus we cannot determine why the amounts are less than those in the source documents we reviewed in our prior audit.

Attorney's Office for the Central District of California conducted a criminal investigation, which resulted in grand jury indictments and the filing of a criminal suit against many of the same defendants. We refer to both the civil and criminal suits as the Altus litigation because Altus Finance was the first defendant listed in the commissioner's civil suit. Through December 2006 the commissioner had recovered more than $730 million from the Altus litigation for the benefit of the ELIC estate.

In May 1991 ELIC's corporate parent, FEC, filed for bankruptcy. Subsequently, ELIC and FEC made claims against Michael Milken; Drexel Burnham Lambert, Inc.; and both FEC's and ELIC's directors, officers, and accountants. The commissioner then was empowered to pursue these claims on behalf of both ELIC and FEC in a lawsuit that focused particularly on the individuals and entities involved in managing FEC's finances and investments. The lawsuits resulted in several settlements, and the proceeds were collected over a number of years. We refer to this litigation as the FEC litigation. Through December 2006 the commissioner had recovered nearly $333 million in FEC litigation proceeds.

The commissioner also received an additional $280.2 million in premium income, which is listed in Table 1. All of this income was earned during the 1991 to 1993 period, when the commissioner was managing ELIC and receiving premium payments from policyholders.

Aurora Used the ELIC Estate's $6.7 Billion Transfer to Continue Policyholder Coverage and for Payments to Opt-Out Policyholders

The $6.7 billion was transferred to Aurora to fund the liabilities that it had assumed and consisted of $789 million from a trust set up by the commissioner as well as $5.9 billion in other assets. As shown in Table 3, Aurora subsequently paid $421 million to guaranteed investment contract (GIC) opt-out policyholders, and an additional $1.2 billion to opt-out policyholders across all policy types, which is generally referred to as the first opt-out payment. Subsequent to these payments, Aurora returned an additional $769 million to the ELIC estate for payment to the remaining opt-out policyholders. In addition, Aurora returned $244 million of the original $789 million to the ELIC estate in 1994. After these adjustments, the net ELIC assets that Aurora retained totaled $4 billion. Table C.1 in Appendix C shows the total amounts that Aurora and the commissioner have paid to the opt-out policyholders by product type, which include the advance payment to GICs, the first opt-out payment, and the additional funds that Aurora returned to the ELIC estate, as well as subsequent amounts that the commissioner paid to the opt-out policyholders due to the sale of ELIC's assets and the ELIC estate's receipt of litigation proceeds.

Table 3
Aurora's Use of Assets Received From the Executive Life Insurance Company Estate on September 3, 1993
(in Thousands)

Assets transferred on September 3, 1993		**$6,670,106**
Advance payment to guaranteed investment contract (GIC) opt-out policyholders	($420,726)	
First opt-out payment on March 29, 1994	(1,236,810)	
Assets returned to the ELIC estate for payment to opt-outs*	(769,086)	
Additional assets returned to the ELIC estate in 1994†	(244,437)	
Assets distributed		(2,671,059)
Total assets retained by Aurora		**$3,999,047**

Sources: Aurora's opening balance sheet and GIC first opt-out payment schedule, independently audited financial statements, and the Conservation and Liquidation Office's Trust Administration System Opt-Out Database.

* This amount is comprised of $646 million returned in 1994 and $123 million returned in 1997.

† These were the remaining assets in the Base Assets Trust, when the trust was returned to the commissioner's control—noted on the timeline in Appendix A.

The Commissioner Paid $2.7 Billion of ELIC's Assets to Policyholders and Other Beneficiaries

As shown in Table 4, the ELIC estate has paid a total of $2.7 billion to ELIC policyholders and other beneficiaries. The commissioner paid $1.1 billion while managing ELIC when it was in conservation (referred to in the table as normal operations), consisting of approximately $300 million in death benefits and $800 million in other policy benefits. Of the remaining $1.6 billion, the commissioner paid $666 million to the opt-out policyholders. In addition to the previously mentioned first opt-out payment distributed by Aurora, opt-out policyholders received later distributions from the estate, consisting of litigation proceeds and funds from the various liquidating trusts that were managed by the trustees, as well as interest accrued by the trusts. These distributions were intended to cover some of the losses the policyholders sustained due to ELIC's insolvency.

Table 4
Paid to Beneficiaries, Executive Life Insurance Company Estate April 11, 1991, to December 31, 2006 (in Thousands)

Normal Operations*		**$1,112,199**
Enhancements†		
Opt-ins‡	$821,904	
Opt-outs§	666,026	
National guaranty organization	74,288	
Enhancement subtotals		**$1,562,218**
Paid to beneficiaries		**$2,674,417**

Sources: Unaudited financial statements for the period 1991 through 1993, independently audited financial statements for the period 1994 through 1996, and other documentation provided by the Conservation Liquidation Office (CLO) for the period 1997 through 2006.

Note: Due to the lack of availability of source documents for the period April 1991 through 1993, the information presented is of undetermined reliability. We include the information in our audit due to the lack of other, more reliable sources.

* Normal operations occurred while the commissioner was managing Executive Life Insurance Company (ELIC) as an insurance company from April 11, 1991, to September 3, 1993.

† Represents payments from various trusts controlled by the trustees after Aurora assumed ELIC's restructured insurance policies. The funds paid to opt-in and opt-out policyholders have the effect of reducing the losses the policyholders incurred as a result of the ELIC insolvency. For more information about the sources of these funds, refer to Table B.3 in Appendix B.

‡ This amount, less $18 million distributed directly by the CLO, plus the return to Aurora of $26 million from one of the trusts established by the commissioner, make up the $830 million reported as received from the CLO and distributed by Aurora displayed in Table 6 on page 26.

§ This amount plus the $769 million transferred by Aurora shown in Table 3 make up the $1.4 billion in enhancement payments that the CLO distributed to opt-out policyholders as displayed by type of policy in Table C.1 in Appendix C.

The commissioner distributed the remaining $896 million of the assets retained in the ELIC estate to opt-in policyholders and other beneficiaries. Of the $896 million, the commissioner distributed $822 million primarily to Aurora, which it subsequently distributed to policyholders and other beneficiaries, as discussed later in this chapter. The commissioner also distributed $74 million directly to the national guaranty organization as reimbursement for some of the payments the participating guaranty associations made to cover policyholders' losses.[9]

We summarize Aurora's use of these funds in a later section of this chapter. Table C.2 in Appendix C displays the amounts that Aurora and the commissioner have paid to the opt-in policyholders by policy type to reduce the losses they incurred as a result of ELIC's insolvency. These figures include amounts attributable to the sale of ELIC's assets and the ELIC estate's receipt of litigation proceeds, as well as amounts that Aurora added to offset policyholders' losses.

The Commissioner Has Used $528 Million of ELIC's Assets for Administrative Costs, Including $231 Million in Legal and Professional Service Costs

The commissioner has used $528 million for administrative costs, including legal and professional service costs, salaries and wages, and other operating expenses associated with the ELIC estate.

As shown in Table 5, the commissioner has used $528 million to administer the ELIC estate, including legal and professional service costs, salaries and wages, and other operating expenses associated with the ELIC estate. Almost half of the administrative costs were incurred from 1991 through 1993, when the commissioner was managing ELIC, before the transfer of ELIC's insurance business to Aurora.[10] The legal and professional costs of $231 million consist of direct legal costs to the ELIC estate, contingent fees paid to outside legal firms, court costs, expert witness fees, professional fees, and $1.8 million paid to the national guaranty organization for legal and professional service costs. The amount paid to the national guaranty organization for legal costs is the result of an agreement with the commissioner to reimburse the organization for expenses it incurred while helping the commissioner present and prosecute the Altus case. Appendix B, Table B.1, shows the periods administrative costs were incurred and Appendix D provides further detail on the legal and professional service costs.

9 The term "participating guaranty associations" refers to the state guaranty associations that participated in the ELIC Enhancement Agreement. The role of the national guaranty organization and its relationship to the state guaranty associations is discussed more fully in the Introduction.

10 Table B.1 in Appendix B provides a summary of administrative costs by time period.

Table 5
**Administrative Costs, Executive Life Insurance Company Estate
April 11, 1991, to December 31, 2006
(in Thousands)**

Legal and professional	$230,641
Salaries and wages	176,197
Other operating expenses	120,944
Total administrative costs	**$527,782**

Sources: Unaudited financial statements for the period April 1991 through 1993, independently audited financial statements for the period 1994 through 1996, and the Conservation and Liquidation Office's (CLO) Executive Life Insurance Company financial database for the period 1997 through 2006.

Note: Due to the lack of availability of source documents for the period April 1991 through 1996, and due to control weaknesses in the CLO accounting system during the period 1997 through 2004, the information presented is of undetermined reliability. We include the information in our audit due to the lack of other, more reliable sources.

Opt-In Policyholders and Other Beneficiaries Have Received Both ELIC Funds and Funds That Aurora Added to Cover Some of the Losses Associated With the Insolvency of ELIC

Between January 1, 1995, and December 31, 2006, Aurora received $830 million of ELIC estate funds for distribution to opt-in policyholders and other beneficiaries, as shown in Table 6 on the following page.[11] According to Aurora, it added an additional $130 million to these funds from profit-sharing and tax participation benefits, funds added due to provisions of the rehabilitation plan, and interest. Aurora also added a $33 million adjustment to the restructuring percentage relating to the rehabilitation plan, for a total of $993 million. According to Aurora, prior to December 31, 2006, it paid or credited $985 million of this amount to policyholders and other beneficiaries for the purpose of reducing losses that resulted from the ELIC insolvency.

Aurora Received $830 Million of ELIC's Assets Retained by the Commissioner for Distribution to Opt-In Policyholders and Other Beneficiaries

Aurora received $830 million from the ELIC estate, primarily from the sale of ELIC assets and litigation proceeds, for distribution to opt-in policyholders and other beneficiaries. The rehabilitation plan specified that opt-in policyholders would be eligible to receive

[11] These funds are from the liquidation of the assets retained by the commissioner and the trusts after ELIC's insurance policies were transferred to Aurora, as well as funds the commissioner received from litigation and interest. The purpose of the funds includes reducing policyholder losses that resulted from the restructuring of ELIC's policies and reimbursing the national guaranty organization for some of the payments it had made to policyholders to reduce their losses.

Table 6
Aurora's Use of Executive Life Insurance Company Estate Enhancement Funds it Received From January 1995 Through December 31, 2006 (in Thousands)

SOURCE OF FUNDS		
Funds received from the ELIC estate*		$829,695
Funds added by Aurora's restructuring percent adjustment		33,402
Agreed-upon profit-sharing and tax participation benefits	$67,502	
Funds added per sections 25 and 26 of the rehabilitation plan	41,059	
Interest added by Aurora	21,989	
Other adjustments by Aurora	(819)	
Total added by Aurora		129,731
Total to be credited/distributed		**$992,828**
DISTRIBUTION OF FUNDS		**AMOUNT**
Paid or credited to policyholders†	($460,008)‡	
Paid or credited to the national guaranty organization	(352,051)	
Retained by Aurora and parent company per the enhancement agreement	(135,915)	
Sent to ELIC and participating guaranty associations' escrow accounts	(35,448)	
Other payments and credits	(1,319)	
Total credited/distributed		**($984,741)**
Amount remaining to be credited/distributed§		**$8,087**

Source: The amounts are as provided by Aurora. The funds received from the Executive Life Insurance Company (ELIC) estate and the ending balance materially agree with Aurora's independent audit reports.

* The amount is $8 million greater than the amounts shown in Table 4 and Table B.3 in Appendix B. Tables 4 and B.3 include $18 million paid by the Conservation and Liquidation Office, which is not included here. Additionally, the amount here includes $26 million that Aurora received from the ELIC Holdback Trust, which is not included in the other tables.

† This amount includes $33 million that was allocated to policyholders due to Aurora increasing the value of opt-in policyholders' policies when it reevaluated its assets. Originally, policyholders who continued their insurance coverage with Aurora had their ELIC policies reduced to approximately 77.7 percent of their former value, termed the restructuring percentage. The effect of this additional $33 million is to increase the restructuring percentage which reduces policyholder losses. Additionally, approximately $50 million of the funds listed were paid to third-party beneficiaries to reimburse them for payments they had previously made to policyholders. See Chapter 3 for more information about third parties.

‡ This amount is $6.1 million less than the amount reported in Appendix C, Table C.2. According to Aurora, the difference between these two amounts primarily results from funds that have been allocated to policyholders but not yet distributed. These amounts are included in the $466 million shown in Table C.2, but are part of the $8.1 million remaining to be credited/distributed in this table.

§ The funds remaining to be allocated at the end of 2006 include $3.7 million to be sent to third parties, $1 million awaiting disposition, $2 million in reserve for contracts that have changed, and $1.3 million in unallocated accrued interest.

additional funds from the sale of ELIC assets and litigation proceeds. The effect of these additional funds paid or credited to policyholders is to reduce the losses that policyholders incurred when ELIC became insolvent and the policies were restructured. Additionally, some of these funds were intended to reimburse the national guaranty organization and other third-party beneficiaries for the amounts that these organizations or entities had previously paid or credited to policyholders to reduce the policyholders' losses.

Aurora Contributed $130 Million to Pay Opt-In Policyholders and Other Beneficiaries

According to Aurora, it added more than $67 million in profit-sharing and tax participation benefits to the ELIC estate funds that it received, and an additional $41 million for certain former ELIC policyholders according to provisions in the rehabilitation plan. The rehabilitation plan required Aurora to provide these benefits for policyholders who chose to continue coverage with the company. Additionally, in 1995 Aurora added $33 million to the funds available for distribution, because of a change in the restructuring percentage (the percentage of the value of their policies that policyholders could expect to receive after restructuring). The court identified the initial restructuring percentage of 77.7 percent when it approved the rehabilitation plan on September 3, 1993. This percentage was adjusted on April 6, 1995, to 78.2 percent after Aurora reassessed its liabilities based on the number of ELIC policyholders who decided to remain with the company. According to Aurora, it also added $22 million in interest to the ELIC funds it received for distribution to policyholders. The rehabilitation plan requires Aurora to pay interest on funds it holds before distributing them to beneficiaries.

Aurora Has Paid or Credited $985 Million to Opt-In Policyholders and Other Beneficiaries

As shown in Table 6, the documentation provided by Aurora shows that it distributed $985 million to policyholders and other beneficiaries through 2006. According to Aurora, it paid a total of $460 million to policyholders or credited their accounts. Some of these payments were distributed to third-party beneficiaries to reimburse them for their previous payments to policyholders. Typically, a third party is either a company that offered ELIC policies to its employees or a state guaranty association. In some cases, these third parties agreed to pay all or some of an ELIC policyholder's losses in return for rights to future distributions of ELIC funds. Additionally, Aurora sent $35 million of the funds to the ELIC and participating guaranty association (PGA) escrow accounts and

According to Aurora, it paid a total of $460 million to policyholders or credited their accounts.

paid the national guaranty organization $352 million in return for payments it made to cover policyholder losses. This amount included $26 million to compensate the guaranty organization for expenses incurred prior to the closing date. As we discussed in the Introduction, the national guaranty organization added funds to policyholder account values in order to alleviate some of the damages incurred by the ELIC insolvency. Providing these funds gave the national guaranty organization a right to future funds policyholders could receive from the liquidation of the ELIC assets retained by the commissioner, referred to as subrogation rights.

Aurora retained $136 million of the funds that it received from the ELIC estate for itself and its parent company, per Article 17 of the enhancement agreement.

Additionally, Aurora retained $136 million of the funds that it received from the ELIC estate for itself and its parent company, per Article 17 of the ELIC Enhancement Agreement (enhancement agreement). The enhancement agreement specifies the formula to be used to calculate the amount Aurora retained. Using this formula, Aurora retained $124 million in enhancement funds, and the parent company retained an additional $12 million.

Substantially All of the Assets Remaining in the ELIC Estate on December 31, 2006, Have Been Distributed to Policyholders

In June 2007 a judge confirmed the arbitration decision regarding the distribution of the remaining Altus litigation proceeds. As discussed in our prior report, the remaining Altus funds designated for distribution to the opt-in policyholders was complicated by a disagreement between the commissioner and the national guaranty organization.[12] Specifically, the two parties disagreed on the portion of the Altus proceeds the national guaranty organization was entitled to, which resulted in binding arbitration to settle the matter. The arbitrator decided in favor of the commissioner's position, which resulted in a greater share of the funds going to opt-in policyholders, under complex formulas specified under Article 10 of the enhancement agreement.

Subsequent to the arbitrator's decision, the commissioner transferred a total of $311 million to Aurora in July and August 2007 for distribution to opt-in policyholders and other beneficiaries, as shown in Table 7.

This amount included $291 million in Altus settlement funds, an additional $18 million from other settlements, and $2.2 million from other sources. In addition, Aurora reports that it paid $3.6 million

[12] Bureau of State Audits report titled *Department of Insurance: Its Conservation and Liquidation Office Continues to Collect and Distribute Proceeds From the Liquidation of the Executive Life Insurance Company*, Report 2005-115.1, October 2006.

Table 7
Aurora's 2007 Distribution to Opt-In Policyholders and Other Beneficiaries (in Thousands)

SOURCES OF FUNDS	AMOUNT
ELIC Estate Funds	
Altus settlement amount	$290,873
Other settlement funds	17,818
Additional CLO funds	2,181
Holdback Trust funds	76
Total funds transferred to Aurora by the CLO	310,948
Additional Funds	
Interest paid by Aurora through October 1, 2007	3,559
Total funds available for distribution as of October 1, 2007	**$314,507**
DISTRIBUTION OF FUNDS BY POLICY TYPE AS REPORTED BY AURORA*	**AMOUNT**
Cash value life insurance	$115,862
Deferred annuities	47,674
Payout annuities	136,802
Guaranteed investment contracts	4,985
Total credited or disbursed to policyholders†	**305,323**
National guaranty organization	9,184
Total	**$314,507**

Sources: Wire transfers and other source documents supporting the transfer of funds from the Conservation and Liquidation Office. Interest paid and distributions are as reported by Aurora National Life Assurance Company (Aurora).

* As of October 31, 2007, Aurora provided a summary of its distribution of available funds by policy type, and reported it had credited or disbursed all but approximately $7 million of the funds. In December 2007 Aurora stated that it is still actively researching the proper payees related to the remaining funds.

† Aurora reports that it paid approximately $37 million of these funds to third-party beneficiaries to reimburse them for payments they had previously made to policyholders. See Chapter 3 for more information about third parties.

in interest on these funds through October 1, 2007. Overall, Aurora had a total of $315 million available for distribution to policyholders and other beneficiaries as of October 1, 2007.

As of October 31, 2007, Aurora reported that it had distributed $9 million to the national guaranty association, which it is legally required to reimburse for some of the payments previously made to policyholders, and had distributed all but $7 million of the remaining funds to opt-in policyholders and other beneficiaries. In December 2007 Aurora stated that it is still actively researching the proper payees related to the remaining funds.

The ELIC Estate Could Receive Additional Funds

In July 2005 a jury awarded the commissioner $700 million in punitive damages in the civil suit against Artemis, one of the defendants in the Altus litigation. However, the judge refused to include these punitive damages in his October 2005 judgment because he found that the award was inconsistent with state law and was unconstitutional. In June 2006 the commissioner appealed the court's decision. A hearing before the court of appeals occurred on December 5, 2007, and the court's decision is pending. The CLO's ELIC estate trust officer estimates that the costs associated with the appeal will be $180,000 plus contingency fees up to a maximum of $49 million if the commissioner prevails.

Although the 2005 judgement did not allow punitive damages, it did allow a net amount of $131 million in restitution. However, Artemis sought, and the court granted, a delay in executing this award pending the outcome of the commissioner's appeal of the $700 million in punitive damages. According to his appeal, if the commissioner wins and the punitive damages are reinstated, he will forgo the $131 million restitution judgment. Artemis is appealing the $131 million. Finally, the commissioner could collect up to an additional $3.8 million from a default judgment against one of the civil suit defendants.

Chapter 2

POLICYHOLDERS HAVE EXPERIENCED SIGNIFICANT ECONOMIC LOSSES AS A RESULT OF THE EXECUTIVE LIFE INSURANCE COMPANY'S INSOLVENCY

Chapter Summary

The insolvency of the Executive Life Insurance Company (ELIC) resulted in substantial economic losses for its policyholders. Once conserved, part of the subsequent effort undertaken by the insurance commissioner (commissioner) involved finding a way to allocate ELIC's assets among its policyholders in a manner that would be approved by the court. Prior to approving a rehabilitation plan for ELIC, the court considered several methods for valuing the various types of policies held by ELIC's policyholders and chose the one it believed would consistently and fairly allow ELIC's assets to be allocated. The method approved by the court valued the policies at their ELIC statutory reserve value. Generally, for life and deferred annuity policies, the statutory reserves are based on the obligation of the insurer to each policyholder, known as the surrender value of their policies. For other annuity policies, the statutory reserve value is an actuarial calculation of the net present value of the future payments policyholders would receive based on 1991 statutory interest rates. The commissioner appropriately used this value to represent the total liabilities owed to policyholders as part of the rehabilitation plan for ELIC.

Responding to a request from a member of the Legislature, in August 2005 the Department of Insurance (department) estimated the losses policyholders had sustained as a result of the ELIC insolvency. The department's model estimates policyholder losses by taking the September 3, 1993, shortfall in policyholder accounts, as defined in the ELIC Enhancement Agreement (enhancement agreement) and approved by the courts, and reduces it by subsequent distributions and by the application of $2 billion from the National Organization of Life and Health Insurance Guaranty Associations (national guaranty organization). The department stated that its estimate of policyholder losses did not consider the time value of money. The department's analysis also did not include the financial impact caused by changes made to policy terms subsequent to ELIC's insolvency in its estimate of policyholder losses. Its calculation resulted in an estimated remaining shortfall of $936 million as of August 2005 that would equate to policyholders receiving an average of 90 percent of their original policy rights. Shortfall is defined in the department's letter responding to the legislative member's request (Appendix E) as the difference between the original ELIC policy value promised and the value of what the restructured policy provided. The department also reported in that same letter that more than 92 percent of the policyholders who continued with Aurora National Life Assurance Company (Aurora) (opt-in policyholders) have received all of the payments they would have received had ELIC not become insolvent.

When we prepared a model to estimate the economic loss to policyholders that reflected the restructuring of their policies and used several factors that the department's analysis did not include, we estimated an economic loss of $3.1 billion as of August 2005, and a resulting 86 percent recovery of policyholders' expected ELIC account values. The two models result in distinct measures of the degree to which policyholders were made whole.

The Department Estimated Policyholder Losses in August 2005

As with any insolvency of a public company, investors and creditors risk substantial losses. This was no different in the case of the policyholders who have incurred significant economic losses as a result of the ELIC insolvency. The commissioner, in his role as regulator, determined that ELIC's liabilities far outweighed its assets and, on April 11, 1991, obtained a court order to take over its operations to conserve the company.

In response to a request from a member of the Legislature, the department prepared a model that estimated policyholder losses by taking the September 3, 1993, shortfall in policyholder accounts, as defined in the enhancement agreement and approved by the courts, and reduced it by subsequent distributions and by the application of $2 billion from the national guaranty organization. The department stated that its calculation of policyholder losses did not include the time value of money. The department's estimate of policyholder losses also did not include the effects of certain changes made to policy terms. Table 8 shows a summary of the department's analysis of the losses incurred by policyholders, and Appendix E shows the department's complete analysis and accompanying qualifications prepared in response to a legislative member's request. As shown in Table 8, the department calculated policyholder losses to be $936 million in August 2005.

Table 8
The Department of Insurance's Estimate of Policyholder Losses as of August 2005
(Dollars in Millions)

	NUMBER OF POLICIES*	PERCENTAGE OF ALL OPT-IN POLICIES	STATUTORY RESERVES ON 4/11/91	SHORTFALL ON 9/3/93†	GUARANTY ASSOCIATION PAYMENTS	SHORTFALL AFTER GUARANTY ASSOCIATION PAYMENTS 9/3/93‡	DISTRIBUTIONS TO POLICYHOLDERS AFTER 9/3/93	REMAINING UNFUNDED SHORTFALL 8/22/05	PERCENTAGE OF ORIGINAL STATUTORY RESERVE AMOUNT‡
Opt-In Policies (by guaranty association coverage)§									
Fully covered	277,320	92.45%	$3,954	$1,638	$1,638	0	0	0	100.00%
Partially covered	11,803	3.93	1,876	850	363	$487	$297	$190	89.87
Not covered	10,844	3.62	488	145	0	145	56	89	81.76
Total Opt-In Policies	**299,967**	**100.0%**	**6,318**	**2,633**	**2,001**	**632**	**353**	**279**	**95.58**
Opt-Out Policies	27,278		3,143	1,068	0	1,068	411	657	79.09
Totals for all policies	**327,245**		**$9,461**	**$3,701**	**$2,001**	**$1,700**	**$764**	**$936**	**90.11%**

Source: California Department of Insurance (department) letter to a member of the Legislature dated August 22, 2005.

Note: See Appendix E for the letter sent from the department, and accompanying documentation.

* The number of opt-in policies is based on data the Conservation and Liquidation Office obtained from Aurora National Life Assurance Company in May 2005, and is as of that date. The number of opt-out policies is as of September 3, 1993.

† Shortfall is the department's calculation of the difference between what the original Executive Life Insurance Company (ELIC) policy promised and what the restructured ELIC policy provided.

‡ These fields do not appear in the department's letter, and are calculated based on other information in the letter.

§ The guaranty association covered percentage is calculated based on the statutory reserve amount of each ELIC policy on April 11, 1991, and other factors.

As shown in Table 9 on the following page, our calculation results in policyholder economic losses of $3.1 billion that are greater than the department's estimated losses by $2.2 billion as of August 2005. Our analysis includes factors that the department's does not. The primary differences between the August 22, 2005, losses of $936 million estimated by the department and our economic loss estimate of $3.1 billion are the time value of money ($1.8 billion), and the difference between the estimated reduction in the interest rate that restructured policies earned and what they would have earned had the policies not been restructured ($0.4 billion). Other less significant factors included premium increases, moratorium charges, and mortality charges that were offset by reductions to economic losses for reasons such as policyholders collecting the full value of death benefits as opposed to their restructured account values.

Table 9
Comparison of the Department of Insurance's Calculation of Estimated Policyholder Losses With the Bureau of State Audits' Calculation (in Millions)

	Department of Insurance (Shortfall Less Distributions)			Bureau of State Audits' Consultant (Economic Loss)		
Date of Analysis	Opt-In Policyholders	Opt-Out Policyholders	Totals	Opt-In Policyholders	Opt-Out Policyholders	Totals
September 3, 1993*	$632	$1,068	$1,700	$882	$1,947	$2,829†
August 22, 2005‡	279	657	936	1,390	1,748	3,138§
December 31, 2006	NA	NA	NA	1,388	1,714	3,102§

Sources: Department of Insurance (department) letter to a member of the Legislature dated August 22, 2005; the Policy Detail File, Account Value Increment (AVI), and AVI Distribution History databases; and other data from the department and Aurora National Life Assurance Company (Aurora).

Note: The inputs to our calculation of the estimated policyholder losses are as reported by Aurora and the Conservation and Liquidation Office and are of undetermined reliability. Our procedures to determine the reliability of the inputs were limited to examining selected checks to policyholders, and source documentation was not available to verify the accuracy of the data we used from the Policy Detail File relating to policyholder losses.

NA = Not applicable.

* The differences in total losses on September 3, 1993, are primarily attributable to timing differences related to the recognition of distributions.

† Losses to opt-in policyholders at September 3, 1993, include the amount promised by the national guaranty association. This amount reduced losses at September 3, 1993, by $2 billion. The total shown for September 3, 1993, is as of that date, and is therefore presented in 1993 dollars.

‡ On August 22, 2005, there were no differences related to the timing of distributions. The two models differ by $14 million before the addition of post-September 3, 1993 factors not included in the department's model. Contributors to this difference include our economic loss model's inclusion of estimated increased mortality charges of $55 million and the reduction in losses of $34 million for factors such as policyholders collecting the full death benefit rather than their account value. The post-September 3, 1993, factors also include increased premiums of $19 million, moratorium charges of $68 million, industry interest rate differential of $356 million, and the time value of money of $1,775 million.

§ Total Bureau of State Audits' calculation includes both past and future estimated losses computed in August 22, 2005, and December 31, 2006 dollars, respectively.

As the department has stated, it did not include the time value of money in its estimation of policyholder losses. This concept is important when measuring economic losses: a policyholder who received $100 in 2005 or 2006 did not have the same opportunity to earn interest on the money that he or she would have had if that same $100 had been paid in 1993. The delay in payments denied policyholders the opportunity to earn interest at the level they would have under their original ELIC policies. This lost interest increases policyholder losses because it reduces the value of the account and payments received from the policy from what they would have been if the policies had not been restructured.

In addition, the department's calculation of the shortfall in policy value does not fully measure policyholder economic losses. The calculation of shortfall does not include or measure the financial impact caused by all of the changes made to policy terms subsequent to ELIC's insolvency, and therefore does not fully reflect policyholder losses. When Aurora assumed ELIC's assets and liabilities, the terms of some policies were changed. In some cases, policyholders were charged higher premiums in order to receive the same benefits, and some policies were restructured to pay out at lower interest rates. Also, additional fees and restrictions were imposed following the conservation date and continued throughout a five-year moratorium period pursuant to the ELIC Rehabilitation Plan (rehabilitation plan). This period lasted from September 3, 1993, to September 3, 1998, and caused the affected policyholders to incur greater losses than the department calculated compared to what they would have received had the policies not been restructured.

The department's statement that, for more than 92 percent of policies held by opt-in policyholders, the policyholders ultimately suffered no losses, only relates to the group of policyholders that were fully covered by the national guaranty organization and excludes the adverse economic impact that the ELIC insolvency had on policyholders who were only partially covered or not covered at all by the national guaranty organization. However, the table supporting the department's statement does indicate the relative size of these partially covered or noncovered policies in relation to other ELIC policies. Although more than 92 percent of the opt-in policies were fully covered by the national guaranty organization, the fully covered policies comprise only 85 percent of all policies when the opt-out policies are considered. In addition, as shown in Table 10 on the following page, the total statutory reserve of the policies that were fully covered by the national guaranty organization represented 42 percent of the total dollar amount of statutory reserves; thus, these policies constituted less than half of the statutory reserve dollar value. In contrast, partially covered and noncovered policies whose policyholders opted to continue coverage with Aurora, comprise only 7 percent of the number of ELIC policies, while these policies accounted for 25 percent of the statutory reserve dollar amount as of the conservation date. Finally, although 8 percent of the policyholders opted not to continue coverage with Aurora (opt-out policyholders), the statutory reserve for these policies accounted for 33 percent of the statutory reserve dollar amount for all of ELIC's policies.

Table 10
Percentages of Policies Covered by Guaranty Associations

	POLICIES		STATUTORY RESERVE	
	COUNT	PERCENT OF TOTAL	AMOUNT (IN MILLIONS)	PERCENT OF TOTAL
Fully covered policies	277,320	85%	$3,954	42%
Partially covered and noncovered policies	22,647	7	2,364	25
Opt-out policies	27,278	8	3,143	33
Totals	**327,245**	**100%**	**$9,461**	**100%**

Source: Calculated from information contained in the Department of Insurance letter to a member of the Legislature dated August 22, 2005.

Policyholders Have Experienced Significant Economic Losses as a Result of the ELIC Insolvency

Taking into consideration changes to policy terms and the time value of money, and estimating the original policy values at September 3, 1993[13] using an industry average rate for crediting interest to policyholder accounts and other factors, we found that policyholders in all four of our policy types (as defined in the text box on the following page) experienced economic losses[14]. This calculation of estimated policyholder losses is determined using a model of the estimated losses to all opt-in and opt-out policyholders.[15] Our analysis estimates total policyholder losses for all policy types to be $3.1 billion as of August 2005.

The first part of our analysis, shown in Table 9 on page 34, is an estimate of the losses that policyholders incurred during the interim period, defined as the period beginning April 11, 1991 (the conservation date), and ending September 3, 1993, when the court approved the rehabilitation plan (the closing date). The amounts in the table represent the estimated losses that had been sustained by policyholders at the time that Aurora took over ELIC's policies. Our analysis indicates that as of September 3, 1993, policyholders' estimated losses totaled $2.8 billion. Estimated losses to opt-in and opt-out policyholders were $882 million and $1.9 billion,

[13] The estimated original policy values at September 3, 1993, is the estimated amount that the policy is expected to have been worth at that date if ELIC had not become insolvent, present valued as of August 22, 2005, and December 31, 2006.

[14] Within each category there are various types of policies and the financial impact to each of these sub-types has not been determined.

[15] The estimated losses could be calculated a number of different ways, such as using individual policyholder files to perform an actuarial analysis of the losses that each policyholder may have suffered. However, such a calculation could require the review of over 300,000 individual policy files. For the purpose of our audit, we believe the approach we used is reasonable.

respectively, after the application of $2 billion from the national guaranty organization. See Appendix F for a more detailed summary of this calculation.

Based on the department's estimate of policyholder losses as of August 22, 2005, we computed the percentage of the original policy rights that policyholders recovered as of that date. This calculation indicates that opt-in and opt-out policyholders had recovered 96 percent and 79 percent, respectively, as shown in Table 8 on page 33. By comparison, as indicated on Table 11 on the following page, our analysis of losses by policy type (see the text box for definitions) found that as of August 22, 2005, opt-in policyholders had recovered 91 percent of their expected ELIC account value[16], while opt-out policyholders had recovered 76 percent of their expected ELIC account value. In total, when estimating the percent of policy values that ELIC policyholders have recovered as of August 22, 2005, our analysis found that policyholders had recovered 86 percent of their expected ELIC account values as compared to the estimate of 90 percent recovery of original policy rights, referred to in Table 8 on page 33. These are two distinct measures of the degree to which policyholders were made whole.

Aurora Policy Types

The ELIC policies that were transferred to Aurora can be grouped into four general policy types:

Whole life policies: A life insurance policy that accumulates a cash value that policyholders can borrow against and that pays a stated amount upon the death of the insured.

Deferred annuity policies: A policy that pays a steady stream of payments, which are delayed until an agreed-upon date.

Payout annuity policies: A policy that pays a steady stream of payments that begin immediately.

Guaranteed investment contracts: Large policies, often issued in connection with pension plans and municipal financing, that pay a guaranteed rate of interest.

Source: Aurora National Life Assurance Company.

Policyholders continued to incur losses after the September 1993 closing date, because, among other reasons, they were not earning interest on their policy values at the same interest rate they would have received had the policies not been restructured. Additionally, in accordance with the rehabilitation plan, some benefit payments that would normally have been paid to policyholders were delayed for five years until September 3, 1998. During the five-year period from September 3, 1993, to September 3, 1998, referred to as the moratorium period, deferred annuity payments that would have matured were delayed, representing losses to policyholders in terms of the interest that could have been earned had these funds been available. In addition to the delayed payments on matured annuities, there were other fees and restrictions imposed during the moratorium period, including the imposition by Aurora of additional surrender charges.

[16] The expected ELIC account value is the estimated amount that the policy is expected to have been worth as of September 3, 1993, had the policies not been restructured, present valued to August 22, 2005.

Table 11
Estimate of Policyholder Economic Losses by Policy Type as of August 22, 2005
(Dollars in Millions)

	NUMBER OF POLICIES*	PERCENTAGE OF ALL POLICIES	ESTIMATED POLICYHOLDER ECONOMIC LOSSES AT 8/22/05†	ESTIMATED EXPECTED ELIC ACCOUNT VALUE AT 9/3/93, PRESENT VALUED TO 8/22/05‡	PERCENTAGE OF ESTIMATED EXPECTED 9/3/93 ELIC ACCOUNT VALUE RECOVERED§
Opt-In Policies					
Life policies	145,634	44%	$719	$6,313	88.61%
Deferred annuities	52,517	16	85	3,057	97.22
Payout annuities	104,935	32	477	5,223	90.87
Guaranteed investment contracts	85	0	109	494	77.94
Total opt-in policies	**303,171**	**92%**	**$1,390**	**$15,087**	**90.79%**
Opt-Out Policies					
Life policies#	15,092	4%	$264	$472	44.07%
Deferred annuities	2,346	1	18	141	87.23
Payout annuities	9,730	3	91	286	68.18
Guaranteed investment contracts	108	0	1,375	6,448	78.68
Total opt-out policies	**27,276**	**8%**	**$1,748**	**$7,347**	**76.21%**
Total for all policies	**330,447**	**100%**	**$3,138**	**$22,434**	**86.01%**

Sources: Policy Detail File, Account Value Increment (AVI), and AVI Distribution History databases; other data from Aurora National Life Assurance Company (Aurora) and the Department of Insurance; and calculations based on these sources.

Note: The inputs to our calculation of the estimated policyholder losses are as reported by Aurora and the Conservation and Liquidation Office and are of undetermined reliability. Our procedures to test the accuracy of distributions to policyholders included examining selected checks to policyholders and other documents, however, source documentation was not available to verify the accuracy of the data we used from the Policy Detail File relating to policyholder losses.

* The number of opt-in and opt-out policies are as of September 3, 1993.

† Estimated policyholder losses are presented net of enhancement distributions to policyholders. See Appendix C for a more detailed explanation of these distributions.

‡ The expected Executive Life Insurance Company (ELIC) account value is the estimated amount that ELIC policies are expected to have been worth if ELIC had not become insolvent. It is calculated at September 3, 1993, and present valued to August 22, 2005.

§ The percentage of the estimated ELIC account value recovered is 100 percent less the estimated losses at August 22, 2005, as a percentage of the estimated ELIC account value at September 3, 1993, present valued to August 22, 2005.

Estimated losses for this policyholder group may be less than reported here due to outstanding loans that these policyholders had with Aurora. These loans are similar to advanced distributions since they reduce policy losses. In our work, we could not determine the exact amount of these loans.

Our model includes factors that reduced policyholder losses estimated at September 3, 1993, such as the effect of making full payments for death benefits paid between September 3, 1993, and August 2005, that were greater than the September 3, 1993, restructured account values. Our analysis of estimated losses also includes the amounts that were paid to policyholders and their beneficiaries out of the ELIC estate after the closing date, which served to reduce their losses. These are funds that were paid or credited to policyholders above and beyond the amounts the opt-in policyholders received as a result of the restructuring of their policies, and the amounts that opt-out policyholders received when they opted out of the rehabilitation plan. The source of these payments and credits include the sale of ELIC's assets that remained with the commissioner after the transfer of ELIC's policies to Aurora, litigation proceeds, and interest. Although these payments reduced policyholders' losses, additional losses for some policyholders remained.

We also updated policyholder losses to December 31, 2006, to include distributions, the time value of money, and other factors occurring between August 2005 and December 2006. As shown in Table 12, policyholder losses were less than those shown in Table 11 by $36 million. The reduction between August 2005 and December 2006 is primarily due to additional economic losses being offset by a 2006 distribution of $276 million as shown in Appendix C, Table C.3.

Table 12
Estimate of Policyholder Economic Losses by Policy Type as of December 31, 2006 (Dollars in Millions)

	NUMBER OF POLICIES*	PERCENTAGE OF ALL POLICIES	ESTIMATED POLICYHOLDER ECONOMIC LOSSES AT 12/31/06†	ESTIMATED EXPECTED ELIC ACCOUNT VALUE AT 9/3/93, PRESENT VALUED TO 12/31/06‡	PERCENTAGE OF ESTIMATED EXPECTED 9/3/93 ELIC ACCOUNT VALUE RECOVERED§
Opt-In Policies					
Life policies	145,634	44%	$758	$6,832	88.91%
Deferred annuities	52,517	16	74	3,309	97.76
Payout annuities	104,935	32	450	5,653	92.04
Guaranteed investment contracts	85	0	106	534	80.15
Total opt-in policies	**303,171**	**92%**	**$1,388**	**$16,328**	**91.50%**
Opt-Out Policies					
Life policies#	15,092	4%	$285	$511	44.23%
Deferred annuities	2,346	1	20	153	86.93
Payout annuities	9,730	3	98	310	68.39
Guaranteed investment contracts	108	0	1,311	6,979	81.22
Total opt-out policies	**27,276**	**8%**	**$1,714**	**$7,953**	**78.45%**
Total for all policies	**330,447**	**100%**	**$3,102**	**$24,281**	**87.22%**

Sources: Policy Detail File, Account Value Increment (AVI), and AVI Distribution History databases; other data from Aurora National Life Assurance Company (Aurora) and the Department of Insurance; and calculations based on these sources.

Note: The inputs to our calculation of the estimated policyholder losses are as reported by Aurora and the Conservation and Liquidation Office and are of undetermined reliability. Our procedures to test the accuracy of distributions to policyholders included examining selected checks to policyholders and other documents, however, source documentation was not available to verify the accuracy of the data we used from the Policy Detail File relating to policyholder losses.

* The number of opt-in and opt-out policies are as of September 3, 1993.

† Estimated policyholder losses are presented net of enhancement distributions to policyholders. See Appendix C for a more detailed explanation of these distributions.

‡ The expected Executive Life Insurance Company (ELIC) account value is the estimated amount that the ELIC policies are expected to have been worth if ELIC had never become insolvent. It is calculated at September 3, 1993, and present valued to December 31, 2006.

§ The percentage of the estimated ELIC account value recovered is 100 percent less the estimated losses at December 31, 2006 as a percentage of the estimated ELIC account value at September 3, 1993, present valued to December 31, 2006.

\# Estimated losses for this policyholder group may be less than reported here due to outstanding loans that these policyholders had with Aurora. These loans are similar to advanced distributions since they reduce policy losses. In our work, we could not determine the exact amount of these loans.

Chapter 3

THE INSURANCE COMMISSIONER HAS NOT CONSISTENTLY MONITORED, REPORTED ON, OR ACCOUNTED FOR THE DISTRIBUTION OF THE ASSETS OF THE EXECUTIVE LIFE INSURANCE COMPANY ESTATE

Chapter Summary

The Department of Insurance (department) is, foremost, a consumer protection agency. As trustee of the Executive Life Insurance Company (ELIC) estate, the insurance commissioner (commissioner) has a fiduciary responsibility to protect ELIC policyholders by preserving and managing the assets of the ELIC estate. Since August 1997 the commissioner has delegated the responsibility for managing the ELIC estate to the Conservation and Liquidation Office (CLO). In managing the estate, the commissioner as trustee also has a fiduciary duty to ensure that the CLO records the amounts and sources of funds it receives for the ELIC estate and reports how it uses those funds to policyholders and other interested parties.

The commissioner has not ensured that the CLO consistently monitored, reported on, or accounted for the distribution of the ELIC estate's assets.[17] Other than requiring special procedures as part of an audit issued in 1998 and including some of those same procedures in an examination that was still ongoing as of October 2007, the commissioner has done little to make sure that ELIC estate funds were distributed in accordance with key agreements. According to legal counsel for the department, neither the court-approved ELIC Rehabilitation Plan (rehabilitation plan), the ELIC Enhancement Agreement (enhancement agreement), nor the agreements with third parties (collectively referred to as the ELIC agreements)[18] give the commissioner, in his role as conservator, rehabilitator, and liquidator of the ELIC estate, the general rights to review or audit the records of Aurora National Life Assurance Company (Aurora) as the successor insurer for ELIC's insurance business. The department indicated, however, that its other reviews of Aurora, such as examinations of Aurora that it conducts as regulator of the insurance industry, have given it confidence in Aurora's adherence to the ELIC agreements, and thus it has not needed to assert additional rights to monitor Aurora.

[17] See Appendix A for a timeline identifying the parties responsible for managing the ELIC estate between April 1991 and December 2007.

[18] We categorize the third-party agreements with the rehabilitation plan and enhancement agreement for ease of reference. However, unlike the rehabilitation plan and enhancement agreement, the third-party agreements are not part of the restructuring of ELIC.

As a result of settlement negotiations in 2005, the commissioner released Aurora from existing known and unknown claims of liability, which may further hinder the commissioner's ability to monitor Aurora's past compliance with the ELIC agreements. Subsequently, as part of an agreement negotiated by the commissioner in June 2007, the CLO was able to monitor Aurora's October 2007 distribution of $305 million to policyholders. However, the commissioner did not monitor other distributions that occurred from 1998 through 2006, and therefore cannot provide policyholders and others the same level of assurance that the $225 million Aurora distributed during this period of time was distributed in accordance with the ELIC agreements.

In addition, consistent information is lacking on ELIC's operations and the disposition of its assets for the period from 1990, before the commissioner conserved ELIC, through 2006. For example, some of the reports authorized by the California Insurance Code (insurance code) or required by individual trust agreements have not been produced. Additionally, inconsistent accounting practices and varying availability of supporting documents hinder a complete accounting of the ELIC estate. Overall, inconsistent reporting and auditing have contributed to a lack of information available to former ELIC policyholders and other parties who have an interest in the ELIC estate.

The Commissioner Has Not Consistently Ensured That Aurora Complies With the ELIC Agreements

The commissioner, as trustee of the ELIC estate, has not consistently ensured that Aurora adds the proper amount of interest to the funds it receives from the ELIC estate, or that it accurately calculates the amounts that it distributes to policyholders and others based on provisions in the ELIC agreements. Between September 1993, when Aurora assumed ELIC's policies, and October 2007, one external examination has been conducted, and an internal examination by the CLO is in the process of being conducted, to verify Aurora's compliance with some of the provisions of the ELIC agreements. In the first, occurring in 1998, the commissioner hired an independent auditor to conduct procedures that included verifying that Aurora had restructured ELIC's policies in accordance with the ELIC rehabilitation plan, and examined Aurora's calculations for ELIC funds it distributed in 1995. In the second, the CLO is evaluating Aurora's October 2007 distribution of ELIC funds to policyholders to ensure that Aurora calculated the amounts it paid to policyholders in accordance with the enhancement agreement. However, the commissioner did not monitor other distributions that occurred from 1998 through 2006 for such compliance and therefore cannot

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According to legal counsel for the department, the ELIC agreements do not give the commissioner, in his role as conservator, rehabilitator, and liquidator of the ELIC estate, general rights to review or audit Aurora's records. The department indicated that although it lacks this general authority, through other reviews it conducted or reviewed in its regulatory role for the insurance industry, the department has gained confidence in Aurora's execution of the ELIC agreements and thus has not needed to assert additional rights to monitor Aurora.

According to legal counsel for the department, the ELIC agreements do not give the commissioner, in his role as conservator, rehabilitator, and liquidator of the ELIC estate, general rights to review or audit Aurora's records.

The ELIC Agreements Have Specific Provisions Related to Aurora's Distribution of ELIC Estate Assets

The commissioner entered into agreements specifying how ELIC's insurance policies would be transferred to Aurora, how the former ELIC policies would be restructured, and how assets that remained under the commissioner's control and future litigation proceeds that he received would subsequently be distributed to policyholders to reduce the losses they incurred as a result of the ELIC insolvency. The commissioner, Aurora, and the National Organization of Life and Health Insurance Guaranty Associations (national guaranty organization) are party to the ELIC agreements. Key provisions of the agreements require Aurora to add interest to the funds it receives from the ELIC estate; calculate distributions to policyholders who opted to continue coverage with Aurora (opt-in policyholders) and other ELIC estate beneficiaries, such as the national guaranty organization, according to complex formulas; and determine the amount of ELIC funds that it pays to third-party companies that offset some policyholders' losses. The following summarizes these key provisions:

The ELIC Rehabilitation Plan

Article 9 of the rehabilitation plan requires Aurora to add interest to funds it receives from the ELIC estate for distribution to opt-in policyholders to offset their losses. Aurora is required to calculate this interest from the date it receives the funds until the date it distributes the funds.

The ELIC Enhancement Agreement

The enhancement agreement specifies how the national guaranty organization's funds are to be allocated to policyholders to offset their losses, specifies the reporting requirements for these funds, and indicates how to calculate the proportionate amounts policyholders and the national guaranty organization receive from the distributions of ELIC estate assets. Articles 10 and 17 of the enhancement agreement require Aurora to distribute ELIC estate funds to policyholders, the national guaranty organization, and others in accordance with specific formulas. The calculations performed under the provisions of Articles 10 and 17 determine each policyholder's share of the total distribution amount based on factors such as the amounts they have received from the participating state guaranty associations and the statutory reserve value of their policies.

Articles 10 and 17 of the enhancement agreement require Aurora to distribute ELIC estate funds to policyholders, the national guaranty organization, and others in accordance with specific formulas.

The calculations performed under Article 10 result in a greater percentage of funds being distributed to policyholders, and calculations performed under Article 17 result in a greater percentage of funds being distributed to the national guaranty organization to reimburse participating state guaranty associations for payments they made to policyholders. Additionally, Article 13 of the enhancement agreement requires Aurora to provide a yearly report to the commissioner and the national guaranty organization stating the guaranty association payments it has made to policyholders. Under the enhancement agreement, policyholders receive guaranty association payments directly from Aurora.

Third-Party Agreements

Third-party agreements require Aurora to reimburse third parties for payments that the third parties made to policyholders to reduce the policyholders' losses. The commissioner, the relevant third party, and Aurora are party to these agreements. As we discussed in Chapter 1, a third party is either a company that offered ELIC policies to its employees or a state guaranty association. Under these agreements, third parties agreed to pay all or some of an ELIC policyholder's losses in return for rights to future distributions of ELIC funds. In order to receive ELIC funds, a third party provides a certification to Aurora regarding the amount it has paid to policyholders. Generally, third parties should not receive an amount greater than what they paid.

The Commissioner Has Monitored Aurora's Compliance with Some Aspects of the ELIC Agreements but Has Not Consistently Ensured That Aurora Complied With the Agreements

As part of the settlement of an indemnity demand that was made by Aurora pursuant to the terms of the rehabilitation plan, the CLO hired an independent auditor to assess Aurora's compliance with the rehabilitation plan for the period from September 1993, when the rehabilitation plan for ELIC took effect, through December 31, 1997. The auditor's procedures included verifying that Aurora had restructured ELIC's policies in accordance with the ELIC rehabilitation plan and examining Aurora's calculations of the ELIC funds it distributed to policyholders in 1995. The auditor found no material errors with these calculations, which provides some assurance that Aurora had complied with the ELIC rehabilitation plan through December 31, 1997.

Additionally, as part of the arbitration decision regarding how the Altus litigation proceeds would be distributed, the CLO entered into an agreement with Aurora in 2007 that allowed the CLO to examine Aurora's distribution of Altus litigation proceeds to opt-in policyholders in October 2007. As we discussed in Chapter 1, the arbitrator's decision resulted in the remaining Altus litigation proceeds being distributed under Article 10 of the enhancement agreement. As part of its agreement with Aurora, the CLO is evaluating Aurora's calculation of the amounts it paid to policyholders to verify that the amounts were calculated in accordance with Article 10 of the enhancement agreement. When we asked the ELIC estate trust officer why the CLO examined the October 2007 distribution and not the earlier ones, he stated that Aurora agreed to allow the CLO to review its distribution because it was more complex than previous distributions of ELIC funds. Thus, because it is in the process of examining Aurora's October 2007 distribution, the CLO will be able to determine whether Aurora distributed the funds in accordance with Article 10 of the enhancement agreement.

The CLO is performing a review of the October 2007 distribution of ELIC estate funds to verify Aurora's compliance with the rehabilitation plan and enhancement agreement even though the department in its regulatory role has conducted other examinations of Aurora and has received yearly audits of Aurora's financial statements. In its regulatory capacity, the department conducted four examinations of Aurora between 1994 and 2007 in accordance with Section 730 of the insurance code, which requires periodic examinations of every insurer operating in the State. Additionally, Aurora has submitted yearly audits performed by an independent certified public accountant to comply with Section 900 of the

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insurance code, which requires all insurers operating in California to undergo an annual audit by an independent certified public accountant and submit it to the commissioner.

However, neither the four examinations that the department has performed in accordance with Section 730 of the insurance code nor the yearly audits submitted by Aurora state that they assessed whether Aurora complied with the specific provisions of the ELIC agreements regarding how it distributed the funds. Specifically, when the department conducts its examinations, its reports do not state whether Aurora correctly calculates the amounts that it distributes to policyholders and others based on the rehabilitation plan or the formulas in the enhancement agreement. We also reviewed the yearly independent audits of Aurora and determined that they did not address whether Aurora complied with the provisions of the ELIC agreements.

We asked the chief of the department's Field Exam Division (chief examiner) if he had any additional documentation showing that the department examined or determined whether Aurora adhered to specific provisions of the ELIC agreements in the annual audits, periodic examinations, or other reviews. He noted that considerable test work was conducted in conjunction with substantial ELIC distributions such as the work completed in 1998 by the independent auditor. In addition, he noted that the department coordinated efforts with the CLO and others to examine Aurora's 2007 distribution for compliance with the ELIC agreements. However, as this examination is still ongoing, the documentation supporting this assertion has not yet been made available. While he provided rationale for why he believed the work performed by the department was sufficient for the period from 1998 through 2006, he could provide no documentation establishing that the department examined or determined whether Aurora adhered to specific provisions of the ELIC agreements for this time period. He also explained that documentation supporting examinations prior to the 2005 examination is no longer available. Thus, although the department periodically examines and receives yearly independent audit reports of Aurora through its general authority to regulate insurers in the State, these examinations and audits do not address whether Aurora is meeting important conditions that are specific to the ELIC agreements.

Additionally, the department's legal counsel stated that the enhancement agreement provides the national guaranty organization with broad rights to review certain records pertaining to Aurora's obligations to policyholders, including account values and benefit payments, records of amounts paid to policyholders, and the allocation of certain funds to policyholders. However, although the national guaranty organization may have reviewed Aurora's distributions of

ELIC funds to policyholders and other interested parties, neither the CLO nor the department had any copies of any reviews that the national guaranty organization might have conducted and reported on. Thus, because neither the CLO nor the department could demonstrate that it had received or reviewed such reports, they have missed an opportunity that may have provided them some assurance that the ELIC funds sent to Aurora were distributed in accordance with certain provisions of the ELIC agreements.

Finally, the commissioner has not established a system for monitoring Aurora's distribution of funds to third parties. Aurora's third-party administrator and the ELIC estate trust officer stated that the CLO, acting on behalf of the commissioner, has no involvement with Aurora's distributions to third parties unless Aurora requests its assistance.

According to the Department, the ELIC Agreements Do Not Contain Language That Allows the Commissioner to Review or Audit Aurora's Records

According to the department's legal counsel, the ELIC agreements do not give the commissioner, in his role as conservator, rehabilitator, and liquidator (receiver) of the ELIC estate, general rights to review or audit Aurora's records. Thus, under the ELIC agreements, the receiver is not required or permitted to monitor Aurora's distribution of funds under the ELIC agreements. The department also stated that although the commissioner continues to act as trustee to ELIC's creditors, including the policyholders, the commissioner does not have a fiduciary duty to oversee or monitor Aurora.

The department stated that, nonetheless, the commissioner can examine Aurora's performance through his regulatory powers, and that examinations are conducted periodically as required by state law or whenever the commissioner has reason to conduct one. Moreover, the department stated that if the commissioner determines that his regulatory powers are unsatisfactory for any reason, the department believes that the commissioner can assert a right to review Aurora's performance in his capacity as receiver, independent of the ELIC agreements. The department's legal counsel cautioned, however, that the nature and extent of such a right is an untested issue. In the case of ELIC, the department stated that Aurora would likely strenuously oppose such a review and would probably assert that the receiver is only entitled to the rights that are specified in the rehabilitation plan.

The department stated that in the course of managing the ELIC estate, the commissioner, in his capacity as receiver, has not needed to assert additional rights to monitor Aurora.

The department further stated that in the course of managing the ELIC estate, the commissioner, in his capacity as receiver, has not needed to assert additional rights to monitor Aurora. Specifically, the department indicated that there has been no shortage of reviews of Aurora and its implementation of the rehabilitation plan and the enhancement agreement. The department's legal counsel pointed to the four examinations the department, as regulator, has conducted, as we discussed earlier, and noted that the department has also received annual audited financial statements with clean opinions from Aurora's auditors. Additionally, the department's legal counsel stated that other reviews have occurred, including the audit of Aurora's compliance with the rehabilitation plan in 1998; the national guaranty organization's reviews under the enhancement agreement; and the CLO's ongoing review of Aurora's distribution of ELIC funds in October 2007. As we acknowledged earlier, the 1998 audit and the CLO's as yet to be completed review of Aurora's 2007 distribution do contain monitoring components concerning certain aspects of the ELIC agreements; however, the scope of the four examinations and the annual audits that the legal counsel referred to do not address Aurora's compliance with key provisions of the ELIC agreements identified in this chapter, nor was the department or the CLO able to provide any reviews or reports the national guaranty organization may have completed.

The legal counsel also stated that there has been constant communication and cooperation between Aurora and the receiver (both through the CLO and through the special deputy receiver prior to the CLO) over the years concerning the implementation and operation of the rehabilitation plan and enhancement agreement. Nonetheless, as conservator, rehabilitator and liquidator of the ELIC estate, the commissioner is responsible for the distribution of ELIC estate assets. Neither we nor the department were able to determine whether the commissioner sought the right to monitor the distribution of ELIC funds from 1998 to 2006 or, in the alternative, considered having the CLO make the distributions based on data maintained by Aurora. However, if the commissioner had obtained the right to monitor those distributions or to have the CLO make the distributions, the commissioner could have provided the policyholders with greater assurance that the funds were distributed as required by the ELIC agreements.

Neither we nor the department were able to determine whether the commissioner sought the right to monitor the distributions of ELIC funds from 1998 through 2006 or in the alternative, considered having the CLO make the distributions based on data maintained by Aurora.

There Is Less Assurance That Aurora Distributed ELIC Estate Funds in Accordance With Key Provisions of the ELIC Agreements for the 1998 Through 2006 Period

Several distributions of ELIC funds occurred during the 1998 to 2006 period totaling $225 million. For example, a distribution was made in February 2000 of nearly $120 million that was paid or credited to policyholders and the national guaranty organization, among others. Additionally, Aurora's records indicate that it added $7.5 million in interest to the funds it received from the ELIC estate from 1998 through 2006. However, the commissioner did not monitor these activities and distributions and therefore cannot provide policyholders and others the same level of assurance that the $225 million in ELIC estate funds that Aurora distributed during this period was distributed in accordance with the ELIC agreements.

The annual reports from Aurora showing guaranty association payments to policyholders, required by Article 13 of the enhancement agreement, would allow the commissioner to track these payments, as part of monitoring compliance with the enhancement agreement. When we asked the ELIC estate trust officer for these reports, we found that the CLO had never received them. In explaining the reason why the CLO did not receive the reports, the trust officer stated that these reports would not be useful as they would require an actuary to interpret them, and they are not a tool the CLO would use in its administration of the ELIC estate. However, Article 13 of the enhancement agreement does not specify the format of the report; it requires only that Aurora report on the amount that guaranty associations have paid to policyholders. Thus, the report format does not have to be complex. These reports would allow the CLO to track how much policyholders have received from the participating guaranty organizations and would help it monitor compliance with the enhancement agreement.

Further, monitoring the amounts that Aurora pays to third parties would help ensure that ELIC funds are distributed correctly. Payments made to third parties represent a significant portion of the ELIC funds that Aurora has received from the commissioner. In our work, we identified some concerns with regard to the amount of ELIC funds that the third parties have received that highlight the need for increased monitoring. Overall, according to Aurora's worksheets, third parties have paid nearly $130 million directly to policyholders to cover some of the policyholders' losses, and in return for these payments, the third parties have received nearly $50 million of the $830 million the commissioner sent to Aurora to distribute to policyholders and others. Using Aurora's worksheets that it uses to track distributions of ELIC estate funds to third parties, we identified nearly 400 policyholders that collectively received approximately $200,000 less from the third parties than the amounts the third parties received from Aurora. When we inquired about this, Aurora stated that because 391 of the 400 cases involve amounts of less than $100, the differences are likely due to interest paid to the third parties. After further analyzing the differences associated with the remaining nine cases, Aurora concluded that the third parties were overpaid by $7,500. Aurora stated that these overpayments appeared to be anomalies from 1995 and were not significant enough to warrant subsequent adjustments, collections, or reallocations. We agree that these nine cases are not significant relative to the overall number

Monitoring the amounts that Aurora pays to third parties would help ensure that ELIC funds are distributed correctly.

of third parties that received distributions from Aurora. However, increased monitoring would help minimize these types of errors and would help ensure that ELIC funds were properly distributed.

As Part of a Complex Settlement Agreement, the Commissioner Granted Aurora a Release From Liability That May Further Limit the Ability to Monitor Aurora's Past Distributions of ELIC Funds

As we discussed earlier, the ELIC insolvency was heavily litigated by multiple parties. In the 2005 Altus settlement agreement with Aurora that resulted in Aurora agreeing to pay $78.5 million to the commissioner, the department provided a release of liability to Aurora covering the period prior to February 14, 2005. Releases from liability for previous conduct, whether known or unknown, is common in settlement agreements, especially involving the large amounts agreed to in this settlement. Nonetheless, in agreeing to this release, the commissioner may have further limited his ability to monitor Aurora's past compliance with the ELIC agreements for the subject matter and time period covered in the release.

Although general releases of liability often release both known and unknown claims, Aurora has asserted that this release even prohibits the CLO from monitoring simple accounting adjustments to distributions of ELIC funds.

Although general releases of liability often release both known and unknown claims, Aurora has asserted that this release even prohibits the CLO from monitoring simple accounting adjustments to distributions of ELIC funds. By signing the release, the commissioner may have further limited the ability to evaluate or question whether Aurora's distributions of ELIC estate funds prior to February 14, 2005, were in accordance with the ELIC agreements.

Information on ELIC Estate Operations Is Lacking Due to Inconsistent Reporting and Auditing

During the period from 1990, before the commissioner conserved ELIC, through 2006, we found that there is a lack of available information on ELIC's operations and the disposition of ELIC's assets. As we discussed in the Introduction, the commissioner has assigned various parties the responsibility of managing the ELIC estate since he conserved ELIC in April 1991. We found that the level of information varied depending on the entity managing the estate or trust at the time. Some of the reports that are either authorized by the insurance code or required by individual trust agreements have not been produced, and audits of the ELIC estate have not been consistently performed. Similarly the extent of audited financial statements available showing the disposition of ELIC's assets, including the receipt and distribution of ELIC funds, is related to which entity was managing the estate. We found that audited financial statements were not available during the 1991 through 1993 period, and while the ELIC estate was extensively audited during the 1994 through 1996 period, it has not been consistently audited since 1997. Overall, inconsistent reporting and auditing have contributed to a lack of information available to former ELIC policyholders and other parties who have an interest in the ELIC estate.

The Commissioner Did Not File an Examination of ELIC He Conducted as of 1990

In 1990 the insurance code authorized the commissioner, in his role as regulator of the insurance industry, to examine every insurance company doing business in the State. We asked the department to provide the examination of ELIC that he conducted as of 1990, four months before the commissioner conserved the company, since it would provide public information on the financial condition of ELIC immediately before it was declared insolvent. The department's deputy commissioner of financial surveillance stated that a draft report may exist but was not finalized and therefore was not filed.

Managers of the ELIC Estate Have Not Consistently Reported on the Disposition of ELIC's Assets

In our work to determine the extent of reporting that has been performed on the ELIC estate, we found that reporting requirements have been met for some trusts but not for others. Annual reports were consistently issued for the liquidating trusts while the trusts were in operation. Specifically, trustees of the Base Assets Trust and the Real Estate Trust issued yearly reports to trust beneficiaries from 1994 to 1996, when the trusts were open.[19] These reports included detailed summaries of how the trust assets were distributed. Similar reports were issued for the ELIC Trust between 1994 and 1999.[20]

However, similar reports were not produced for other ELIC trusts as required by the trust agreements. In settling the ELIC estate, the commissioner established a series of trusts to receive and distribute funds to policyholders (distribution trusts), as described in the text box. These distribution trusts are governed by separate

ELIC Distribution Trusts

Opt-Out Trust: Established in 1994, this trust receives, holds, and invests funds owed to opt-out policyholders and makes distribution payments to them as appropriate.

Holdback Trust: The commissioner established this trust in 1994 to ensure that the CLO had funds available to address financial uncertainties. For a time, a portion of each payment to policyholders was deposited in this trust to cover potential costs that could occur if the court of appeal reconfigured the rehabilitation plan or if other legal changes took place.

FEC Litigation Trust: Established in 1992, this trust is a repository for litigation proceeds from the lawsuits filed principally against Michael Milken; Drexel Burnham Lambert, Inc.; and the First Executive Corporation's directors, officers, and accountants.

Sources: Opt-out, Holdback, and FEC litigation trust agreements, the rehabilitation plan, and various court documents.

[19] See Appendix A for a timeline that includes the dates the trusts were opened and when they were closed.

[20] The trustees of the liquidating trusts included a representative appointed by the commissioner, a representative selected by a policyholder committee, and a representative appointed by the national guaranty organization.

agreements, which specify the purposes of the trusts and other conditions, such as establishing the party responsible for managing the trusts (trustee) and the reporting requirements. The commissioner was established as the trustee for all three distribution trusts. The Opt-Out and Holdback Trust agreements require the commissioner to issue reports to policyholders and other beneficiaries both annually and at the termination of the trusts, describing how funds in the trusts have been used. Specifically, Article 9 of both the Opt-Out and the Holdback Trust agreements require the commissioner to prepare annual reports that include the assets and liabilities as well as the amount of all distributions made to trust beneficiaries. However, according to the CLO's ELIC estate trust officer, these reports have not been produced.

Additionally, although the FEC Litigation Trust agreement does not require annual reports to policyholders, Article 7 requires the commissioner to provide a yearly report to Aurora and a committee established by the trust showing all payments resulting from or received from litigation claims and all other receipts or disbursements in connection with the trust. Once completed, copies of the FEC Litigation Trust annual reports are also to be on file with the commissioner and as a public document, this report would be available at the request of trust beneficiaries. A former general counsel for the department stated that there are no records that the reports were ever completed. By not producing the reports that are required by the distribution trust agreements, the commissioner has not kept policyholders and other beneficiaries informed of the disposition of ELIC's assets as intended by the trust agreements.

By not producing the reports that are required by the distribution trust agreements, the commissioner has not kept policyholders and other beneficiaries informed of the disposition of ELIC's assets as intended by the trust agreements.

When we asked why these reports were not produced, the CLO's ELIC estate trust officer stated that the reports required by the Opt-Out and Holdback Trust agreements were not produced because of cost considerations, which included the cost of mailing reports to policyholders. Although we acknowledge that the costs of issuing reports are an important consideration, ensuring that policyholders and other beneficiaries are properly informed is a requirement of the trust agreements. To reduce costs, the CLO could pursue alternatives to mailing reports, such as posting the reports to the CLO's Web site or posting a notice on its Web site that would allow only those beneficiaries that desire them to request copies of the reports.

In response to our questions regarding the FEC Trust reports, the department's former general counsel stated that a former commissioner had maintained constant contact with Aurora and the trust committee and at various times had provided copies of a spreadsheet tracking the trust's financial activities. He also noted that data provided to interested parties appeared to fulfill their needs. We obtained a copy of this spreadsheet, and although it contained information on the receipts and distributions of funds from the trust, we found that it would not sufficiently provide other trust beneficiaries with summary information on the trust's financial activities.

We considered whether any of the CLO's other procedures would satisfy the reporting requirements of the trust agreements. We examined the 17 court documents posted to the CLO's Web site but found that none specifically mentioned the Holdback or FEC Litigation trusts. Some of the court documents refer to anticipated deposits and distributions from the Opt-Out Trust and noted specific amounts that the commissioner was authorized to distribute from the trust. However, because the documents do not report on the net income earned or received by the trust, the receipts and disbursements of the trust, or the amount of actual distributions made to trust beneficiaries, they do not fulfill the specific reporting requirements of the Opt-Out Trust agreement.

We also considered whether the reports that the commissioner provided to the governor during the 1991 through 2006 period consistently provided information that would allow interested parties to track the disposition of ELIC's assets. Because many of the earlier reports were not required, and because of the lack of detail in the most recent reports, the commissioner's annual reports have not consistently provided information to parties interested in ELIC. The reports issued in 1991 and 1992 provide some detailed information on the disposition of ELIC's assets, including the assets and liabilities of the estate and revenue and expenditures for each year. However, due to a temporary change in the Government Code that eliminated the requirement for the commissioner to provide annual reports to the governor, the commissioner did not issue these reports between 1993 and 1998. Additionally, although the commissioner reestablished the practice of submitting annual reports to the governor in 2000 and 2001, and these reports contain some level of financial detail for the estate as a whole for 1998 and 1999, the reports submitted since 2002 lack such detail. The CLO's chief financial officer confirmed that the CLO no longer provides detailed financial statements in the commissioner's annual report to the governor. He stated, the detail is not required to be provided in the report, and the department has not asked for the information to be included in the reports. Although the insurance code may not explicitly require these detailed statements for insolvent insurance companies, the decision to stop providing them resulted in a missed opportunity to inform policyholders and other interested parties about the disposition of ELIC's assets.

Because of the lack of detail in the most recent reports, the commissioner's annual reports have not consistently provided information to parties interested in ELIC.

Managers of the ELIC Estate Have Not Consistently Audited the Estate

Similar to our findings regarding inconsistent reporting for the various trusts described earlier, we found that auditing requirements have been met for some trusts but not for others. Audits were issued for the liquidating trusts covering the years the trusts were in operation. Specifically, managers of the Base Assets Trust and the Real Estate Trust saw to it that yearly audits were issued covering 1994, when the trusts were opened, through 1996, when the trusts were closed, including detailed summaries of how the trust assets were distributed. Similar audits were issued for the ELIC Trust covering the period from 1994 through 1999.

However, similar audits were not consistently produced for other ELIC trusts as required by the trust agreements. In addition to the reporting requirements specified in the trust agreements, the Opt-Out and Holdback Trust agreements require the commissioner to include audited financial statements in the yearly reports issued for the trusts. The purpose of the audits is to ensure that the reported financial information is accurate, and the audited financial statements were to include financial information such as a balance sheet and a profit and loss statement. Although prior to the CLO managing the estate, an independent auditor conducted audits of the Opt-Out and Holdback trusts from the inception of the trusts in February 1994 through December 1996, audits were not completed for the two trusts from 1997 through 2004. In response to our inquiries regarding why audits of these trusts ceased after 1996, the CLO's ELIC estate trust officer stated that the CLO had received independent audits of ELIC's combined financial statements for the years 1997 through 2000, which included the trusts. Although the trust officer is correct, these audits of ELIC were on a consolidated basis, which means they did not separately report on the activities in these two trusts as required by the trust agreements.

The consolidated audits performed of the ELIC estate from 1997 to 2000 are not comprehensive, and no audits were performed from 2001 to 2004.

Additionally, the consolidated audits performed of the ELIC estate from 1997 to 2000 are not comprehensive, and no audits were performed from 2001 to 2004. The consolidated audits performed of the ELIC estate from 1997 to 2000 state that they exclude the FEC Trust, and are therefore not comprehensive because they did not include all ELIC estate trusts. Additionally, there were no audits of the ELIC estate conducted from 2001 through 2004. It is the ELIC estate trust officer's understanding that former CLO management discontinued the audits because the insurance code did not require them and because the audits provided little or no benefit to the estate. Although the insurance code does not explicitly require the audits, the trust agreements for the Opt-Out Trust and Holdback Trust do require annual audits to be performed. Additionally, discontinuing the audits did not allow the commissioner to ensure that ELIC's financial statements were accurate and further reduced the amount of publicly available information on the disposition of the ELIC estate's assets. In 2006 the CLO's chief financial officer requested the Department of Finance (Finance) to conduct a separate review of the ELIC estate and each of its trusts covering the 2005 and 2006 period. He stated that he plans to continue these reviews yearly until the trusts are closed.

Inconsistent Accounting Practices and Inconsistent Availability of Supporting Documents Hinder a Complete Accounting of the ELIC Estate

Since ELIC was first conserved in 1991, a variety of methods have been used to account for the estate. For example, from 1991 to 1993, the available financial information is primarily contained in unaudited financial statements prepared by outside contractors and unaudited financial statements included in the annual report to the governor. These statements include a balance sheet and a statement of cash flow but no operating statement that would summarize various types of revenues and expenses. The revenues and expenses that we present in Chapter 1 and related appendices for this period are based on our formatting of available information from the statements of cash flows. As a result, we have less confidence in the amounts for this time period, including our calculation of the estimated loss from the liquidation of ELIC investment securities in 1992.

For the 1994 to 1996 period, audited financial statements exist for the various trusts and generally include balance sheets, statements of changes in net assets that display revenues and expenses, and statements of cash flows. However, for the ELIC estate in 1994, only a balance sheet was included in the audit report.

Financial reporting was not consistent from 1997 through 2006. For example, in 1998 a $75 million indemnity payment was paid to Aurora pursuant to the rehabilitation plan. While the 1998 ELIC Trust audit reports a $55.5 million expense for its portion of this amount, the CLO's general ledger does not report a $19.5 million expense for the remaining portion that it paid from the ELIC estate. Additionally, the cash-flow statements prepared from 1991 through 1996 were not prepared during the period from 1997 through 2006. Since comprehensive annual audits were not performed for the 1997 to 2006 period, we initially attempted to acquire cash-flow statements from the CLO, because that statement was generally available for the 1991 to 1996 period and would have provided a method for reporting on the use of ELIC assets. In response to our request, the vice president of the estate finance group attempted to prepare them, but was unsuccessful in producing statements that reconciled to the changes in the cash account balance. His draft statements also excluded the previously discussed $19.5 million cash transaction.

Various trust agreements identify the recipients of ELIC estate distributions as opt-in and opt-out policyholders, Aurora, and the national guaranty association. Although the notes to the financial statements for the 1994 to 1996 period identified the amount of funds paid to opt-in and opt-out policyholders and refer to opt-in and opt-out accounts, the CLO accounting system does not maintain separate accounts to record distributions to these recipients. In addition, it does not maintain separate accounts to record payments made to the national guaranty organization or Aurora. We worked with Aurora staff to identify the amounts that the commissioner sent, and it ultimately took Aurora about 100 hours of staff time to provide the information. Although there is no specific requirement for structuring the accounting records, maintaining subsidiary accounts that separately track payments to each category of trust recipient would aid the timely reporting of payments to recipients of ELIC estate distributions.

Although there is no specific requirement for structuring the accounting records, maintaining subsidiary accounts that separately track payments to each category of trust recipient would aid the timely reporting of payments to recipients of ELIC estate distributions.

The lack of maintaining separate accounts for tracking the payments made to the four recipients of the trusts may have contributed to the delayed identification of a $90 million posting error to the CLO general ledger distribution account in 1997 and a $62 million posting error to the CLO general ledger distribution account in 2002, which the CLO did not correct until September 2007. Another reason that the distribution account errors may not have been promptly identified during the 1997 through 2006 period is that, although the CLO reconciles its cash account to subsidiary databases for distributions to maintain control of cash, it did not reconcile the distributions reported in its general ledger to the subsidiary databases in order to maintain control for correct financial reporting. In addition, the inconsistent accounting and reporting practices for the 1997 through 2006 period when the CLO maintained the accounting records, may have contributed to the four months it took for the CLO to provide us with information on its sources and uses of ELIC estate funds from 1997 through 2006.

During this four-month period, the CLO made adjustments to its general ledger data and attempted to reconcile its beginning estate balances to supporting documentation, but found that the accounting records did not separately identify sources of ELIC estate funds during early 1997, prior to the time it took over the estate, and as a result, it needed to analyze source documents. The vice president of the CLO's estate finance group worked to correct these and other problems before providing us with a data extract from the CLO's general ledger for the ELIC estate. According to the vice president of the estate finance group, when the CLO began managing the estate in 1997, it received custody of thousands of boxes from the prior record keepers. The CLO eventually was able to provide a variety of source documents related to significant transactions we reviewed from the 1997 to 2006 period. Failure to maintain such basic accounting information hinders the CLO's ability to report on the uses of the distributions from the trusts.

Various reports covering the 2001 through 2004 period comment on CLO accounting problems and internal control weaknesses. In 2007 Finance issued a report on its review of the CLO's internal controls. The purpose of this review was to help the CLO assess the effectiveness of its internal control operations and to provide it with opportunities to correct any identified weaknesses. In addition, Finance reviewed the status of 30 findings from its 2004 audit and found the CLO had fully resolved 27.

The CLO's chief financial officer stated that the CLO has taken various steps to improve internal controls and accounting procedures. For example, the CLO has worked to improve its internal reporting functions by implementing an oversight committee. This three-person committee consists of the department's chief deputy of operations, its general counsel, and the deputy commissioner of financial surveillance. These executives meet on a quarterly basis to discuss the status and any current issues with the estates, the CLO's budget, and other topics relevant to managing the estates. The chief financial officer stated that this is an improvement over the past reporting functions because it formalizes communication and information sharing between the department and the CLO. The CLO's chief financial officer also stated that staff have addressed and made appropriate corrections of the problems contained in the prior Finance audit reports with respect to internal controls and procedural findings.

The CLO's chief financial officer reports the CLO has taken various steps to improve internal controls and accounting procedures.

Recommendations

To increase assurance that Aurora follows key provisions in the ELIC agreements, the commissioner should seek the right to review Aurora's future distributions of ELIC estate funds and review those distributions to ensure that it adds the proper amount of interest to the funds, and distributes the funds correctly.

In order to ensure that information is available to policyholders and other parties interested in the disposition of ELIC's assets, the commissioner should, as soon as practical after the end of each year and upon the termination of any trust, complete a report that includes the assets and liabilities; the amount of all distributions, if any, made to the trust beneficiaries; and all transactions materially affecting the trust and estate.

In order to ensure that the financial information reported by the CLO is accurate, the commissioner should continue the practice of auditing the ELIC estate and any trusts that remain open on a periodic basis as recently implemented by the current chief financial officer.

In order to ensure that it accurately records distributions in its primary accounting system, and its financial reporting is correct, the CLO should periodically reconcile the distributions reported in its general ledger to its subsidiary databases.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of the report.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

Date: January 31, 2008

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For questions regarding the contents of this report, please contact
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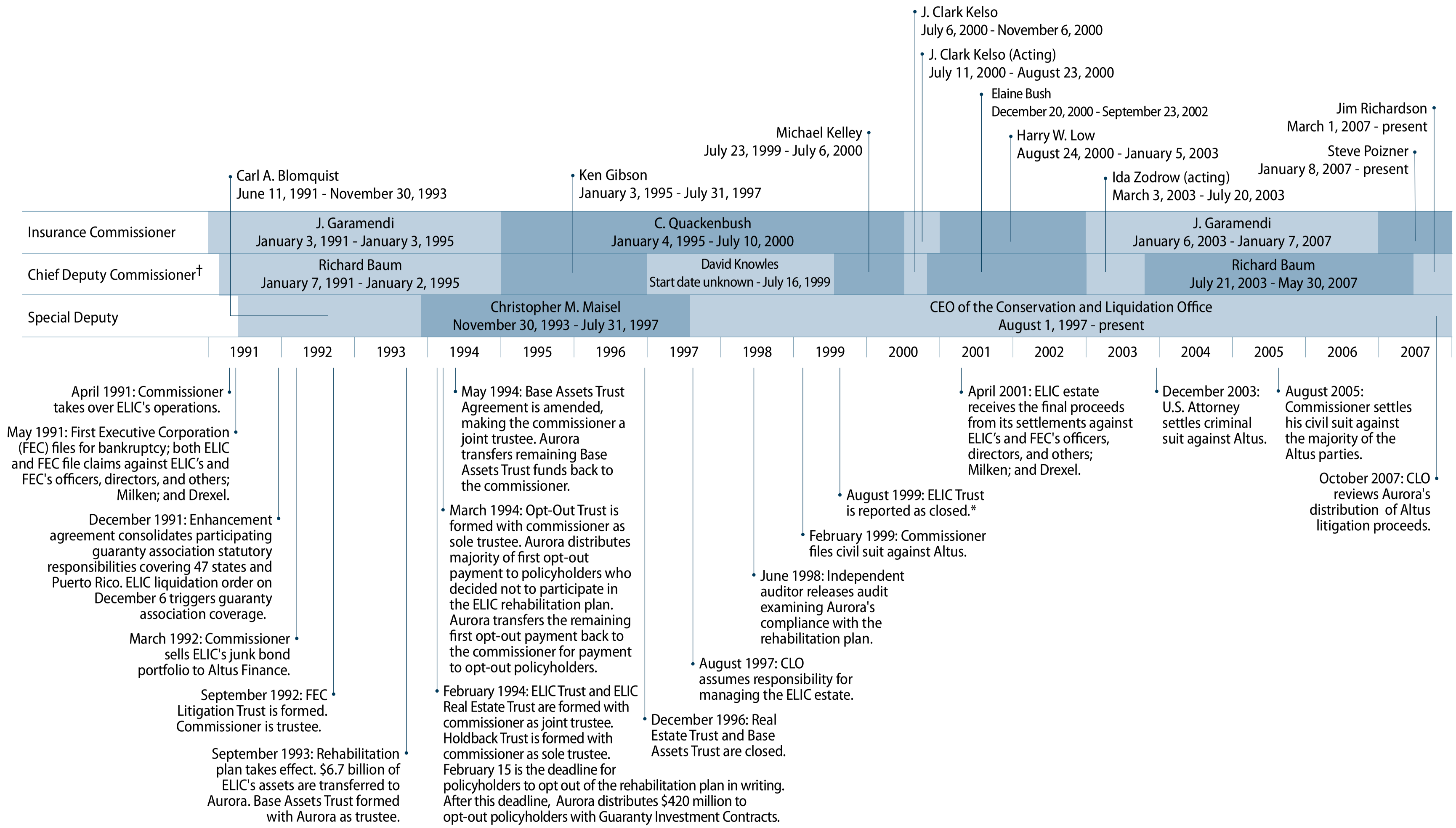
Appendix A

TIMELINE OF SIGNIFICANT EVENTS RELATED TO THE EXECUTIVE LIFE INSURANCE COMPANY

In the years leading up to the Executive Life Insurance Company's (ELIC) conservation to its current status as an estate being administered by the Conservation and Liquidation Office, a total of five different individuals have held the position of insurance commissioner. Additionally, over the years there have been eight chief deputy insurance commissioners (chief deputy) and three parties directly responsible for the day-to-day management of the ELIC estate. Figure A on the following page gives a timeline showing these various commissioners, chief deputies, and entities, as well as significant events related to the conservation and liquidation of ELIC and the distribution of its assets.

Figure A

Timeline of Significant Events Related to Conserving and Liquidating the Executive Life Insurance Company (ELIC)



Sources: The ELIC Rehabilitation Plan, ELIC trust agreements, court documents, and other documentation provided by the Department of Insurance.

* The Superior Court of California approved the termination of the ELIC Trust effective August 1999; however, the CLO did not close this trust until 2007.

† Chief deputy insurance commissioners as reported by the Department of Insurance.

Appendix B

SOURCES OF FINANCIAL INFORMATION USED IN THIS REPORT

During the process of gathering financial information on the Executive Life Insurance Company (ELIC) estate, we found three types of source information, depending on the time period. The first time period, April 1991 through 1993, occurred during ELIC's initial conservation, when the insurance commissioner (commissioner) was managing ELIC as an insurance company. During this period, the only available financial reports were the commissioner's annual reports to the governor and unaudited financial statements prepared by consultants to the commissioner. The underlying transactions and source documents were no longer available. The second time period, 1994 through 1996, occurred while a different special deputy insurance commissioner administered the estate and trusts. For this period, audited financial statements are available, but the underlying transactions were not. During the third time period, 1997 through 2006, the commissioner's Conservation and Liquidation Office (CLO) administered the ELIC estate and trusts, with the exception of the ELIC Trust, which was not transferred to the CLO until 1999. During this period, audit reports were provided for the ELIC Trust only up to 1999. The CLO did not have audits performed on the individual trusts in the estate until 2005.

Table B.1 on page 63 displays changes to the available assets by time period. From April 1991 though 1993, the commissioner managed ELIC in conservation, sold ELIC's junk bond investments, and transferred assets to the Aurora National Life Assurance Company (Aurora) for the ongoing servicing of policies whose holders continued with Aurora (opt-in policies). From 1994 through 1996, the commissioner appointed a special deputy to administer the ELIC estate. During this period many of the remaining ELIC estate assets were liquidated and distributed to policyholders and other estate beneficiaries. From 1997 through 2006, the CLO administered the ELIC estate, also distributing funds and continuing to recover litigation proceeds. In 2005 the largest settlement was reached, related to the Altus litigation. The commissioner has recovered $730 million from the Altus litigation thus far, using it to offset policyholder's losses.

Table B.2 on page 64 displays the ELIC estate's assets on four specific dates. The first date, April 11, 1991, was the day ELIC was conserved. On this date, the majority of ELIC's assets were in investments. December 31, 1993, was the year end after the majority of ELIC's assets were transferred to Aurora. As of this date, the commissioner still held approximately $670 million of ELIC's assets. December 31, 1996, was the year end preceding the date the

CLO began administering the ELIC estate and trust. On this date, the commissioner still held $432 million in assets and reported $223 million in liabilities. December 31, 2006, was the date through which we requested financial information from the CLO. On this date, the commissioner still held $378 million in assets and reported $53 million in liabilities.

Table B.3 on page 65 displays the funding sources for the commissioner's enhancement payments to beneficiaries. Beneficiaries including the National Organization of Life and Health Insurance Guaranty Associations have received $1.6 billion in enhancement payments from the commissioner. During the 1994 through 1996 period, $424 million was paid from the Real Estate Trust, $354 million from the Base Assets Trust, and $241 million from the ELIC Trust. These three trusts were known as the liquidating trusts. Over time the three trusts converted assets to cash, which subsequently was distributed to the opt-in policyholders and those who chose not to continue with Aurora (opt-out policyholders). All three trusts have served their purposes and are now closed. During the same period, $5.6 million in interest from the Holdback Trust was distributed. The commissioner established the Holdback Trust in 1994 to ensure that the department had funds available to address financial uncertainties.

The remaining $537 million in funding sources during the 1997 through 2006 period consisted of payments from the ELIC Trust, the FEC Litigation Trust, First Lincoln (discussed in the next paragraph), the ELIC Estate, and interest during the time when the CLO was managing ELIC.

During 1997 through 2006, the ELIC Trust paid $67 million to beneficiaries. The FEC Litigation Trust, established in 1992 as a repository for litigation proceeds from the lawsuits filed principally against Michael Milken; Drexel Burnham Lambert, Inc.; and the First Executive Corporation's directors, officers, and accountants, paid $72 million. Additionally, $2.8 million was distributed from First Lincoln. First Lincoln's contributed funds were related to the dissolution of a reinsurance agreement with ELIC. Finally, distributions of $352 million from the ELIC estate related to the Altus litigation and $44 million in interest were made during this period.

Table B.1
Changes in Available Assets for Three Time Periods of the Executive Life Insurance Company Estate
April 11, 1991, to December 31, 2006
(in Thousands)

	UNAUDITED FINANCIAL STATEMENTS		AUDITED FINANCIAL STATEMENTS		UNAUDITED FINANCIAL DATABASE			
	1991–1993		1994–1996		1997–2006		1991–2006	
Beginning Balances		**$8,803,945**		**$669,749**		**$209,105**		**$8,803,945**
1992 investment losses*		(1,343,431)		–		–		(1,343,431)
Assets after losses		7,460,514		669,749		209,105		7,460,514
Additions to Assets								
Investment income	$919,368		$324,254		$127,149		$1,370,771	
Litigation proceeds†	–		322,087		745,518		1,067,605	
Premium income	280,203		–		–		280,203	
Miscellaneous‡	59,136		53,716		(94,566)		18,286	
Total additions		1,258,707		700,057		778,101		2,736,865
Total available assets		**8,719,221**		**1,369,806**		**987,206**		**10,197,379**
Deductions to Assets								
Transferred to Aurora§	(6,670,106)			–	–		(6,670,106)	
Paid to beneficiaries‖	(1,112,199)		(1,024,829)		(537,389)		(2,674,417)	
Administrative costs#	(267,167)		(135,872)		(124,743)		(527,782)	
Total deductions		**(8,049,472)**		**(1,160,701)**		**(662,132)**		**(9,872,305)**
Ending balances		**$669,749**		**$209,105**		**$325,074**		**$325,074**

Sources: Unaudited financial statements for the period April 1991 through 1993, independently audited financial statements for the period 1994 through 1996, and the Conservation and Liquidation Office's (CLO) Executive Life Insurance Company (ELIC) financial database for the period 1997 through 2006.

Note: Due to the lack of availability of source documents for the period April 1991 through 1996, and due to control weaknesses in the CLO accounting system during the 1997 through 2004 period, the information presented is of undetermined reliability. We include the information in our audit due to the lack of other, more reliable sources.

* 1992 investment losses represent the estimated loss from the sale of long-term investments in 1992. Gains and losses for other periods are included in investment income. The available financial statements for 1992 do not include an operating statement reporting investment losses, income, and expenses. Thus, this estimate is auditor prepared based on available information from the statement of sources and uses of cash.

† As shown in Table 2 on page 21, most of this amount represents the proceeds from two lawsuits to which the commissioner was a party representing ELIC.

‡ This amount consists of various additions and deductions not otherwise classified, including $244 million in Base Assets Trust funds that Aurora transferred back to the ELIC estate in 1994; a $230 million reduction in net assets of the ELIC estate in 1994 due to a change in the method of reporting net assets between 1993 and 1994; $81.5 million in miscellaneous income; $75 million paid to Aurora in a 1998 legal settlement; and various other less material amounts.

§ As shown in Table 3 on page 22, $ 2.7 billion has been paid to beneficiaries and $4 billion remained with Aurora for the ongoing servicing of opt-in policies.

‖ As shown in Table 4 on page 23, $1.1 billion was paid to policyholders prior to the transfer of assets to Aurora. Additionally, $822 million was distributed by the CLO or sent to Aurora for it to distribute to opt-in policyholders and other beneficiaries, $666 million was paid to opt-out policyholders, and $74 million was paid to the National Guaranty Organization.

\# As shown in Table 5 on page 25, this amount consists of legal and professional fees, salaries and wages, and operating expenses.

Table B.2
Balance Sheets for Three Time Periods of the Executive Life Insurance Company Estate (in Thousands)

	UNAUDITED FINANCIAL STATEMENTS		AUDITED FINANCIAL STATEMENTS	UNAUDITED FINANCIAL DATABASE
	APRIL 11, 1991	DECEMBER 31, 1993	DECEMBER 31, 1996	DECEMBER 31, 2006
Assets				
Cash	$12,967	$26,326	$346,014	$6,749
Investments	7,703,910	475,364	–	368,300
Receivables	1,076,750	149,520	86,224	3,367
Other assets	10,319	18,539	–	–
Total assets	**8,803,946**	**669,749**	**432,238**	**378,416**
Liabilities				
Liability to policyholders			209,140	2,998,732
Deficiency				(2,968,508)
Secured liabilities				13,741
Payables			13,993	9,377
Total liabilities	**–**	**–**	**223,133**	**53,342**
Assets available for future distribution	**$8,803,946**	**$669,749**	**$209,105**	**$325,074**

Sources: Unaudited financial statements for the period April 1991 through 1993, independently audited financial statements for the period 1994 through 1996, and the Conservation and Liquidation Office's (CLO) Executive Life Insurance Company financial database for the period 1997 through 2006.

Note: Due to the lack of availability of source documents for the period April 1991 through 1996, and due to control weaknesses in the CLO accounting system during the period 1997 through 2004, the information presented is of undetermined reliability. We include the information in our audit due to the lack of other, more reliable sources. Additionally, the financial statements for the April 1991 through 1993 period did not separately identify the liabilities. Instead, they displayed all the assets as the conservator's liabilities. In an effort to remain consistent throughout the April 1991 through 2006 period, we excluded the liabilities during this period from this table. The net assets for each period correspond to the changes in net assets shown in Table B.1.

Table B.3
Funding Sources for Enhancement Payments to Beneficiaries (in Thousands)

	OPT-INS	OPT-OUTS	NATIONAL GUARANTY ORGANIZATION	TOTALS
1994 to 1996				
Real Estate Trust	$280,332	$143,700	–	$424,032
Base Assets Trust	230,323	123,836	–	354,159
ELIC Trust	142,141	98,859	–	241,000
Holdback Trust	5,638	-	–	5,638
Subtotals	658,434	366,395	–	1,024,829
1997 to 2006				
ELIC Trust	51,306	15,500		66,806
FEC Litigation*	15,785	28,082	$27,949	71,816
First Lincoln*	2,451	330	–	2,781
ELIC Estate (Altus)	93,928	211,380	46,339	351,647
Interest	–	44,339	–	44,339
Subtotals	163,470	299,631	74,288	537,389
Totals	**$821,904†**	**$666,026‡**	**$74,288**	**$1,562,218**

Sources: Independently audited financial statements for the period 1994 through 1996, and other documentation provided by the Conservation and Liquidation Office (CLO) for the 1997 through 2006 period.

Note: See Table 6 on page 26 for more information on how the opt-in funds were distributed.

* The opt-in amounts totaling $18.2 million were distributed directly by the CLO. See Appendix C, Table C.2.

† Table 6 differs from this amount by $8 million because it excludes the $18 million First Executive Corporation and First Lincoln distribution made by the CLO but includes $26 million in proceeds from the Holdback Trust that is not included in this table.

‡ This amount plus the $769 million transferred by Aurora as shown in Table 3 make up the $1.4 billion enhancement payments that the insurance commissioner distributed to opt-out policyholders as displayed by type of policy in Table C.1 in Appendix C.

Appendix C

PAYMENTS TO POLICYHOLDERS BY POLICY TYPE AND DISTRIBUTION YEAR

The three tables in this appendix summarize payments made to policyholders by policy type and distribution year. Table C.1 on the following page lists these payments for policyholders who decided not to participate in the Executive Life Insurance Company's (ELIC) Rehabilitation Plan (opt-out policyholders). These policyholders received an initial opt-out payment from Aurora National Life Assurance Company (Aurora). This payment represented each opt-out policyholder's share of the liquid assets that the commissioner transferred to Aurora, and it amounted to $1.2 billion of the $6.7 billion in ELIC assets that were transferred. Additionally, Aurora paid $420 million to guaranteed investment contract (GIC) opt-out policyholders prior to the distribution of the first opt-out payment.

After the distribution of the first opt-out payment, opt-out policyholders received further distributions from the commissioner that consisted of proceeds from the sale of assets and litigation funds from the various liquidating trusts and interest accrued by the trusts, as well as the remainder of the first opt-out payment.

Table C.2 on page 69 lists distributions made to policyholders who chose to continue with Aurora (opt-in policyholders). As the table illustrates, Aurora credited or distributed a total of $466 million in funds to opt-in policyholders between September 3, 1993, and December 31, 2006. This amount includes funds credited or distributed to policyholders as part of the ELIC distributions occurring in 1995, 1996, 1997, 2000, and 2006, as well as $50 million paid to third parties and $41 million paid to opt-in policyholders under articles 25 and 26 of the Rehabilitation Plan (rehabilitation plan). Under these provisions of the rehabilitation plan, Aurora agreed to provide additional funding to some policyholders who incurred large losses as a result of ELIC's insolvency.

Table C.3 on page 70 lists the combined distributions to both opt-in and opt-out policyholders made by Aurora and the Conservation and Liquidation Office (CLO) by year. This table combines the distribution data from the previous two tables in this appendix. In 1994 Aurora provided $41 million to opt-in policyholders under articles 25 and 26 of the rehabilitation plan. Opt-in policyholders received additional distributions of ELIC funds from Aurora in 1995, 1996, 1997, 2000, and 2006, totaling $425 million, and an $18 million 2002 distribution from the CLO primarily from the FEC Litigation Trust. In addition to a $1.7 billion payment to opt-out policyholders from Aurora, the CLO distributed approximately $1.4 billion to opt-out policyholders from the Opt-Out Trust from 1995 through 2006, for a total of $3.1 billion.

Table C.1
Distributions to Opt-Out Policyholders by Policy Type
September 3, 1993, to December 31, 2006
(in Thousands)

POLICY TYPE	LIQUIDATION ADVANCE AND FIRST OPT-OUT PAYMENT (AURORA)*	LITIGATION PROCEEDS, REMAINDER OF FIRST OPT-OUT PAYMENT, AND OTHER ENHANCEMENTS (COMMISSIONER)†	TOTAL DISTRIBUTION BY POLICY TYPE
Whole life products	$55,233	$56,222	$111,455
Deferred annuities	35,493	29,882	65,375
Payout annuities	58,397	50,479	108,876
Guaranteed investment contracts	1,508,413	1,298,529	2,806,942
Totals for all opt-out contracts	**$1,657,536‡**	**$1,435,112§ǁ**	**$3,092,648**

Sources: Aurora's Policy Detail File (PDF) and guaranteed investment contract (GIC) first opt-out payment schedule, Conservation and Liquidation Office's (CLO) Trust Administration System and third-party spreadsheets.

* This distribution was funded from the $6.7 billion transferred to Aurora on September 3, 1993, as shown in Table 3 on page 22. The distribution of these funds is as reported by Aurora and the CLO and is of undetermined reliability. Although we were able to reconcile the first opt-out payment to postings to policyholder accounts in the PDF, some of the supporting checks evidencing payments were not available for our review. Additionally, we were unable to determine the reliability of the GIC liquidation advance amounts. Although an independent auditor verified these payments in 1998, and we were able to obtain copies of letters sent to relevant GICs regarding the amount of funds they would or had received, we did not obtain documents supporting actual payments.

† The distribution of these funds is reported by the CLO through December 31, 2006, and is sufficiently reliable for the purposes of the audit; we were able to determine that the data was complete and all of the transactions we tested agreed with source documents. These funds have the effect of reducing the losses the policyholders incurred as a result of the Executive Life Insurance Company insolvency, referred to as enhancements.

‡ This amount comprised of a $1.2 billion first opt-out payment and a $420 million liquidation advance to guaranteed investment contracts. Additionally, some policyholders may have received more than what we have reported as a result of Aurora providing loans to policyholders. In our work, we could not determine the exact amount of these loans.

§ Of this amount, approximately $285,000 was paid directly to third parties. The CLO tracks third-party payments through third-party spreadsheets. We could not determine the exact amount paid to third parties because the CLO has not recorded all payments that it has made to third parties. Additionally, policyholders may have received more than what we have reported in the table as a result of payments they received from third parties. However, because the CLO does not fully track these amounts, we could not determine the amounts.

ǁ This distribution was funded from the $6.7 billion transferred to Aurora on September 3, 1993, ($769,086) as shown in Table 3, and from the CLO ($666,026) as shown in Table 4 on page 23.

Table C.2
Distributions to Opt-In Policyholders by Policy Type
September 3, 1993, to December 31, 2006
(in Thousands)

POLICY TYPE	AURORA*	CONSERVATION AND LIQUIDATION OFFICE†	TOTALS
Whole life products	$135,044	$2,057	$137,101
Deferred annuities	83,051	1,043	84,094
Payout annuities	208,577	12,710	221,287
All other contracts	38,642	1,433	40,075
Undetermined	756	993	1,749
Totals	**$466,070‡**	**$18,236**	**$484,306**

Sources: Aurora's Policy Detail File, Account Value Increment (AVI), and AVI Distribution History databases, and the Conservation and Liquidation Office's (CLO) First Executive Corporation distribution spreadsheets.

Note: Represents payments from various trusts controlled by the insurance commissioner after Aurora assumed Executive Life Insurance Company's (ELIC) restructured insurance policies as well as funds that Aurora added through December 31, 2006. These funds have the effect of reducing the losses the policyholders incurred as a result of the ELIC insolvency, referred to as enhancements.

* The distributions are as reported by Aurora and are of undetermined reliability. Our procedures to determine the reliability of the data were limited to examining selected checks to policyholders and did not include tracing credits to policyholder accounts from these systems to source documents verifying policyholder account balances.

† The distributions are as reported by the CLO through December 31, 2006, and are of undetermined reliability. Because the total distributed by the CLO is less than 4 percent of the total distributed to opt-ins, we obtained listings of the policies receiving payment, but did not perform test procedures such as examining checks to verify amounts paid at the policy level. Amounts the CLO distributed from the Holdback Trust are not included; the CLO does not have a systematic way of summarizing all enhancement funds it paid directly to policyholders from the Holdback Trust, hence, we were not able to obtain this amount.

‡ This amount is $6.1 million more than the amount listed as paid or credited to policyholders in the "Note" in Table 6 on page 26.

Table C.3
Distributions to Opt-In and Opt-Out Policyholders by Year (in Thousands)

DISTRIBUTION YEAR	OPT-INS *	OPT-OUTS†	TOTALS
1994	$41,060‡	$1,657,536§	$1,698,596
1995	122,105	798,363	920,468
1996	65,740	175,018	240,758
1997	28,498	207,730	236,228
1998	–	148	148
1999	–	21,066	21,066
2000	110,797	217	111,014
2001	–	156	156
2002	18,236ll	21,944	40,180
2003	–	2,053	2,053
2004	–	3,895	3,895
2005	–	26,751	26,751
2006	97,870	177,771	275,641
Totals	**$484,306**	**$3,092,648**	**$3,576,954**

Sources: Aurora's Policy Detail File, guaranteed investment contract (GIC) first opt-out payment schedule, Account Value Increment (AVI), and AVI Distribution History databases; the Conservation and Liquidation Office's (CLO) First Executive Corporation distribution spreadsheets and Trust Administration System Opt-Out Database; and other documentation provided by the CLO.

Note: Represents payments from various trusts controlled by the insurance commissioner after Aurora assumed Executive Life Insurance Company's (ELIC) restructured insurance policies as well as funds that Aurora added. These funds have the effect of reducing the losses the policyholders incurred as a result of the ELIC insolvency.

* Except for the distribution that occurred in 2002, these distributions are as reported by Aurora and are of undetermined reliability. Our procedures to determine the reliability of the data were limited to examining selected checks to policyholders, but did not include tracing credits to policyholders from these systems to policyholder accounts.

† Except for the first opt-out payment, this distribution is reported by the CLO and is sufficiently reliable for the purposes of our audit because we were able to determine universe completeness and all transactions sampled agreed with source documents.

‡ Amount Aurora credited to policyholder accounts for structured and special settlements.

§ First opt-out payment and GIC liquidation advance distributed by Aurora. The amount is of undetermined reliability, as some of the supporting checks from 1994 evidencing payments were not available for our review. Additionally, we were unable to determine the reliability of the GIC liquidation advance amounts. Although an independent auditor verified these payments in 1998, and we were able to obtain copies of letters sent to relevant GICs regarding the amount of funds they would or had received, we did not obtain documents supporting actual payments.

ll The distributions are as reported by the CLO and are of undetermined reliability. This distribution by the CLO is not material, so we did not examine checks to policyholders or credits to policyholder accounts.

Appendix D

LEGAL AND PROFESSIONAL SERVICE FEES SINCE 1991

In a previous report, we determined that $165 million had been spent on the two major lawsuits related to the Executive Life Insurance Company (ELIC), and its corporate parent First Executive Corporation (FEC) litigation, and the Altus litigation, and concluded that outside counsel fee agreements and other service agreements had reasonable terms and fees.[21] As of the end of December 2006, the commissioner had spent a total of $231 million for legal and professional services. From April 1991 through 1993, $59 million in legal, audit, and consulting services fees were incurred. From 1994 through 1996, $73 million was spent on legal, professional, contingent, and litigation fees. From 1997 through 2006, $99 million was spent on legal and professional fees, most of which was for outside legal contingent fees. Table D on the following page displays a summary of these costs for each of the time periods we examined.

[21] Bureau of State Audits report titled *Department of Insurance: Its Conservation and Liquidation Office Continues to Collect and Distribute Proceeds From the Liquidation of the Executive Life Insurance Company*, report 2005-115.1, October 2006.

Table D
Legal and Professional Fees, Executive Life Insurance Company Estate (in Thousands)

	1991–1993	1994–1996	1997–2006	TOTAL
Legal and Professional				
Legal, audit, and consulting services	$59,151			$59,151
Legal and professional fees		$5,602		5,602
Contingent fees*		65,573	$54,371	119,944
Department of Insurance legal			419	419
Department of Justice legal			345	345
Other legal expense (outside legal)			22,786	22,786
Other litigation expense (experts, court fees, etc.)			13,750	13,750
Litigation costs†		1,419		1,419
Professional Fees				
Accounting and auditing expense			479	479
Department of Insurance nonlegal			14	14
Other professional fees			5,107	5,107
Software contractor expense			741	741
Tax consultant and compliance expense			884	884
Total legal and professional fees	**$59,151**	**$72,594**	**$98,896‡**	**$230,641**

Sources: Unaudited financial statements for the period April 1991 through 1993, independently audited financial statements for the period 1994 through 1996, the Conservation and Liquidation Office's (CLO) Executive Life Insurance Company financial database, and other documentation provided by the CLO for the period 1997 through 2006.

Note: Due to the lack of availability of source documents for the period April 1991 through 1996, and due to control weaknesses in the CLO accounting system during the 1997 through 2004 period, the information presented is of undetermined reliability. We include the information in our audit due to the lack of other, more reliable sources.

* Our source for the 1997 through 2006 period was limited to separately identifying the contingent fees.

† Litigation costs were reported separately in the audit reports for the 1994 through 1996 period.

‡ Included in this amount is $1.8 million paid to the National Organization of Life and Health Insurance Guaranty Associations (national guaranty organization) for legal costs in 2005. This amount is the result of an agreement with the commissioner to reimburse the national guaranty organization for expenses it incurred while helping the insurance commissioner present and prosecute the Altus case.

Appendix E

THE DEPARTMENT OF INSURANCE'S LETTER TO A MEMBER OF THE LEGISLATURE REGARDING EXECUTIVE LIFE INSURANCE COMPANY POLICYHOLDER LOSSES

The following pages contain the letter prepared by the Department of Insurance (department) in response to a member of the Legislature's request for information regarding the losses suffered by Executive Life Insurance Company policyholders. We present a summary version of the table included in the department's letter, with additional calculations, as shown in Table 8 on page 33 in Chapter 2.

Page 1
8/19/2005STATE OF CALIFORNIA
JOHN GARAMENDI, *Insur.*

DEPARTMENT OF INSURANCE
Legal Division, Office of the Commissioner
45 Fremont Street, 23rd Floor
San Francisco, CA 94105

Gary M. Cohen
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RECEIVED
AUG 2 3 2005
COMMISSIONER'S OFFICE
SACRAMENTO, CA

August 22, 2005

The Honorable Dave Cox
State Capitol, Room 2068
Sacramento, CA 95814

SUBJECT: Executive Life Insurance Company

Dear Senator Cox:

I am writing on behalf of Commissioner Garamendi to respond to your letter dated August 2, 2005 regarding the value of the Executive Life Insurance Company (ELIC) bond portfolio and the payments that have been made to ELIC.

There was no accounting that was used by the Department of Insurance to value the ELIC portfolio at the time of sale. One of the principal reasons the bond portfolio was sold by an auction was because it was very difficult, if not impossible, to value. Judge Lewin concluded that the only way to determine its value was by looking at what a buyer was willing to pay for it. Whatever analysis the bidders did to determine what their bids should be was not available to the Department.

Enclosed is a chart which shows the recoveries that have been made to date, by policy type and guaranty fund coverage, and also shows a calculation of the estimated remaining shortfall. The $936 million estimated shortfall set forth in the chart is somewhat artificial; it represents the amount of the shortfall that would have existed as of September 3, 1993 if all of the subsequent distributions had been paid to the policyholders on that date. In addition, it does not reflect the amount by which the benefits due to policyholders would have increased over time.

Also enclosed is a chart showing the distributions to policyholders that were made from litigation recoveries (but not including the *Credit Lyonnais* litigation) and the ELIC trusts. The latter chart, and a chart showing shortfalls, were previously provided to the "ELAN" policyholder group.

You may be aware that approximately 8% of the ELIC policyholders elected to opt out of the ELIC Rehabilitation Plan. As the Commissioner has stated, 92.45% of the policyholders that opted-in to the Plan received all of the payments they would have received had ELIC not become

The Honorable Dave Cox
August 22, 2005
Page 2

insolvent. They were made whole through payments made from the assets of ELIC (that were transferred to Aurora National Life Assurance Company) and the state guaranty associations. Losses that were suffered in connection with those policies were borne by the guaranty associations.

Of the opt-in policyholders, 7.55% were either partially covered or uncovered by guaranty associations. Although some received 100% of the payments promised by their ELIC policies, most received less due to a number of factors. Chief among those were large policy values and relatively low payment limits of state guaranty funds, and in certain instances the taking of hardship payments during the conservation period (April 1991 through September 1993.) Other factors in the court-approved Rehabilitation Plan, including the calculation of reserves and interest rates, affected their recoveries. Large structured settlement policyholders (which are included in the chart's "annuities in payment status" lines) are in the group that received less than 100%. We would be happy to discuss the effect of the Rehabilitation Plan on different policyholder groups with you in detail if you desire.

The unfortunate result of insolvency is that creditors may not receive 100% of their claims. Between the Rehabilitation Plan, Enhancement Agreement, trust recoveries, litigation recoveries and pending *Credit Lyonnais* recoveries, we believe we achieved the best possible result for the ELIC policyholders. We look forward to working with you and your staff to discuss any further questions that you may have.

Sincerely,

Gary M. Cohen
General Counsel

cc: The Honorable Jackie Speier
Insurance Commissioner John Garamendi

#348582v1

Executive Life Insurance Company
Policyholder Return to Date
And Associated Notes
(Dollars in Millions)

Contract Type	Contract Count	Note 1 Total Statutory Reserves at 4/11/91	Note 2 "Shortfall" at 9/3/93	Note 3 Guaranty Association Payments	Note 4 Post Closing Distributions to Policyholders	Note 5 Remaining Unfunded Shortfall	Note 6 Percentage of Original Policy Rights Funded
Opt In Contracts:							
Fully Covered by Guaranty Associations:							
Whole Life Products	130,949	$1,714	$592	$592		$0	100.00%
Deferred Annuities	48,028	990	297	297		0	100.00%
Annuities in Payment Status	98,290	1,203	739	739		0	100.00%
All Other Contracts	53	47	10	10		0	100.00%
Total Fully Covered Contracts	277,320	3,953	1,638	1,638	0	0	
Percentage of all Opt In Contracts (Note 7)	92.45%						
Partially Covered by Guaranty Associations:							
Whole Life Products	5,836	811	275	132	87	57	93.02%
Deferred Annuities	2,722	303	90	53	47	(11)	103.68%
Annuities in Payment Status	3,231	699	469	165	158	147	78.99%
All Other Contracts	14	63	16	13	6	(3)	104.35%
Total Partially Covered Contracts	11,803	1,876	850	363	297	189	
Percentage of all Opt In Contracts	3.93%						
Non-Covered Contracts:							
Whole Life Products	5,666	114	39		12	27	76.39%
Deferred Annuities	1,324	34	10		6	5	86.24%
Annuities in Payment Status	3,406	72	46		16	29	59.05%
All Other Contracts	448	268	50		22	28	89.55%
Total Non-Covered Contracts	10,844	489	145	0	56	89	
Percentage of all Opt In Contracts	3.62%						
Total -- All Opt In Contracts	299,967	6,318	2,633	2,001	353	279	
Opt Out Contracts:							
Whole Life Products	15,093	204	78		27	51	74.77%
Deferred Annuities	2,292	55	16		7	9	83.95%
Annuities in Payment Status	9,731	82	41		11	30	63.27%
All Other Contracts	162	2,802	933		366	567	79.77%
Total -- All Opt Out Contracts	27,278	3,142	1,068	0	411	657	
Total -- All Contracts	327,245	$9,461	$3,701	$2,001	$764	$936	

Executive Life Insurance Company
Policyholder Return to Date
And Associated Notes
(Dollars in Millions)

Note 1 -- In order to distribute the assets of ELIC among the policyholders a consistent claim basis had to be determined. In accordance with a decision of the Court of Appeals, the Commissioner selected Conservation Date (4/11/91) Statutory Reserves (commonly referred to as "CDSR") as the basis of allocation among policyholders. While CDSR does not necessarily reflect the "value" of a policy, it is presented here to give the reader an indication of the relative size of various policy types and the overall magnitude of the liabilities of ELIC as of the conservation date.

Note 2 -- "Shortfall" in the context of ELIC is the difference between what the original ELIC policy promised and what the restructured ELIC policy provided. For a policy which had an account value, (life products and deferred annuities) Shortfall is the amount that would restore the account value to its pre-conservation level. For annuity products in payment status shortfall is the additional amount that would be required to restore the payment stream to the level promised by the original ELIC contract. Shortfall is the best measure of the loss of ELIC policyholders. There has been considerable press about the fact that the loss to ELIC policyholders was approximately $4.5 billion. This amount is a function of the total shortfall noted above of $3.7 billion, incremented with interest after September 3, 1993. September 3, 1993 was the date of closing of the Rehabilitation Plan for ELIC, the date at which the ELIC policies were restructured and the date at which Shortfall was computed

Note 3 -- The Participating Guaranty Associations (PGA's) as represented by the National Organization of Life and Health Guaranty Associations, or NOLHGA, funded their statutory requirements in ELIC through the "Enhancement Agreement". The amount in this column represents the liability of the PGA's to fund their obligations relative to ELIC. This amount is paid over time, with interest, as payments are made to policyholders, either through withdrawal of funds for life and deferred annuity products, or through policy required routine periodic payments to annuitants. The liability of the PGA's relative to life and deferred annuity products was funded in its entirety pursuant to the Enhancement Agreement in 1998.

Note 4 -- Following the restructuring of ELIC's policies in September, 1993 certain assets were placed into, and liquidated by, trusts referred to in ELIC as "Enhancement Trusts". The Enhancement Trusts distributed in excess of $1.1 billion. Pursuant to statutory requirements and the Enhancement Agreement, the PGA's are subrogated to post-closing distributions to the extent of their payments. The amounts in this column reflect only those payments which were made directly to the policyholders and exclude amounts paid to the PGA's pursuant to their subrogation rights.

Note 5 -- This amount represents the remaining amount which would be required to fully restore the ELIC policyholders to their pre-conservation levels as of September 3, 1993. It does not reflect the time value of money.

Note 6 -- The percentage is presented as a reflection of the extent of payment of ELIC's policyholders through a combination of the assets of ELIC, the support of the PGA's and the post closing distributions, and is calculated as the reciprocal of the relationship between unfunded shortfall. and CDSR.

Note 7 -- The Commissioner has stated that 92% of ELIC's policyholders who opted in to the Rehabilitation Plan received 100% of their contract rights. This percentage shows that 92.45% of ELIC's "opt-in" contractholders were fully covered by the PGA's, and had no shortfall following enhancement of their policies by the PGA's.

EXECUTIVE LIFE INSURANCE COMPANY
ENHANCEMENT TRUST DISTRIBUTIONS

		AURORA (OPT IN CONTRACTS)	OPT OUT TRUST (OPT OUT CONTRACTS)	TOTAL
REAL ESTATE TRUST				
First Distribution	1/26/95	112,390,230	57,609,770	170,000,000
Second Distribution	12/14/95	105,779,040	54,220,960	160,000,000
Third Distribution	12/30/96	62,163,802	31,868,623	94,032,425
Total Real Estate Trust		280,333,072	143,699,353	424,032,425
BASE ASSETS TRUST				
First Distribution	1/26/95	115,695,825	59,304,175	175,000,000
Final Opt Out Adjustment	2/1/95		5,772,311	5,772,311
Second Distribution	12/14/95	66,111,900	33,888,100	100,000,000
Third Distribution	12/30/96	48,515,606	24,871,799	73,387,405
Total Base Assets Trust		230,323,331	123,836,385	354,159,716
ELIC TRUST				
First Distribution	1/26/95	72,723,090	37,276,910	110,000,000
Second Distribution	12/14/95	69,417,495	35,582,505	105,000,000
Third Distribution	12/30/96		26,000,000	26,000,000
Fourth Distribution	1/99	6,700,000	4,200,000	10,900,000
Fifth Distribution	8/99	22,600,000	11,300,000	33,900,000
Total ELIC Trust		171,440,585	114,359,415	285,800,000
Deemed Securities Proceeds		35,652,122		
Article 10		135,788,463		
FEC LITIGATION TRUST				
First Distribution	10/02	46,796,298	24,064,919	70,861,217
TOTAL ENHANCEMENT TRUST DISTROS		728,893,286	405,960,072	1,134,853,358

Appendix F

ESTIMATE OF ECONOMIC LOSSES AS OF THE CLOSING DATE

Tables F.1 and F.2 on the following pages show the results of our estimate of the economic losses suffered by policyholders as a result of the Executive Life Insurance Company (ELIC) insolvency as of September 3, 1993, the date the ELIC Rehabilitation Plan (rehabilitation plan) closed and Aurora National Life Assurance Company (Aurora) assumed substantially all of the assets and liabilities of ELIC. We estimated the total losses as of September 3, 1993, to be $2.8 billion. Specifically, we estimated the losses to opt-in policyholders at September 3, 1993, to be $882 million, and we estimated the losses to opt-out policies to be $1.9 billion.

Our calculation of estimated opt-in policyholder losses is the sum of several factors. The first factor that is included in our calculation is the increase in mortality charges for opt-in life policies during the interim period.[22] Mortality charges are a feature of life insurance policies. Because the insurance company bears the risk of the insured's death at any time, there is a cost associated with any time period during which that risk is borne. To the extent that these charges are greater than would be expected had ELIC not become insolvent, they represent a loss to policyholders.

We also included the lost account value interest that resulted from the insolvency due to decreased crediting rates. This loss was determined using the difference between the industry average interest rates and the rates that annuity policies actually earned under the rehabilitation plan. Lost interest that resulted from delayed or reduced payments and the difference between what policyholders earned under the rehabilitation plan and what they would have earned had ELIC not become insolvent are important factors that affect policyholder losses.

Our estimation of opt-in losses at closing also includes the department's calculation of the shortfall in policy value, which is the department's calculation of the difference between what the original ELIC policy promised and what the restructured ELIC policy provided. This amount was reduced by the guaranty association enhancement amount, which was contributed by the participating guaranty associations and administered by the National

22 The interim period was the period between the date when ELIC was conserved (April 11, 1991) and the date when the rehabilitation plan took effect (September 3, 1993).

Organization of Life and Health Insurance Guaranty Associations (national guaranty organization).[23] We estimate the total losses to opt-in policyholders as of the closing date to be $882 million.

The estimation of losses to opt-out policyholders was much less complicated. We started with the expected account value at industry average rates that policyholders would have held had ELIC not become insolvent and reduced this amount by the payments received by opt-out policyholders prior to the closing date. We estimated total losses for opt-out policyholders as of the closing date to be $1.9 billion.

Table F.1
Calculation of Estimated Losses to Opt-In Policyholders as of September 3, 1993
(Dollars in Millions)

ITEM	OPT-IN
Number of policies	303,171
Increased mortality charges during interim period	$51
Lost account value interest resulting from the Executive Life Insurance Company's insolvency	$107
Shortfall	$2,757
National guaranty organization enhancement amount	($2,033)
Estimated losses to opt-in policyholders	$882

Sources: Policy Detail File, other documentation from the Department of Insurance and Aurora, and calculations based on these sources.

Note: The inputs to our calculation of the estimated policyholder losses are as reported by Aurora and are of undetermined reliability. Our procedures were limited to examining selected checks paid to opt-in policyholders and source documentation was not available to verify the accuracy of the data we utilized from the Policy Detail File relating to policyholder losses.

[23] The term "participating guaranty associations" refers to the state guaranty associations that participated in the ELIC Enhancement Agreement. The role of the National Organization of Life and Health Insurance Guaranty Associations and its relationship to the state guaranty associations is discussed more fully in the Introduction.

Table F.2
Calculation of Estimated Losses to Opt-Out Policyholders as of September 3, 1993
(Dollars in Millions)

ITEM	OPT-OUT
Number of policies	27,276
Estimated expected Executive Life Insurance Company account value as of September 3, 1993	$3,551
Value of pre-closing payments to opt-out policyholders as of September 3, 1993	($1,604)
Estimated losses to opt-out policyholders	$1,947

Sources: Policy Detail File, other documentation from the Department of Insurance and Aurora, and calculations based on these sources.

Note: The inputs to our calculation of the estimated policyholder losses include payments made by the commissioner that we determined to be reliable, and payments as reported by Aurora, which are of undetermined reliability. Our procedures for evaluating payments made by Aurora were limited to examining selected checks paid to opt-out policyholders who terminated their Aurora policies at the opt-out determination date, and source documentation was not available to verify the accuracy of the data we utilized from Aurora's Policy Detail File relating to policyholder losses.

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(Agency response provided as text only.)

Department of Insurance
300 Capitol Mall, Suite 300
Sacramento, California 95814

January 24, 2008

Ms. Elaine Howle*
State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814

Dear Ms. Howle:

The California Department of Insurance and its Conservation and Liquidation Office have reviewed the Bureau of State Audit's draft report entitled, "Department of Insurance: Former Executive Life Insurance Company Policyholders Have Incurred Significant Losses, and Distributions of Funds Have Been Inconsistently Monitored and Reported."

The audit is an extensive retrospective review of the management of the Executive Life Insurance Company ("ELIC") estate spanning a timeframe of nearly 17 years and oversight by five insurance commissioners. It includes a detailed analysis of all funds paid into and out of the estate and an estimate of policyholder losses arising from the insolvency of ELIC. We are pleased to note that after this extensive review of the ELIC estate, the audit report contains no findings of inappropriate use of estate funds or any negative findings regarding the proper and prompt distribution of funds to policyholders.

We intend to implement the four recommendations set forth in the report. As your auditors learned, by any standard the ELIC liquidation is extraordinarily complex. There are some instances in which the report does not provide a full and accurate context or is erroneous. We have enclosed a detailed response with specific substantive comments to help you address these deficiencies. 1

Should you have any questions or comments, please feel free to contact me.

Sincerely,

(Signed by: Steve Poizner)

STEVE POIZNER
Insurance Commissioner

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* California State Auditor's comments begin on page 101.

CALIFORNIA DEPARTMENT OF INSURANCE
Response to Bureau of State Audits Report 2005-115.2

Department of Insurance: Former Executive Life Insurance Company Policyholders Have Incurred Significant Losses, and Distributions of Funds Have Been Inconsistently Monitored and Reported.

I. SECTION 1 - EXECUTIVE SUMMARY

A. BACKGROUND

Executive Life Insurance Company (ELIC or Company) was the largest life insurance insolvency of its time. The Company was placed into conservation on April 11, 1991 and has remained such under five different Insurance Commissioners. At that time, the California Commissioner of Insurance ("Commissioner") pursued two goals: (1) stabilize the Company's financial position and marshal the available assets in order to minimize the losses that ELIC policyholders would otherwise suffer, and (2) rehabilitate the Company to avoid any lapse in the insurance coverage of policyholders, thus providing policyholders the greatest likelihood of future financial security. To this end, ELIC entered into a rehabilitation phase and was subsequently placed into liquidation on December 6, 1991.

At conservation, ELIC's approximately 330,000 policyholders (or contract holders) were spread throughout 46 states and its assets were excessively concentrated in high yielding junk bonds. The Company's policyholder liabilities consisted of an extremely complex and varied book of business; there were over 1,000 different policy types that yielded high and attractive returns to the policyholders. To protect their interests, the Commissioner effectively directed his resources to address this problem. As discussed in more detail below, the Commissioner achieved this goal.

At the time of ELIC's liquidation, the individual state guaranty associations, represented by the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA), were activated to provide continuing coverage to policyholders in exchange for subrogation rights of the covered policyholders.

Over a 17-year period, the Commissioner aggressively acted in the best interests of policyholders. For example, the Commissioner filed lawsuits against a number of companies to recover money for the estate. The Commissioner's lawsuit against Altus Finance S.A. (Altus) and other companies has recovered more than $700 million to date for the estate.

Throughout its rehabilitation and liquidation, ELIC has been governed by two operational documents: the court-approved ELIC Rehabilitation Plan and the ELIC Enhancement Agreement (collectively, the "ELIC Agreements"). Over time, both documents have been amended with court approval. Throughout the 17-year history of the ELIC insolvency, the Commissioner has scrupulously abided by the terms of those agreements.

Subsequent to the sale and transfer of the Company's opt-in policies to Aurora National Life Assurance Company (Aurora) on September 3, 1993 and the termination of benefits to those policyholders who elected to opt-out of the Rehabilitation Plan, the majority of the remaining ELIC estate assets were managed by three court-approved trustees. One trustee was appointed by the Commissioner, one by NOLHGA and one by the Contract Holders Representative Committee. Among other things, the Rehabilitation Plan requires: (1) the Commissioner, as rehabilitator, to convey all or a portion of ELIC estate's retained assets to the trustees through the establishment of the ELIC Trust, the Real Estate Trust and the Base Asset Trust (Enhancement Trusts); (2) the trustees to assume all or a portion of ELIC Retained Liabilities; and (3) the trustees to liquidate the principal ELIC assets and take such other actions to conserve and protect the principal and provide for the orderly liquidation of any and all such assets.

From 1991 to 1997, the ELIC estate was managed outside the CLO by Special Deputy Insurance Commissioners. Management responsibility was transferred to the CLO in August 1997 to prepare the estate for closure. The trustees, during their tenure, had monetized the majority of ELIC estate assets and distributed in excess of $1.1 billion to policyholders. But for the Commissioner's civil lawsuit against Altus et al., the ELIC estate would have been closed and the Commissioner discharged of all responsibilities.

B. THE BSA REPORT'S THREE FINDINGS

The BSA Report makes three findings:

1. The Commissioner used ELIC's assets to continue insurance coverage, reduce policyholder losses and pay administrative costs;

2. Policyholders experienced significant losses as a result of the ELIC insolvency; and

3. The Commissioner has not consistently monitored, reported on or accounted for the distribution of ELIC assets.

C. OVERVIEW OF THE COMMISSIONER'S RESPONSE

With respect to the first finding, the Commissioner does not dispute that he used ELIC's assets to continue insurance coverage, reduce policyholder losses and pay administrative costs. Indeed, those were precisely the actions that the Commissioner was obligated to undertake to protect the interests of ELIC's 330,000 policyholders. He did so effectively.

The report's second finding – that policyholders experienced significant losses as a result of the ELIC insolvency – reflects the regrettable reality that insurance company insolvencies typically result in losses to policyholders. But, as reflected in the report's first finding, the Commissioner took aggressive steps, including filing litigation, to increase recoveries for the estate and to minimize losses to ELIC's policyholders. Despite the insolvency, ELIC policyholders have recovered approximately 90% of their statutory losses and approximately 86% of their economic losses, as defined by BSA.

The Commissioner disputes the BSA Report's third finding that the Commissioner has not consistently
monitored, reported on or accounted for the distribution of ELIC assets.. Contrary to the BSA's assertions,
the Commissioner's monitoring, reporting on and accounting for the distribution of ELIC assets were
both appropriate and effective. In suggesting otherwise, the BSA picks and chooses a handful of asserted 2
improper actions from among the myriad indisputably appropriate, policyholder benefit maximizing
decisions by the Commissioner over a 17-year period

The BSA's approach fails to put the Commissioner's actions in context. For example, the BSA criticizes
the Commissioner for not preparing reports concerning certain trusts. The BSA fails to explain that the
Commissioner considered preparing such reports, but concluded that it would be costly to do so and would 3
provide only minimal benefit to policyholders. This decision served the interests of ELIC's policyholders.

Perhaps most noteworthy is what the BSA Report does not find. It does not find any misappropriation of funds with respect to the ELIC estate or any wrongdoing with respect to use of funds in the ELIC estate. (4) The 111 pages of analysis result in four modest "recommendations." One of those recommendations – that the Commissioner "continue its practice" of auditing the ELIC estate on a periodic basis – affirms the Commissioner's proper handling of the ELIC estate.

In sum, the Commissioner welcomes several of the BSA's recommendations and the recognition in parts of the BSA Report of the Commissioner's appropriate oversight of this extraordinarily complex insolvency proceeding. (5) However, much of the Report is a flawed effort aided by 17 years of hindsight. It makes issue of practices by the Commissioner that, in context, were insignificant and/or had no adverse effect on the ELIC estate.

D. SUMMARY COMMENTS TO THE REPORT

BSA Findings - Chapter 1: The Commissioner Used the Executive Life Insurance Company's Assets to Continue Insurance Coverage, Reduce Policyholder Losses, and Pay Administrative Costs

The analysis prepared by the BSA audit team used data obtained from a variety of audited and unaudited financial reports issued prior to 1997 and from the CLO general ledger for the period 1997 through 2006. The Commissioner has no reason to believe the analysis is incorrect.

BSA Findings - Chapter 2: Policyholders Have Experienced Significant Economic Losses as a Result of the Executive Life Insurance Company's Insolvency

This chapter was prepared by BSA with the assistance of its consultants, Hemming Morse, Incorporated (HMI). The Commissioner and his consultant were given significant access to HMI and the model and, while this did not constitute a detailed review, we are comfortable that the results produced are not unreasonable given the assumptions used and the limitations of a model as compared to a policyholder by policyholder calculation.

The losses estimated by BSA using the HMI model are based on economic losses as if ELIC never went into bankruptcy. The primary difference between the BSA estimate and the Department's statutory-based estimate is the accumulation of interest on losses incurred in 1993 to the loss estimate date. We question the appropriateness of including the accumulation of interest in loss estimates. Accumulated interest (6) depends on the date of calculation and tends to inflate the figure for losses. An earlier calculation would result in a lower loss estimate and a calculation at a later date will increase the loss estimate. As noted above, from a legal standpoint, California law fixes losses at the date of insolvency. If one lost $100 in the stock market in 1993 and someone asked about that loss today, one would say one lost $100 not $240 ($100 with accumulated interest at 6% for 15 years).

BSA Findings - Chapter 3: The Insurance Commissioner Has Not Consistently Monitored, Reported on, or Accounted for the Distribution of the Assets of the Executive Life Insurance Company Estate

1. Monitoring of Distributions

We strongly disagree with the BSA finding that the Commissioner did not adequately monitor Aurora's compliance with the ELIC agreements. The Commissioner has a two-fold relationship to Aurora: he is both (7) receiver and regulator. As receiver, the Commissioner's role with respect to overseeing the opt-in policies transferred to Aurora is expressly prescribed by the Rehabilitation Plan and the Enhancement Agreement. Neither of these documents allows or provides for the Commissioner, as receiver, to review or audit the records of Aurora which is an on-going domestic insurance company.

Aurora, as a domestic insurance company, has been and is monitored by the Commissioner, as regulator. Such oversight is defined within the California Insurance Code and has been consistently applied. At the time of the closing of the Rehabilitation Plan, the parties recognized that Aurora would be regulated in the same manner as any other domestic life insurance company. This was memorialized in Exhibit N to the Agreement to Facilitate Closing. Exhibit N states that the Insurance Commissioner would regulate Aurora as follows: "…only in accordance with, and pursuant to those insurance laws, rules, regulations and directives of the State of California that are generally applicable to California domiciled life, annuity and disability insurers….". Pursuant to this requirement, the Department of Insurance has performed periodic field examinations. In addition, the Department of Insurance required annual audits of Aurora by its independent auditors, Ernst & Young. Aurora was also subject to various other industry-required third party examinations. Each of these examinations and reviews has resulted in no material adverse findings. 7

Generally accepted auditing standards require that independent auditors have a strong understanding of the agreements that are in place and test transactions at the insurance contract or policy level as deemed necessary. Since inception, Aurora has received annual "clean" opinions from its independent auditors, with no material weaknesses being noted.

2. Reporting on Distributions

The Commissioner acknowledges that certain reports were not made for two pass-through trusts and for the First Executive Corporation (FEC) Litigation Trust. The Commissioner believes, nonetheless, that pertinent information regarding the ELIC estate assets was available to policyholders.

During the life of an estate, it is prudent for the Commissioner to make decisions that will benefit the interest of the policyholders, provided that the benefits outweigh the costs. Because of the pass-through nature of these trusts referenced by BSA, the Commissioner did not report the trust activities to the beneficiaries. The Commissioner believes that furnishing the reports would not have provided meaningful information to the beneficiaries because the main requirement of these trusts was to distribute funds. This information was provided to each policyholder receiving payment in a detailed analysis of the source of the funds within each payment check stub. In closing these trusts, the Commissioner will address the non-reporting to beneficiaries of these trusts in the application to close the trust.

3. Accounting for Distributions

The Commissioner acknowledges that over the life of the ELIC estate the accounting practices, including those for distributions, have varied. Nevertheless, the BSA and Department of Finance (DOF) examiners were able to obtain information needed to complete their reviews. The DOF has issued clean review opinions for the ELIC estate and each of its grantor trusts for calendar years 2005 and 2006.

C. BSA RECOMMENDATIONS

BSA Recommendation 1: To increase assurance that Aurora follows key provisions in the ELIC agreements, the Commissioner should seek the right to review Aurora's future distributions of ELIC estate funds and review those distributions to ensure that it adds the proper amount of interest to the funds and distributes the funds correctly.

Commissioner's Response: The Commissioner and the CLO have effectively monitored Aurora's compliance pursuant to the terms of the ELIC Agreements. The Commissioner will seek an agreement to oversee future Aurora distributions.

BSA Recommendation 2: In order to ensure that information is available to policyholders and other parties interested in the disposition of ELIC's assets, the Commissioner should, as soon as practical after the end of each year and upon the termination of any trust, complete a report that includes the assets and liabilities, the amount of all distributions, if any, made to the trust beneficiaries, and all transactions materially affecting the trust and estate.

Commissioner's Response: The Commissioner will comply with the recommendation.

BSA Recommendation 3: In order to ensure that the financial information reported by the Conservation & Liquidation Office is accurate, the Commissioner should continue its practice of auditing the ELIC estate, and any trusts that remain open, on a periodic basis as implemented by the current Chief Executive Officer.

Commissioner's Response: The Commissioner agrees and will continue to review the ELIC estate and its related grantor trusts annually or upon closing.

BSA Recommendation 4: In order to ensure that it accurately records distributions in its primary accounting system, and ensure correct financial reporting, the CLO should periodically reconcile the distributions reported in its general ledger to its subsidiary databases.

Commissioner's Response: The Commissioner disagrees with the underlying premises of this recommendation. The BSA found that distributions had been properly made, but criticized the organization
8 of the accounting records. The CLO will continue its practice of reconciling distributions to the Trust Administration System (TAS) subsidiary databases and to the general ledger. The CLO has reformatted the financial presentation of the ELIC financial statements and has established separate accounts in the ELIC estate general ledger for each future distribution.

II. SECTION 2 – SPECIFIC SUBSTANTIVE COMMENTS

1 Responses to specific findings in which BSA is in error or does not provide full and accurate context.

A. BSA Finding - POLICYHOLDERS HAVE EXPERIENCED SIGNIFICANT LOSSES AS A RESULT OF THE EXECUTIVE LIFE INSURANCE COMPANY'S INSOLVENCY (Pages 46 - 60)[1]

This chapter was prepared by BSA and its consultants, Hemming Morse, Incorporated (HMI). The Commissioner and his consultant were given significant access to HMI and the model and, while this did not constitute a detailed review, we are comfortable that the results the model produced are not unreasonable given the assumptions used and the limitations of a model as compared to a policyholder by policyholder calculation.

9 [1] Page numbers referenced are those appearing in the BSA draft report dated January 10, 2008, which is the only complete draft received by the Commissioner and the CLO.

We believe that the title of this chapter should indicate that **not all policyholders incurred a loss**.
Approximately 30% of the policyholders (including both opt-in and opt-out policyholders), representing (10)
13% of statutory liability, were fully covered by guarantee associations and incurred no loss whatsoever.

As noted in the BSA report, the loss estimates as of August 22, 2005 contained in the Department's letter to Senators Speier and Cox are based on Conservation Date Statutory Reserve (CDSR) statutory losses, as defined by the Rehabilitation and Enhancement agreements and California Law Section 1019, reduced by subsequent distributions from guaranty associations and litigation proceeds. The letter states that the $936 million shortfall experienced by ELIC policyholders "…represents the amount of shortfall as of September 30, 1993 if all subsequent distributions had been paid to the policyholders on that date." The BSA report notes that their calculation of that amount on that date differs by only $14 million.

Losses estimated by BSA using the HMI model are based on economic losses as if ELIC never went into bankruptcy. The primary difference between the BSA estimate and the Department's statutory-based estimate is the accumulation of interest on losses incurred in 1993 to the loss estimate date (August 2005 or December 31, 2006, as applicable). The BSA estimate also includes an estimate of the losses attributable to contract adjustments to credited rates and other terms which are not included in the Department's estimate above. The BSA analysis does not include a $305 million distribution made in 2007 since their calculation ends at December 31, 2006.

We question the appropriateness of including the accumulation of interest in loss estimates. Accumulated
interest depends on the date of calculation and tends to inflate the figure for losses. An earlier calculation (6)
would result in a lower loss estimate and a calculation at a later date will increase the loss estimate. As noted
above, from a legal standpoint, California law fixes losses at the date of insolvency. If one lost $100 in the
stock market in 1993 and someone asked about that loss today, one would say one lost $100 not $240 (11)
($100 with accumulated interest at 6% for 15 years).

Nevertheless, the BSA estimate of 86% of ELIC policy value recovered as of August 22, 2005 compares favorably to the Commissioner's estimate of 90% as noted in the August 22, 2005 letter to Senators Speier and Cox.

B. BSA Finding - THE COMMISSIONER HAS NOT CONSISTENTLY ENSURED THAT AURORA COMPLIES WITH THE ELIC AGREEMENTS (Pages 63 - 75)

1. **BSA Finding - The Commissioner Has Monitored Aurora's Compliance with Some Aspects of the ELIC Agreements but Has Not Consistently Ensured That Aurora Complied with the Agreements (pp. 66 - 70)**

2. **BSA Finding - According to the Department, the ELIC Agreements Do Not Contain Language That Allows the Commissioner to Monitor Aurora's Compliance with Key Provisions (pp. 70 - 72)**

3. **BSA Finding - There Is Less Assurance for the 1998 Through 2006 Period That Aurora Distributed ELIC Estate Funds in Accordance With Key Provisions of the ELIC Agreements (pp. 72 - 74)**

Commissioner's Responses:

The Commissioner ensured through numerous financial audits and reviews – all done in accordance with industry standards – that Aurora has properly performed its obligations within the terms of the ELIC Agreements. Neither the Rehabilitation Plan nor the Enhancement Agreement contemplates that the Commissioner, as receiver, will review or audit Aurora's records.

While acknowledging that neither the Rehabilitation Plan nor the Enhancement Agreement require such
(12) monitoring, the BSA uses their absence to assert that the Commissioner, in his capacity as receiver, failed to ensure that Aurora properly paid interest and properly calculated distributions. They further opine incorrectly that the Commissioner did not monitor distributions. This assertion and opinion ignore the intent of the Agreements and the Commissioner's role as regulator.

Discussion:

- Right to Review

Neither the Rehabilitation Plan nor the Enhancement Agreement provides that the Commissioner review or audit Aurora's records, nor do they contain any language regarding monitoring of Aurora's performance by the Commissioner. Monitoring Aurora was the job of the regulator. The ELIC Agreements, which are 129 pages and 159 pages respectively, were negotiated by the Commissioner, NOLHGA and Aurora, and approved by the Los Angeles County Superior Court in the ELIC proceeding. The Commissioner is bound
(13) by the terms of these agreements. BSA opines that the Commissioner, in his capacity as receiver, failed to ensure that Aurora properly paid interest and properly calculated distributions. They also opine (incorrectly) that the Commissioner did not monitor distributions. In doing so, BSA fails to cite any provision in the agreements that requires or permit such reviews or audits. Further, BSA ignores the work that was performed by Aurora's independent auditors (which is part of the Commissioner's oversight as regulator of Aurora). Page 68 of the BSA report states:

> The tasks performed during these examinations and audits included identifying the ELIC estate funds that Aurora has received and presenting a high-level
> (14) summary of Aurora's uses of those funds, including the amounts that have been paid to the national guaranty organization and the participating guaranty associations. These examinations do not separately identify the amounts paid to policyholders or the interest Aurora earned on the ELIC funds it had received.

This statement is inaccurate and out of context. BSA did not review the work papers of the independent
(15) auditors. The independent auditors indicated to us that they tested Aurora's records at a policyholder level as part of their annual audit.

As the BSA was advised by the Commissioner, the Rehabilitation Plan specifies two very limited audit rights for the Commissioner. Rehabilitation Plan Sections 9.2.6 and 9.3 allow the Commissioner to seek an audit (in the manner specified in the Rehabilitation Plan) with respect to Aurora's calculation of profit sharing and mortality profit sharing. In contrast to these limited rights however, the Enhancement Agreement -- a three-party agreement between the Commissioner, NOLHGA, and Aurora's holding company (and is also signed by Aurora) -- gives specific audit rights to NOLHGA. These rights are specified in Section 13.1 of the Enhancement Agreement as follows:

> . . . Newco [Aurora] no more frequently than annually, shall allow NOLHGA on behalf of the Participating Guaranty Associations and NOLHGA . . . to review, audit and copy documents, records, files, computer programs, and the methodology developed by Newco . . . which pertain to (i) the Participating Guaranty Associations' obligations to Covered Contract Holders (including but not limited to ... the Covered Contract Holder's *account value and benefit payments, records of amounts paid to such Covered Contract Holders and the other items set forth in Section 9.3 hereof* . . .), (ii) the computation of payments due pursuant to Section 5.1, . . . (iv) Newco's application of such [guaranty association] funds (*and funds to be applied pursuant to* . . . *Articles 10 and 17*) to the Contracts of Participating Covered Contract Holders; (v) Newco's payment of such amounts to Participating Covered Contract Holders . . . " [emphasis added]

NOLHGA's review rights broadly cover Aurora's performance and the designation of such review rights (16)
to NOLHGA, and thus the guaranty associations which had ongoing payment obligations, were reasonable.

As noted in various parts of the BSA Report, Aurora's performance of the Rehabilitation Plan and the Enhancement Agreement has been reviewed through multiple examinations. The Commissioner, in his capacity as a regulator, conducted financial reviews of Aurora for periods ending in 1994, 1997, 2002, and 2005. These examinations were performed in accordance with the NAIC Examiners Handbook, which relies extensively on auditor judgment. The NAIC Examiners Handbook promotes the use of work performed by
others to minimize the duplication of work. Moreover, as a regulated insurance company, Aurora has been (15)
audited annually by certified public accountants; it has always received an unqualified audit opinion. In a recent conversation with the audit partner of the certified public accounting firm, Ernst & Young LLP, who conducted the financial audits of Aurora, it was confirmed that while the audit report did not provide the details of the work performed, they did perform detailed testing at the policyholder level (including testing of the account value increments (AVI's) and interest calculations). Generally accepted auditing standards were applied to render a clean opinion on Aurora's operation.

As noted in the BSA Report, the Commissioner, as receiver, undertook a comprehensive audit of Aurora's performance in connection with the 1998 settlement of an indemnity claim by Aurora pursuant to the terms of the Rehabilitation Plan. Aurora initially made an indemnity demand for $520 million and, pursuant to the Rehabilitation Plan, had the right to take the full amount of the demand from policyholders. The Commissioner settled Aurora's claim for $75 million (with court approval) and at that time, when a Plan-imposed five-year moratorium period was set to expire, the Commissioner and Aurora agreed to settle certain other then-outstanding matters and agreed to conduct an overall review of Aurora's performance to date. CLO believed that it was an opportune time to request an audit of Aurora because the estate responsibilities had recently been transferred to CLO from the Special Deputy Insurance Commissioner who was responsible for ELIC's operation up to that time. In the 1998 audit, the Commissioner reviewed the
following matters: (a) the restructuring percentage; (b) the final restructuring percentage; (c) the total ELIC (17)
Conservation Date Statutory Reserves; (d) the Opt-Out percentage; (e) the method of calculating Opt-Out Excess Cash Amount; (f) the First Opt-Out Amount Percentage; (g) the first and second participation (profit-sharing) credits; (h) the participation statutory net income for 1993 – 1996; (i) the actual distributable amounts for 1993 – 1996; the APWL Mortality Profit Amount for 1993 – 1996; (j) the SPWL Mortality Profit Amount for 1993 – 1996; (k) the APWL Mortality participation factor; (l) the SPWL Mortality participation factor; (m) the opt-out recoverable loan percentage; (n) the AVI's; the method of calculating total liquidation value advances;(o) the recoverable liquidation value advances; and (p) Article 25 and 26 payments. AVI's are the additions that Aurora paid or credited to policyholders as the result of the receipt of additional funds from the ELIC Trust, the Base Assets Trust and the Real Estate Trust. Hence, the Commissioner did audit Aurora's calculation and payment of interest and its distributions to policyholders.

As also noted in the BSA Report, the Commissioner undertook a comprehensive review in 2007 of Aurora's
18 distribution of some of the proceeds of the Altus litigation (i.e., the proceeds that were available after the Commissioner won the arbitration with NOLHGA). This review was not provided for in the ELIC Agreements. The Commissioner and NOLHGA agreed to allow a portion of the Altus proceeds to be distributed to policyholders before the arbitration was completed and agreed that the other portion would be distributed after the arbitration was completed (the agreement was approved by the Los Angeles County Superior Court.) The distribution formula in the Enhancement Agreement was not designed to permit a split distribution such as this. Therefore, the Commissioner, Aurora and NOLHGA had to modify the formula (which was approved by the Court). In this unique circumstance, the Commissioner was able to negotiate an agreement with Aurora to permit his comprehensive review.

The Commissioner has no rights set forth in the ELIC agreements to monitor or oversee Aurora; however, as acknowledged in the BSA Report, he believes he has a general right to assure that Aurora performs its obligations under the ELIC Agreements. The BSA Report appears to have mischaracterized the Commissioner's statement in this regard. The BSA Report cites the Commissioner as stating that "neither the court-approved
19 Rehabilitation Plan . . . the ELIC Enhancement Agreement . . . nor the agreements with third parties . . . give the commissioner general rights to review or audit *compliance* of the Aurora National Life Assurance Company (Aurora) with the provisions of the ELIC agreements." [emphasis added] (BSA Report pp. 61 - 62.) The Commissioner stated that the agreements do not provide the right to review Aurora "records." The Commissioner's statement was in response to prior discussions with BSA in which the BSA appeared to assert that the Commissioner's fiduciary duty in liquidating ELIC extended to overseeing Aurora's operations. In those discussions, BSA was advised that Aurora is a separate company, it is not a "rehabilitated" ELIC, and the Commissioner's fiduciary duty, as receiver/rehabilitator, does not extend to supervising or overseeing Aurora.

As previously stated to the BSA, and as set forth in the BSA Report (pp. 70 - 71), had the Commissioner's
20 financial examinations of Aurora, the annual audits of Aurora by its certified public accountants, and NOLHGA's audit rights been insufficient to assure that Aurora was performing the agreements, then we believe the Commissioner, as receiver, could assert a right to review Aurora's performance. As we stated, and BSA reports, the nature and extent of such a right depends on the facts and circumstances then at hand and we would be likely to face legal opposition from Aurora.

- <u>Monitoring of Third Party Agreements</u>

21 In footnotes, BSA acknowledges that the "third party agreements" are not part of the Rehabilitation Plan or the Enhancement Agreement (although they are provided for therein) and they have no bearing on how much a policyholder receives as a result of ELIC's insolvency. BSA defines a third party as "either a company
22 that offered ELIC policies to its employees or a state guaranty association." This is imprecise. Most third parties fit into one of three categories: property and casualty companies that fund a liability with an ELIC structured settlement, a corporate retirement plan, or a state guaranty association.

Third party agreements, which contain no monitoring provisions, pertain mostly to persons who received their ELIC policies as part of structured settlements or in connection with pension plans. In both situations, a person (a tortfeasor or a pension plan sponsor) purchased an ELIC policy to satisfy an obligation owed to a claimant or employee. The Commissioner created a program (approved by the Los Angeles County Superior Court) known as "gap subrogation" in which the person that purchased the ELIC policy (a "gap payor") for the policyholder would make up the difference between what the policyholder received before the ELIC insolvency and what it received under the Rehabilitation Plan (the "gap.") Although it was encouraged by the Commissioner, participation in gap subrogation was voluntary.. The gap payor would pay the gap to the

ELIC policyholder. Because the gap payment brought the policyholder to 100% of its ELIC contract amounts, the gap payor received a right to all or part of future distributions to the policyholder (but not to exceed the gap payment.) The gap program also allowed a percentage reimbursement to a gap payor who pays only a portion of the gap payment by signing an Indemnification and Acknowledgement Agreement. The gap payor was required to file an annual certification with Aurora stating that it made the payments required by its gap agreement. If a certification was not filed, Aurora, as administrator, notified the Commissioner and under the Commissioner's guidance, placed any payments due to the gap payor in suspense until the certification was received and/or the matter was investigated. There are numerous instances in which the Commissioner investigated and resolved these situations to insure that the policyholder had been fully provided for.

Aurora administers the gap subrogation program, the cost of which is provided for by the gap payor. Aurora pays monies that are due to the gap payor as a result of the payor's certified gap payments. The amount due in connection with a policy, whether it is due to a policyholder or a gap payor, is not increased or decreased (either by principal amount or interest) as a result of a gap agreement. Furthermore, as noted in other areas within this response, oversight by the Commissioner, as regulator, through periodic reviews and annual independent audits of Aurora provides a reasonable level of assurance that substantive errors would be noted.

- Performance of ELIC Agreements

The BSA Report refers to a statement in a letter from the Commissioner that there has been "constant communication and cooperation between Aurora and the receiver ... over the years concerning the implementation and operation of the rehabilitation plan and enhancement agreement. Nonetheless, as conservator, rehabilitator, and liquidator of the ELIC estate, the commissioner is responsible for the distribution of ELIC estate assets."(p. 71 - 72). The Commissioner's letter did not imply that communication and cooperation substituted for review and controls. The Commissioner's letter cited the financial 23
examinations, audits and reviews of Aurora over many years and stated that the receiver, working with Aurora, had reviewed numerous detailed transactions that typically involved in-depth reviews of policyholder values, and AVI's (including interest calculations.) The letter simply cited additional indicia of the integrity of Aurora's staff and their performance of the ELIC Agreements. The communication and cooperation were never considered to be a substitute for audit or review.

The BSA report states that the Commissioner, as receiver, . . . should have ensured that he had the authority 24
to monitor Aurora's distribution of ELIC funds and compliance with the ELIC agreements, or ensured that he could administer the distributions based on data maintained by Aurora." (p. 72.) (The Commissioner, as regulator, agreed that Aurora would be regulated like any other insurer and therefore he could not monitor distributions.) An Insurance Commissioner exercises discretion in the rehabilitation and liquidation of an insurance company to provide the most optimal and likely recovery for policyholders. The current Commissioner is not familiar with the negotiations from 1991 through 1993 that led to the final versions of the Rehabilitation Plan and the Enhancement Agreement that were approved by the Los Angeles County Superior Court. The Commissioner does not know, for example, whether the absence of monitoring provisions in the Rehabilitation Agreement was the subject of negotiation between the parties and whether it was possible to have such provisions in the agreements. As noted elsewhere, monitoring by NOLHGA was expressly provided for in the Enhancement Agreement. Regardless, at the time it was industry practice to 16
leave monitoring of such agreements to the authority of the Commissioner in his capacity as a regulator, not as a rehabilitator or liquidator. Given industry practice, entering into the ELIC agreements was a proper exercise of the Commissioner's discretion. Evidence for this can be found repeatedly in the regulatory reviews;; the 1998 audit; the review rights provided to NOLHGA; the annual independent audits by Aurora's 15
certified public accountants; the "clean opinions"; and the absence of any problems noted in reviews or by BSA's Report.

Moreover, the Commissioner is not confident that, prior to the issuance of this BSA Report, Aurora would have voluntarily agreed to modify the Rehabilitation Plan to permit audits. Similarly, the Commissioner cannot reasonably estimate whether he would have been able to obtain a court order to modify the Rehabilitation Plan over Aurora's objection. As noted in the BSA Report, the Commissioner believes that he can assert a right to review Aurora's performance, but the nature of the right and the likelihood of success would depend on specific facts and issues (p. 71).

The Commissioner disagrees with the statement that the Commissioner should have " … ensured that he
could administer the distributions based on data maintained by Aurora." Opt-in policyholders were Aurora
25 policyholders, Aurora – not the Commissioner – was obligated to make distributions to such policyholders.
A plan in which the Commissioner would make distributions to Aurora's policyholders (opt-ins) is not
reasonable, workable or cost effective.

4. BSA Finding - As a Part of a Complex Settlement Agreement, the Commissioner Granted Aurora a Release From Liability That May Further Limit the Ability to Monitor Aurora's Distribution of ELIC Funds (pp. 74 - 75)

<u>Commissioner's Response and Discussion:</u>

26 BSA has no basis for assuming that the settlement would have proceeded without such a release, nor does it
have a basis to contend that the settlement should have been abandoned if the release was required.

BSA notes that releases of prior conduct, both known and unknown, are common in settlement agreements, " . . . especially [ones] involving large amounts agreed to in this settlement." (p. 74) As part of the Altus litigation in which Aurora agreed to pay net $78,750,000 to the ELIC estate, the Commissioner gave a release of both known and unknown claims (see, pp. 62 and 74 - 75). The release provided by the Commissioner is indeed common and was required by Aurora as a condition to settlement. Providing the release was a reasonable exercise of discretion by the Commissioner.

The BSA Report states that the release " . . . may further hinder the commissioner's ability to monitor
Aurora's compliance with the ELIC Agreements" (p. 62). The Commissioner disagrees. The release covers
27 matters arising before February 14, 2005, with the exception that the Commissioner may take enforcement
action with respect to any of the following matters arising after February 14, 2004 (one year earlier): (1) a
policyholder complaint against Aurora; (2) a complaint "from outside the Department"; and (3) matters
arising from the Commissioner's periodic examination of Aurora.

As previously noted, Aurora's compliance with the provisions of the Rehabilitation Plan and the Enhancement Agreement has been part of the annual audit of Aurora by its certified public accountants. Aurora's compliance with the provisions of the Rehabilitation Plan and the Enhancement Agreement was extensively audited by the Commissioner in 1998, and Aurora underwent numerous financial examinations by the Commissioner, as regulator. None of the audits disclosed a failure of Aurora to comply with the Rehabilitation Plan or the Enhancement Agreement, and accordingly, providing a release in exchange for receiving $78.75 million and avoiding the risks of litigation was reasonable.

C. BSA Finding - INFORMATION ON ELIC ESTATE OPERATIONS IS LACKING DUE TO INCONSISTENT REPORTING AND AUDITING (Pages 75 – 82)

1. BSA Finding - The Commissioner Did Not File an Examination of ELIC in 1990 (pages 75 - 76)

<u>Commissioner's Response and Discussion:</u>

This title is confusing and misleading. The examination in process at that time would have been "as of" December 31, 1990 – for the years 1988 – 1990. At that time there was no time requirement for when the examination should be completed and filed. But common practice for the Commissioner was to complete an examination within nine to twelve months after the "as of" date (December 31, 1990), which would put the completion of the examination in the period of October 1 to December 31, 1991. It would have been impossible for the Commissioner to file the Examination Report in 1990 since the draft Examination Report reflected an "as of" date of December 31, 1990, and the financial statements (Annual Statement) submitted by ELIC was not filed with the Commissioner until March 1, 1991. The Commissioner took regulatory action in April 1991. 28

Regarding the filing of Examination Reports, the Commissioner has broad discretion in determining the form, scope and nature of examinations. There was no requirement to file an Examination Report in 1990 or 1991. Pursuant to Insurance Code Section 734.1(c) (1), the Commissioner can terminate or otherwise suspend any examination in order to pursue other legal or regulatory action. The Commissioner was appointed conservator of ELIC in April 1991, and the need for filing an Examination Report was not critical to the Commissioner's duties as conservator.

2. (a) BSA Finding - Managers of the ELIC Estate Have Not Consistently Reported on the Disposition of ELIC's Assets (Pages 76 - 80)

(b) BSA Finding - Managers of the ELIC Estate Have Not Consistently Audited the Estate (Pages 80 - 82)

<u>Commissioner's Response:</u>

(a) The BSA is correct in stating that the Commissioner reported under some trusts and not others. The Commissioner believes the omission to report on pass-through trusts did not deny policyholders valuable information. The pass-through trusts are fundamentally different than the Enhancement Trusts.

(b) Audits were performed for 1997 – 2000 on a consolidated basis. 29

Over the life of an estate, the Commissioner has the discretion to make decisions that will positively benefit the interest of the policyholders. The Commissioner believes that not furnishing the reports and audits during certain periods did not harm the beneficiaries.

Insurance Code Section 1037 provides that the Commissioner has broad discretion in performance of his duties as receiver.

Discussion:

Holdback Trust and Opt-Out Trust

The BSA Report notes that certain reports for the Holdback Trust and the Opt-Out Trust (grantor trusts of ELIC) were not prepared (p. 62). The Commissioner believes that the BSA Report may leave the impression that the Holdback Trust and the Opt-Out Trust performed similar functions as the ELIC Trust, Base Assets Trust, and Real Estate Trust (collectively, the "Enhancement Trusts") and that they had similar responsibilities. This is not the case. The purpose of the Enhancement Trusts was to identify, pursue, collect and monetize assets for the benefit of the ELIC estate, including through litigation. As noted in the BSA Report, the Enhancement Trusts collected in excess of $1.1 billion dollars for the benefit of the ELIC policyholders. In contrast, the Holdback Trust and the Opt-Out Trust were devices to hold money temporarily for subsequent distribution (pass-through trusts). Neither trust was charged with collecting or monetizing assets. The trusts were essentially parking places while issues were resolved that affected, in the case of the Holdback Trust, all ELIC policyholders, and in the case of the Opt-Out Trust, opt-out policyholders. Both trusts allowed for the segregation of expenses that were only chargeable against the activities of the trusts.

30 Because of the limited nature, purpose and function of the Holdback Trust and the Opt-Out Trust, and given the facts discussed below, the fact that audits were not performed did not jeopardize ELIC policyholders and did not deprive them of pertinent information or information that would have been of significant value.

The Holdback Trust was a grantor trust of Aurora administered by the Commissioner as trustee. It was created in 1994 to hold ELIC assets while certain litigation challenges to the terms of the Rehabilitation Plan were pending on appeal. Subsequently, in 1996, the Holdback Trust was amended (with court approval) to provide that it would hold funds that would otherwise have been distributed to policyholders as AVI's until such time as certain indemnity demands that Aurora anticipated making were resolved. In 1998, when Aurora's indemnity demands were resolved, all funds in the Holdback Trust were disbursed except for funds that were due to ELIC policyholders that could not be located. Since 1998, the Commissioner vigorously continued to attempt to locate the missing policyholders. Presently, with Aurora's assistance, the Holdback trust is scheduled for closure.

The Opt-Out Trust was created in 1994 to hold assets to be disbursed to opt-out policyholders. It also is a cost center for charging expenses that apply only to opt-out policyholders. The Opt-Out Trust received funds from the Enhancement Trusts, and with those trusts being closed, it now receives funds from the ELIC estate. It was required to distribute funds to policyholders "as soon as practicable" which, in practice, has been a short period of time. With each distribution, policyholders were advised of their principal, interest, reserves and expenses.

During the period 1997 - 2000, the Holdback and the Opt-Out Trusts were audited in connection with annual financial audits of the ELIC estate by certified public accountants. Information regarding those trusts was available to ELIC policyholders and the public. After 2000, audits were not performed on the Holdback and Opt-Out Trusts until 2005 when the Department of Finance completed its review of the financial statements. Although the Commissioner acknowledges that the trust agreements required that reports be
31 made, reports would not have provided significant information to policyholders.

1. As to the Holdback Trust, reports would not have advised individual policyholders of the funds being held for them individually.

2. Like the Opt-Out Trust, with each distribution from the Holdback Trust, policyholders were advised of their principal, interest, reserves and expenses.

3. After the Holdback Trust distributed its assets in 1998, funds that remained belonged to policyholders that could not be located. Reports to those that could not be located would have been meaningless.

4. Similarly, reports by the Opt-Out Trust would not have been meaningful when the Opt-Out Trust only held funds for the administration of the ELIC estate.

FEC Litigation Trust Agreement

The FEC Litigation Trust Agreement (FEC Trust) was established September 11, 1992 between FEC and the Commissioner in his capacity as conservator, rehabilitator and liquidator of ELIC. The purpose of the FEC Trust was to facilitate implementation of Article 111 of the Joint Plan of Reorganization for FEC. The implementation is to (1) collect the proceeds of certain litigation claims, (2) retain and liquidate non-litigation assets, and (3) preserve, hold and distribute the trust assets to ELIC policyholders in accordance with the provisions of the trust. The Commissioner was appointed trustee.

Administration of the FEC Trust was transferred to CLO in August 1997 by which time the majority of the assets were collected. The distribution of the funds to policyholders did not occur for a period of time because of uncertainties that existed in the FEC Trust relating to the distribution methodology. The terms of the FEC Trust were completed before finalization of the ELIC Rehabilitation Plan, and it specified a distribution methodology that was later rejected by the California Court of Appeals in connection with the Rehabilitation Plan. As a result, the FEC Trust had to be formally amended through the FEC bankruptcy court to reflect those changes. Completing the appropriate changes to the FEC Trust took additional time as the FEC bankruptcy court proceeding was closed. The FEC Trust was also amended in the Los Angeles County Superior Court which had concurrent jurisdiction over the matter

Upon obtaining court approval to amend the FEC Trust, the distribution of funds was completed. BSA states, "Additionally, although the FEC Litigation trust agreement does not require annual reports to policyholders, Article 7 requires the commissioner to provide a report every year to Aurora and a committee established by the trust showing all payments made resulting from or received from litigation claims and other receipts of disbursements in connection with the trust. Once completed, copies of the FEC Trust annual reports are also to be on file with the commissioner, and as a public document this report would be available at the request of trust beneficiaries. A former general counsel for the department stated that there are no records that the reports were ever completed. By not producing the reports that are required by the distribution trust agreements, policyholders and other beneficiaries have not been kept informed of the disposition of ELIC assets as intended by the trust agreement." (p 78),

We informed BSA of the following:

1. While we recognize that Article 7 requires quarterly and annual reports to beneficiaries of the trust, provision 7.2 states; "At the sole discretion of the trustee, he may produce and furnish to any or all of the policyholders the Quarterly Reports, the Annual Reports or any extracts there from or summaries thereof." 32

2. Based on Article 7.2, CLO decided from a cost-benefit standpoint to defer the reporting requirement to increase the distributable amounts to the beneficiaries.

3. The distribution checks mailed to policyholders included on the check stub sufficient detailed information to identify the source of the funds, interest earned, pro-rata expense incurred and calculation of final amount.

4. Presently, FEC Litigation Trust Account is scheduled for closure. Funds held for individual policyholders that cannot be located will be escheated to the State.

D. BSA Finding - INCONSISTENT ACCOUNTING PRACTICES AND INCONSISTENT AVAILABILITY OF SUPPORTING DOCUMENTS HINDER A COMPLETE ACCOUNTING OF THE ELIC ESTATE (Pages 82 - 85)

Commissioner's Response and Discussion:

1. Internal Control Matters (pp. 7 and 85)

33 Comments contained in the BSA report do not adequately describe the significant improvements to the CLO's accounting and internal control policies and practices that have been in effect at the CLO since mid 2005. BSA did not do a formal review of CLO's internal controls.

The CLO acknowledges that various examiners issued reports stating that there were control weaknesses during the period 1997 to 2004. The latest of these reports was an internal control review report issued covering the 2004 calendar year issued by DOF auditors in early 2005. Since then, the CLO has taken aggressive actions to correct each and every finding contained in the DOF reports. DOF completed an additional internal control review which concluded that none of the findings contained in their report for that review were considered material control weaknesses.

In 2005, the CLO restructured its entire internal control environment. It formeda Board and Audit Committee that meet quarterly; hired seasoned financial employees; restructured the Accounting and Finance Department; engaged a firm to perform a review of the CLO's internal controls in a manner similar to the requirements of Sarbanes-Oxley Section 404; and developed quarterly internal financial statements on each estate under the management of the CLO.

In addition, the DOF noted to the CLO's Audit Committee that there have been significant improvements in controls and operating procedures since its 2004 internal control review work.

For calendar years 2005 and 2006, the CLO requested that the DOF auditors review complete financial statements for ELIC, its grantor trusts as well as for each of the other estates for which the CLO is responsible. The DOF completed its reviews and issued clean reports for all estates, including ELIC and its grantor trusts, with one exception relating to a non-ELIC entity for which the CLO is still in process of verifying conservation date balances.

2. Other Accounting Matters

This chapter of the BSA Report contains comments regarding several other accounting matters.

Inconsistent financial reporting (p. 82):

We agree that over the life of the ELIC estate, different managers responsible for oversight of the ELIC estate have not used consistent methods for accounting for the assets, liabilities and operations of the ELIC estate and their related grantor trusts.

Cash flow statements (pp. 20 and 83):

In 2005, independent of the BSA audit, cash flow statements were prepared for each estate being administered by the CLO, including the ELIC estate and its related grantor trusts. The cash flow statements were prepared in a format consistent with financial reporting standards established by Generally Accepted Accounting Principles (GAAP). The BSA was given the GAAP-based cash flow statements for ELIC and its related grantor trusts. The BSA later requested cash flow statements in a different format which we agreed might better serve the purpose of their review. In order to complete this request which the BSA describes as four month project, it was necessary for the CLO to analyze and reformat over 83,000 general ledger entries for the 10 year period 1997 through 2006. This work was done in addition to performing the day-to-day (34) tasks associated with the other 24 estates managed by the CLO. This was a complex project that was done using database analysis software. The resulting cash flow statement was then carefully reviewed to ensure its accuracy. The project was completed in addition to the many other demands made upon Accounting Department personnel during that period as part of the normal ongoing operations of the CLO.

The BSA tested the data in the cash flow statements provided as well as the contents of the CLO general ledger. The CLO produced support documentation for each and every transaction requested by the BSA for testing.

Inconsistent availability of data (p. 84):

Regarding comments about the inconsistent availability of supporting data, we agree that it might be possible to better organize the information and supporting data produced by CLO systems. As noted in the BSA report ". . . there is no specific requirement for structuring the accounting records, maintaining subsidiary accounts that separately tracks payments. . ." (p. 84). On the other hand, we note that in spite of the fact that the ELIC estate documents requested by BSA were generated over a period in excess of 10 years, the CLO was able to produce all documents requested to support its testing.

As noted above, the Department of Finance was able to issue unqualified reports on their reviews of the ELIC estate and its related grantor trusts which provide verifiable evidence that data needed for an accounting of the ELIC entities is in deed available at the CLO.

Lack of separate general ledger accounts for recording disbursement payments (p. 84)

The BSA auditors reviewed the reconciliations of disbursements to policyholders to its TAS databases (which was tested and found reliable by the BSA auditors). Disbursements to Aurora are single accounting entries which require no reconciliation in as much as the amounts are self evident. We agree that distributions could be more easily tracked if separate disbursement accounts were established for the ELIC estate.

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE DEPARTMENT OF INSURANCE

To provide clarity and perspective, we are commenting on the response from the California Department of Insurance (department). The numbers below correspond to numbers we have placed in the margin of the department's response.

1 While the department may disagree with some aspects of the report, as is our long-standing administrative practice, we communicated with appropriate parties throughout the audit and listened to and addressed any meritorious concerns to ensure that our report was fair and accurate. Further, our audit was conducted in accordance with generally accepted government auditing standards, which require sufficient, competent, and relevant evidence to provide a basis for the auditor's conclusions. Thus, our report contains factual information, supported by interviews, documentation, and analysis.

2 The department asserts that the insurance commissioner's (commissioner) monitoring, reporting, and accounting for the distribution of Executive Life Insurance Company's (ELIC) assets were both appropriate and effective. In our report we conclude that inconsistent monitoring of Aurora National Life Insurance Company's (Aurora) distribution of ELIC estate funds has resulted in less assurance that funds were distributed correctly from 1998 through 2006 as compared to other periods (pages 48 – 49); inconsistent reporting has resulted in a lack of information available to policyholders and others interested in the ELIC estate (pages 50 – 53); and inconsistent accounting practices and inconsistent availability of supporting documents hinder a complete accounting of the ELIC estate (pages 55 – 57).

3 The department is incorrect when it states that we fail to put the commissioner's actions in context. To the contrary, as we state on page 52, the Conservation and Liquidation Office's (CLO) ELIC estate trust officer stated that the reports required by the Opt-Out and Holdback Trust agreements were not produced because of cost considerations, which included the cost of mailing reports to policyholders. In order to give context to this comment, we also stated that the CLO could pursue alternatives to mailing the reports, such as posting the reports on its Web site or posting a notice on its Web site that would allow only those beneficiaries that desired them to request copies of the report. Throughout the report we provide the department's perspective on the issues.

4 The department mischaracterizes our recommendation that the commissioner continue its practice of auditing the ELIC estate on a periodic basis. Contrary to the department's assertion, this recommendation does not affirm the commissioner's proper handling of the ELIC estate. In the report we disclose that financial statement audits have not been consistently completed over the life of the ELIC estate. Audits of the Opt-Out and Holdback trusts were not completed from 1997 through 2004; the independent audits of ELIC's combined financial statements for the years 1997 through 2000 were not comprehensive; and there were no audits of the ELIC estate conducted from 2001 through 2004 (page 54). While our audit was in progress, the CLO's chief financial officer requested the Department of Finance to conduct a separate review of each ELIC entity covering the 2005 and 2006 period, and plans to continue these reviews yearly until the trusts are closed. Hence, our recommendation refers to the recent actions of the CLO to audit the estate.

5 We disagree with the department's assertion that much of our report is a flawed effort aided by 17 years of hindsight, and that the report makes issue of practices by the commissioner that, in context, were insignificant and/or had no adverse effect on the ELIC estate. For example, we do not agree that limited oversight of $225 million in distributions is insignificant, nor do we think the failure to report on ELIC's operations and the disposition of its assets would be viewed by the policyholders who suffered great losses as insignificant.

6 The department contradicts information it previously provided to a State Senator when it questions the appropriateness of including the accumulation of interest in loss estimates. In 2005 the department stated in a letter to a California Senator (Appendix E of the report on page 74) that its estimate of policyholder losses was somewhat artificial because it represented the amount of shortfall that would have existed as of September 3, 1993, if all of the subsequent distributions had been paid to policyholders on that date and does not reflect the amount by which benefits due to policyholders would have increased over time. In other words, its estimate of loss did not adjust distributions to reflect the time value of money. By including the accumulation of interest in our analysis, we provide a more complete picture of the economic losses policyholders have incurred.

7 The department mischaracterizes the report when it states that we found the commissioner did not adequately monitor Aurora's compliance with the ELIC agreements. Specifically, we were unable to conclude whether the department's monitoring was adequate, because while the department asserted that it monitored Aurora's compliance with the ELIC agreements during the 1998 through 2006 period, it

could not provide documentation to support its assertion. From the documentation that the department was able to provide, it is clear that the department's four field examinations and the annual audits of Aurora by its independent auditors did not conclude whether Aurora complied with the ELIC agreements when it distributed ELIC estate funds. When asked, the department could not provide documentation to substantiate its assertion that these examinations evaluated Aurora's compliance with the ELIC agreements.

It is also clear that the audit CLO commissioned in 1998, and its current examination of Aurora's October 2007 distribution, both include substantially more monitoring than the department asserted it or Aurora's independent auditors did during the 1998 through 2006 period. Based on those facts, we correctly conclude that the department's monitoring has been inconsistent, and that there is less assurance for the 1998 through 2006 period that Aurora distributed ELIC estate funds in accordance with key provisions of the ELIC agreements.

The department mischaracterizes the scope of our report when it states that we found that distributions had been properly made. The scope of our audit included determining the sources and uses of ELIC estate funds between April 11, 1991, when the commissioner conserved ELIC, and December 31, 2006. However, we do not conclude that distributions were properly made. 8

It is our long-standing administrative practice to allow auditees five business days to respond to a draft report. It is correct that the draft report was delivered to the department on January 10, 2008, with its response due by the close of business on January 16. However, the department fails to acknowledge that prior to delivering the completed draft on January 10, we met with representatives of the department on numerous occasions and, when appropriate, shared written drafts of the issues we intended to publish in the final audit report. In fact, the department and the CLO had the opportunity to see a draft containing all the issues as early as November 9, 2007. Finally, as is our standard process, we consistently communicated with the department regarding issues we intended to report on. 9

We believe the title of the chapter is accurate. Further, we are uncertain of the source of the department's claim that 30 percent of policyholders, including both opt-in and opt-out policyholders, representing 13 percent of statutory liability, were fully covered by guaranty associations and incurred no loss whatsoever. In the department's 2005 letter to a State Senator, it states "92.45 percent of the policyholders that opted-in to the plan received all payments that they would have received had ELIC not become insolvent." As such, the department's response is inconsistent with information it previously provided to a State Senator. 10

11 As we state in comment 6, by including the accumulation of interest in our analysis we provide a more complete picture of the economic losses policyholders have incurred. If a policyholder had a $100 loss in 1993, they were unable to earn interest on that $100 beginning in 1993. This lost interest increases policyholder losses because it reduces the value of the account and payments received from the policy from what they would have been if the policy had not been restructured.

12 The department has mischaracterized our report. As the department notes in its response, the ELIC liquidation is extraordinarily complex. Thus, we believed it was important to report on how the commissioner interprets the ELIC agreements rather than form our own opinion. Thus, on page 47, we state that "according to the department's legal counsel, the ELIC agreements do not give the commissioner, in his role as conservator, rehabilitator, and liquidator (receiver) of the ELIC estate, general rights to review or audit Aurora's records." Further, the department incorrectly states that we "opine incorrectly that the commissioner did not monitor distributions." This is not an "opinion." As explained in comment 1, we report on what the commissioner did based on the evidence we reviewed. As stated on page 49, the commissioner did not monitor these activities and distributions and therefore cannot provide policyholders and others the same level of assurance that the $225 million in ELIC estate funds that Aurora distributed during the period from 1998 through 2006 was distributed in accordance with the ELIC agreements.

13 Again, the department has mischaracterized our report. We did not "opine that the commissioner, in his capacity as receiver, failed to ensure that Aurora properly paid interest and properly calculated distributions." As indicated in comment 12, we present the facts as we found them. Based on those facts, we conclude on page 48 that if the commissioner had obtained the right to monitor the distributions or alternatively, had retained the right to have the CLO make the distributions, the commissioner could have provided the policyholders with greater assurance that the funds were distributed as required by the ELIC agreements. Finally, we did not ignore the work of the Aurora's independent auditors—in fact on page 45 we acknowledge that work as well as the four examinations the commissioner, as regulator, performed under Section 730 of the California Insurance Code (insurance code). On page 46 we do point out, however, that the audits and examinations do not state that they assessed whether Aurora complied with the specific provisions of the ELIC agreement relating to distribution of funds.

After the commissioner's receipt of our draft report on January 10, 2008, the CLO voiced concern regarding the generality of this statement. Upon consideration, we agreed that the statement could be interpreted differently than intended and we subsequently deleted it. We informed the CLO of this change before it submitted its response. ⑭

During the course of our audit, we asked the CLO and examiners from the department to provide documentation of any testing of Aurora's compliance with the ELIC agreements for the period from 1998 through 2006, but none were provided. As we state on page 46, we asked the department's chief examiner if he had any additional documentation showing that the department examined or determined whether Aurora adhered to specific provisions of the ELIC agreements in the annual audits, periodic examinations, or other reviews. He could not provide any documentation establishing that the department examined or determined whether Aurora adhered to specific provisions of the ELIC agreements for this time period. ⑮

We agree that the enhancement agreement provides audit rights to the National Organization of Life and Health Insurance Guaranty Associations. However, as we state on pages 46 and 47, "although the national guaranty organization may have reviewed Aurora's distributions of ELIC funds to policyholders and other interested parties, neither the CLO nor the department had any copies of any reviews that the national guaranty organization might have conducted and reported on." Hence, the department could produce no evidence that they had received or reviewed these reports. ⑯

We agree that testing of Aurora's compliance with the rehabilitation plan was completed in 1998. In the report we note that the CLO hired an independent auditor to conduct an audit to assess Aurora's compliance with the rehabilitation plan for the period from September 1993, when the rehabilitation plan for ELIC took effect, through December 31, 1997 (page 45). However, as we state on page 46, neither the four examinations the department performed nor the yearly audits submitted by Aurora from 1998 through 2006 state that they assessed whether Aurora complied with the specific provisions of the ELIC agreements. Therefore, the department's claim that the commissioner did audit Aurora's calculation and payment of interest and its distributions to policyholders is misleading. ⑰

We agree that the CLO is currently reviewing Aurora's October 2007 distribution of ELIC estate funds. However, we do not state that it is a comprehensive review. We cannot comment on its comprehensiveness, as the department has not provided any documentation to support the work being performed during this review. ⑱

19 On pages 43 and 47, we have changed the phrase that the commissioner says does not accurately reflect his statement. The phrase now reads: "the general rights to review or audit Aurora's records." We are disappointed that this was not brought to our attention earlier, as we have made numerous efforts to ensure that we accurately summarized the commissioner's statement in our report and could have easily made this change, as we made other changes, during the period that the commissioner had the draft report for review (see comment 9). In fact, this specific language was originally sent to the commissioner's staff on December 13, 2007, for confirmation of its accuracy, but the staff declined to make changes at that time, preferring instead to make any changes to our summary of the commissioner's statement when they had the entire draft report in hand.

Furthermore, the department is confusing the issues. On page 41 we state that the commissioner has a fiduciary duty to protect ELIC policyholders by preserving and managing the assets of the ELIC estate and, as trustee, to ensure that the CLO records the amounts and sources of funds it receives for the ELIC estate and reports how it uses those funds to policyholders and other interested parties. However, in the report we do not "assert that the commissioner's fiduciary duty in liquidating ELIC extended to overseeing Aurora's operations." Thus, it is unclear why the commissioner raises discussions that we had with his staff in which we were attempting to understand the commissioner's obligations under the insurance code so that we could accurately portray his fiduciary obligations as a receiver and rehabilitator in our report. Finally, the commissioner's statement was in response to a written summary of discussions that we had with the commissioner's staff about numerous issues. In accordance with audit standards, we provided this summary to the commissioner's staff in an attempt to confirm that we were accurately stating what the staff had verbally communicated to us. That written summary did not "assert that the commissioner's fiduciary duty . . . extended to overseeing Aurora's operations."

20 It is unclear how the commissioner would have been able to determine the sufficiency of the department's examinations, Aurora's annual audits, and the national guaranty organization's audit rights in assuring that Aurora was complying with the ELIC agreements. As we state on page 46, neither the four examinations that the department performed nor the yearly audits submitted by Aurora state that they assessed whether Aurora complied with the specific provisions of the ELIC agreements regarding how it distributed the funds for the period from 1998 through 2006. Further, as we state on pages 46 and 47, although the national guaranty organization may have reviewed Aurora's distributions of ELIC funds to policyholders

and other interested parties, neither the CLO nor the department had any copies of the reviews that the national guaranty organization might have conducted and reported on.

The department mischaracterizes our report when it states that we acknowledge that third-party agreements are not part of the rehabilitation plan or the enhancement agreement. As the footnote on page 41 indicates "we categorize the third-party agreements with the rehabilitation plan and enhancement agreement for ease of reference. However, unlike the rehabilitation plan and the enhancement agreement, the third party agreements are not part of the restructuring of ELIC." 21

The definition of third parties that we provide is not imprecise as the department alleges. As we state on page 27, "typically, a third party is either a company that offered ELIC policies to its employees or a state guaranty association." While our definition is simpler than the one provided by the department, it is not imprecise. 22

On pages 47 and 48 of the report we summarize portions of the commissioner's statements relating to examinations, reviews, and audits of Aurora and his confidence in Aurora's performance under the ELIC agreements. We do not suggest or imply that the commissioner believes that "communication and cooperation substituted for reviews and controls." In fact, we agree with the department that communication and cooperation does not substitute for reviews and controls. 23

The phrase that the department refers to was changed as part of our quality control review of the draft audit (see comment 9). We informed the department of the change the day the response was due, but the department chose to still respond to the language in the draft audit. On page 48 we now say: 24

> "Neither we nor the department were able to determine whether the commissioner sought the right to monitor the distribution of ELIC funds from 1998 to 2006 or, in the alternative, considered having the CLO make the distributions based on data maintained by Aurora. However, if the commissioner had obtained the right to monitor those distributions or to have the CLO make the distributions, the commissioner could have provided the policyholders with greater assurance that the funds were distributed as required by the ELIC agreements.

As stated on page 48, neither we nor the department know whether the commissioner considered either of these two approaches to monitoring, including whether he considered having the CLO make the distributions. However, we stand by our conclusion that if the 25 commissioner had obtained the right to monitor distributions or have them made by the CLO, the commissioner could have provided the policyholders with greater assurance.

26 The department mischaracterizes our report. Our report does not say or imply that we assumed that "the settlement would have proceeded without a release" nor did we imply or contend that "the settlement should have been abandoned if the release was required." Instead, on page 50, we merely report the fact that there was a release and, as the department points out, we state that releases from liability for previous conduct, whether known or unknown, are common in settlement agreements, especially involving the large amounts agreed to in this settlement.

27 On page 50, we modified our report to state that the release may hinder the commissioner's ability to monitor Aurora's "past" compliance with the ELIC agreements. Further, as noted on page 11, to obtain the data we needed from Aurora to perform this audit, we entered into a memorandum of understanding (MOU) with Aurora and the department. The MOU contains clauses reflecting that we believe "that as a matter of law the bureau is entitled to" the information we were able to obtain under the MOU. Based on Section 8545.2 of the Government Code, we believed that we had access to the records of Aurora to the same extent that the commissioner would have access to those records. That statute gives us access to all records of public entities, as well as access to the records and property of any public or private entity or person subject to review or regulation by the public agency or public entity being audited or investigated to the same extent that employees or officers of that agency or public entity have access. Aurora disagreed with our position, and in another clause:

> "disputed the assertion that the bureau is entitled as a matter of law to the information that the bureau has requested because Aurora has received a general release from the ELIC Estate and the Commissioner, for all matters relating to time periods prior to February 14, 2005 (other than certain policy holder and other complaints with respect to actions occurring on or after February 14, 2004)."

The parties to the MOU agreed to disagree on whether the bureau had a legal right to obtain the data, and Aurora agreed to provide that data pursuant to the terms of the MOU.

28 We agree that the title was not precise, and have corrected it for clarity. Our intent in this section is to disclose that this report, which would have provided public information on the financial

condition of ELIC immediately before it was declared insolvent, was not filed. We do not state that the commissioner did not comply with the insurance code in not filing the report.

29 The trust agreements require these reports, and the reports had been consistently performed until the CLO took over the estate in 1997. Therefore, while the department believes the decision to discontinue reporting on these trusts after 1996 did not deny policyholders valuable information, and states that the commissioner had the authority to discontinue these reports, information on ELIC estate operations is lacking. The decision to discontinue the reports has resulted in less information available to policyholders and others interested in the disposition of ELIC estate assets.

30 We do not conclude that policyholders were jeopardized by not performing these audits. However, we do state on page 54 that these audits are required by the trust agreements, and discontinuing the audits did not allow the commissioner to ensure that ELIC's financial statements were accurate and further reduced the amount of publicly available information on the disposition of the ELIC estate's assets.

31 The department acknowledges that the trust agreements required the reports to be made, but asserts that the reports would not have provided significant information to policyholders. Since these reports would have included the assets and liabilities as well as the distributions made to trust beneficiaries, it is unfortunate that the department assumed that policyholders would not have been interested in this information.

32 We understand that the reports are not required, and we understand the department's assertion that it did not produce the reports for cost reasons. Our concern is that information on the disposition of ELIC estate operations is lacking due to inconsistent reporting. Additionally, taking each of the ELIC trusts in isolation, the department's decision to not produce reports for each individual trust may not seem to significantly impact the amount of information available on the sources and uses of ELIC estate assets; however, in combination, the CLO's decision to not produce reports on the Opt-Out Trust, the Holdback Trust, and the First Executive Corporation Litigation Trust from 1997 through 2004 has a compounding affect on the lack of information available to policyholders and others interested in the ELIC estate.

33 We disagree. On page 57 we acknowledge that the CLO's chief financial officer reported that the CLO has taken various steps to improve internal controls and accounting procedures.

34 The department's statement is disingenuous. If the department had prepared cash flow statements in 2005 independent of our audit, it neither informed us that it had done so nor provided the cash flow statements when we requested them. Additionally, if the CLO would have had information on its sources and uses of cash readily available, it would not have required four months to produce this basic accounting information.

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
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