REPORT BY THE STATE AUDITOR

OF CALIFORNIA

POOR MANAGEMENT PRACTICES AT THE DEPARTMENT OF INSURANCE'S CONSERVATION AND LIQUIDATION DIVISION WARRANT THE DEPARTMENT'S CONTINUED CORRECTIVE ACTION

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Poor Management Practices at the Department of Insurance's Conservation and Liquidation Division Warrant the Department's Continued Corrective Action

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California State Auditor
Bureau of State Audits

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Summary

Results in Brief

The Conservation and Liquidation Division (division) of the Department of Insurance is responsible for conserving and liquidating insurance companies (insurers) that experience financial or other problems or that are not authorized to transact insurance business in the State of California. During conservation, an insurance company is placed under court-ordered control to conserve the insurer's assets until the insurer's status is determined. If the insurance commissioner (commissioner) determines that it would be futile to rehabilitate the insurer in conservation, he may apply to the court for an order to liquidate the assets of the conserved insurer. Liquidation is a process in which a conserved insurer's assets are converted to cash and applied to the outstanding debt. After the division has liquidated a conserved insurer's assets, the commissioner must apply for a court order to distribute the liquidated insurer's assets to its policyholders, creditors, and other groups in the order required by the California Insurance Code. After final distribution of the assets takes place and the division makes a declaration of that fact to the court, the closure of the insurer is complete.

The purpose of this audit was to evaluate the effectiveness and efficiency of the division's operations. Most of our review focused on the operation of the division between 1991 and 1993. Our audit revealed a series of improper decisions by former division managers, which in several instances led to the expenditure of division funds on questionable items. Our audit also disclosed lax procedures or no established procedures for important aspects of the division's operation, including identifying new employees to work in the division, administering employees' salaries, controlling the amount of overtime worked by division employees, and disposing of assets of liquidated insurers. Our audit also addressed the division's need to better plan for the essential responsibilities of the division by developing a strategic plan focusing on the division's long-term goals, continuing its recently adopted practice of developing an annual budget, and following through on its intention to draft management plans specific to each of the estates that the division supervises. A more specific discussion of the conditions identified follows:

- Forty-two of the 76 estates with court-ordered liquidations are still not closed even though it has been from 3 to 15 years since the court order. Among these 42 estates are 15 where the division shares joint responsibility for conservation with another state. Also, according to the commissioner, there are certain estates that cannot be closed readily because of the nature of their outstanding claims;

- New procedures have been adopted by the division for the drafting of an annual budget, and the division drafted a budget for 1994. However, deficiencies still exist, such as the absence of budgeted expenditures for consultant contract costs that will be directly charged to conserved insurers, even though in 1993 these expenditures amounted to $6.5 million;

- The division's payroll grew rapidly between 1991 and 1993 (57 percent increase from 1991 to 1992 and 57 percent increase from 1992 to 1993). The division's payroll growth can be attributed to an increase in the salary rates of employees, employee promotions, and an increase in the number of division employees. The salary rates of division employees outpaced the salary rates of comparable positions in the insurance industry and in the public sector. Between 1991 and 1993, the promotion of division employees whose salaries increased an average 29 percent also outpaced the rate of employee promotions in the insurance industry, which averaged 1 percent during the same period. The division also added a net total of 50 employees to its work force between 1991 and 1993;

- Information provided to us by the division on the amount of insurer assets distributed by the division from 1991 to 1993 that, according to the division, are an indicator of the division's workload, showed a significant increase in assets distributed from 1991 to 1992 and a slight increase from 1992 to 1993;

- Between 1991 and 1993, the division's payments for overtime increased by more than 400 percent, which the division attributed to an increase in the number of insurer conservations, estate closures, and insurer insolvencies, and efforts to implement better controls over division operations. In January 1992, the division dropped its requirement that division employees obtain prior approval in writing before working overtime. During 1989 and 1990, the division's exempt employees were allowed to accumulate compensatory time off (CTO) for overtime that they worked even though the division had in place a requirement prohibiting this practice. Between 1990 and 1993, although the division's policy prohibited the payment to exempt employees for overtime worked, the division paid more than $119,000 to such employees who had accumulated CTO;

- In June 1993, two former managers of the division paid approximately $72,000 in net severance payments to 26 employees, even though these employees never severed their employment with the division. In November 1993, the division informed all of these employees that the payment they received was improper and requested that the employees pay back the division, and about $9,000 of the $72,000 has been repaid thus far;

- According to our interviews with division employees, vacant positions within the division were advertised primarily by word of mouth, and most of the employees who were hired formerly worked for failed insurance companies;

- Our review of 31 contracts revealed that for 4 of the contracts, the division did not have written agreements with its consultants. Also, the division did not always attempt to obtain competition before it awarded contracts, and it did not always write all the essential provisions into its contracts. In addition, the division's process for reviewing invoices was flawed, leading to questionable payments to its consultants, such as three payments totaling $34,000 that were made twice for the same work, and reimbursements to consultants for questionable items, such as the expense of a hotel health club and long-distance calls not related to division business;

- Our review of 66 expenditures that the division allocated to the conserved companies identified several instances of erroneous allocations, such as $75,000 of expenditures that were allocated to a single month that the division should have distributed over several months. Also, in 1992 and 1993, the division allocated $181,000 of its costs of servicing conserved insurers with few assets to estates that had more assets. The $181,000 has since been paid back by the Department of Insurance. In July 1993, the division began allocating its costs of rendering services to all the insurers it manages regardless of whether the insurers have assets; however, because the division does not have the funds to cover ongoing costs of managing insurers with few assets, the insurers having more assets are still bearing a disproportionate share of the division's costs;

- In 1992 and 1993, the division allowed its employees and consultants, as well as their friends and families, to purchase the assets of liquidated insurers, posing a conflict of interest. In 1991, the division retained three oil paintings worth about $35,000 at the division's offices instead of disposing of them through a public sale. As of March 1994, these paintings were still not sold; and

- In three of the four claims that we reviewed, the division did not process the claims promptly, taking over two years to process them.

Corrective Action Taken by the Division

The department has taken steps to address most of the weaknesses discussed in this report. In October 1993, the department terminated the employment of the general manager of the division and demoted the division chief to a position elsewhere in the department. Also, in the past 12 months the division has been reorganized and hired a new chief executive officer. Additionally, the division has adopted new procedures covering the division's essential activities, including compensating division employees; selecting, managing, and paying outside consultants and law firms; disposing of the assets of liquidated insurers; and creating an operating budget for the division each year. Also, in March 1994, the division adopted new accounting procedures that were drafted especially for the division by a public accounting firm.

The department has more to do to remedy the shortcomings of the division, however. An area of primary importance is for the division to create a strategic plan that will enable it to better prioritize its workload into the foreseeable future. The division also needs to focus on developing individual management plans for each of the open and active estates under its care.

Recommendations

To ensure that the new policies established by the division operate as intended and are adhered to by the division, the department must improve its oversight of the division's activities. Currently, the division's activities are overseen by the courts, by executive management of the department, and through regular reviews by the Department of Finance. We recommend that the Bureau of State Audits or another independent auditor conduct a followup review of the division's operations in one year. For a complete list of our recommendations, see Chapter 7, page 56.

Agency Comments

With few exceptions, the Department of Insurance concurs with the conclusions and recommendations in our report.

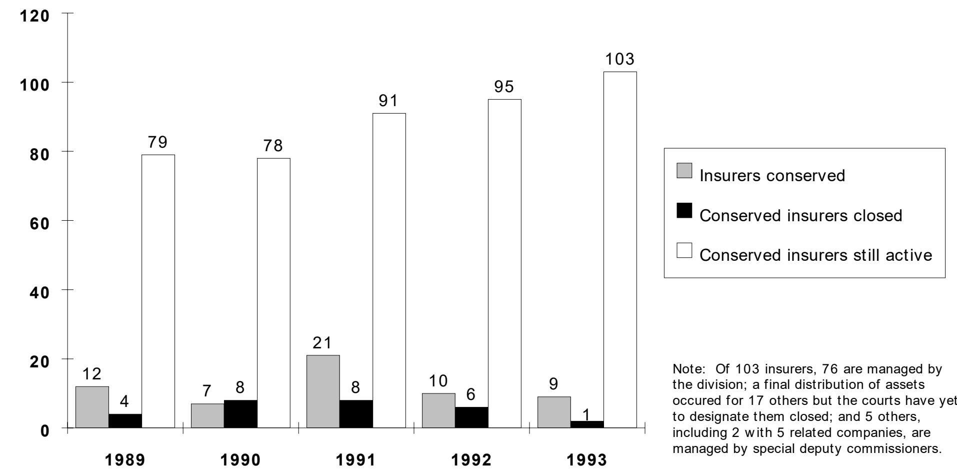
Chapter 1 Introduction

The authority for the Conservation and Liquidation Division (division) within the Department of Insurance (department) dates back to 1935, when the Legislature enacted Article 14 of the California Insurance Code. The division is responsible for conserving and liquidating insurance companies (insurers) that experience financial or other problems or that are not authorized to transact insurance business in the State of California. Section 1011 of the California Insurance Code authorizes the insurance commissioner (commissioner) to file for a court order to take possession of the assets of an insurer that is experiencing financial or other problems or that is an unlicensed insurer and, with the court order, conserve the insurer's assets.

During conservation, the insurance company is placed under court-ordered regulatory control to conserve the insurer's assets until the insurer's status is determined. If the commissioner determines that it would be futile to rehabilitate the insurer in conservation (conserved insurer), he may apply to the court for an order to liquidate the assets of the conserved insurer. Liquidation is a process in which a conserved insurer's assets are converted to cash and applied toward its outstanding debt.

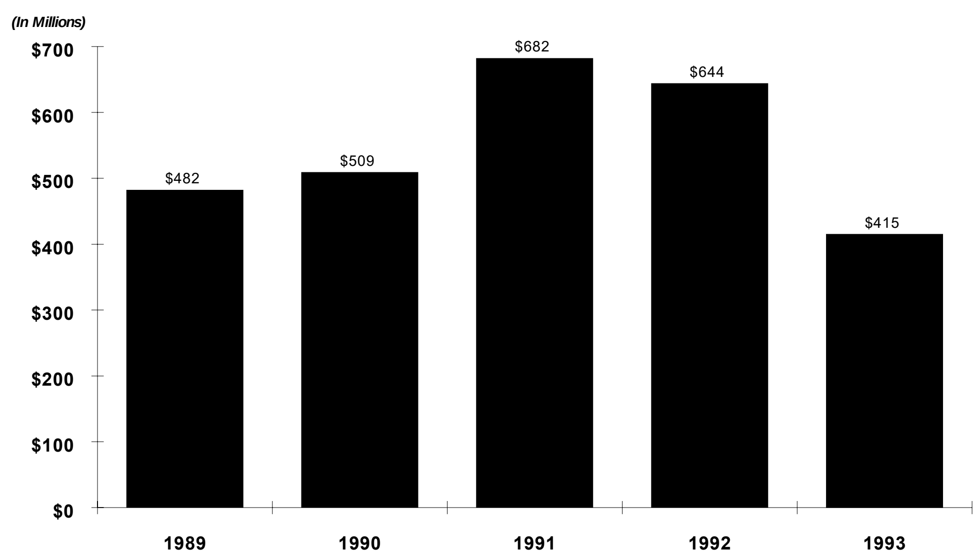
After the division has liquidated a conserved insurer's assets (liquidated insurer), the commissioner must apply for a court order to distribute the liquidated insurer's assets to its policyholders, creditors, and other interested parties in the order required by the California Insurance Code. The final distribution of assets and declaration to the court of that fact serves as closure of that insurer. Figure 1 shows the number of insurers conserved, closed, and being actively managed by the division during each year from 1989 through 1993.

Figure 1 Number of Insurers Conserved, Closed, and Being Managed by the Conservation and Liquidation Division



As of January 1994, the division has conserved or is liquidating the assets of 76 failed and unlicensed insurers. These insurers' assets total approximately $415 million. The total amount of assets of insurers in conservation or liquidation managed by the division from calendar years 1989 through 1993 is shown in Figure 2 below.

Figure 2 **Total Assets in Conservation or Liquidation 1989 to 1993**



Of the 76 insurers in conservation or liquidation, 70 are being managed within the division, and 6 are being managed by division employees at the insurer's location. In addition to the 76 insurers being managed during conservation or liquidation by the division, the commissioner is responsible for conserving 5 other insurers that are managed by special deputy commissioners appointed by the commissioner. According to the department, these 5 insurers are managed outside the division's control because of their size and complexity. The externally managed conservations include Executive Life Insurance Company and First Capital Life Insurance Company, both of which were conserved in 1991. These 5 insurers had assets totaling approximately $10.2 billion as of December 1992.

The division's responsibilities in managing conserved and liquidated insurers primarily consist of reviewing claims not covered by insurance guarantee funds; determining amounts owed to the claimants; and taking action to identify, marshal, and manage the assets of insurers in conservation to maximize the return to policyholders and general creditors should a liquidation of assets become necessary.

Many policyholders of licensed insurers in conservation or liquidation are covered by a state insurance guarantee fund. In California, the California Insurance Guarantee Association, the California Life Insurance Guarantee Association, and the Robbins-Seastrand Health Insurance Guarantee Association process and pay covered claims of insolvent property and casualty, life, and health insurers who are members of these associations.

The operations of the division are funded through the assets of the conserved and liquidated insurers. For calendar years 1992 and 1993, the total operating expenses of the division were approximately $14.6 million and $14 million, respectively.

Historically, the division has interpreted the code and long-standing case law as exempting it from budgetary oversight by the Department of Finance, expenditure and financial statement oversight by the State Controller's Office, contracting and purchasing oversight by the Department of General Services, and personnel practices, salary administration, and travel policy oversight by the Department of Personnel Administration and State Personnel Board.

According to the department, oversight of the division's operations is provided through three independent sources: the internal management of the department, superior courts and judges (where conservation and liquidation matters are reviewed), and the audits conducted by the Department of Finance.

The Division's Organization and Staffing

Before its recent reorganization, the division was organized into seven units: (1) administration and special projects; (2) property and casualty claims; (3) life, health, and surety claims; (4) special receiverships; (5) management information systems; (6) accounting and finance; and (7) reinsurance. Each of these units was headed by a manager who was a non-civil service employee, or "at-will" employee. "At-will" employees are non-civil service employees whose employment the division may terminate at any time, with or without cause. These managers reported to the general manager, who also was an at-will employee. The general manager in turn reported to the division chief, who was a civil service employee. The division also had an assistant chief, who was a civil service employee. In September 1993, the chief of the enforcement division terminated the employment of the general manager, and in October 1993, he transferred the division chief to the department's Financial Surveillance Division.

In November 1993, the department reorganized the structure of the division into three bureaus under the proposed direction of a chief executive officer (CEO): the estate trust bureau, the financial bureau, and the operations bureau. The estate trust bureau will be staffed with an estate trust officer, who will oversee five estate trust managers to manage all conserved and liquidated insurers. The financial bureau will be staffed with a chief financial officer, who will oversee the data processing, accounting, investments, and reinsurance units. The division is evaluating the time line for hiring an administrative officer for the operations bureau, who will oversee the administration, claims, and human resources units. All of these positions are or will be staffed by at-will employees.

According to the commissioner, the division employs a non-civil service work force because, under that arrangement, staff may be added or decreased based on the flow of the work, which is more complicated and often impossible to do with a civil service staff. The commissioner stated that it is impractical to predict the annual number of insurer insolvencies or fraudulent activity that will result in conservation actions managed by the division. The commissioner also stated that by employing at-will employees, the division can hire highly trained and experienced personnel as needed at competitive market salaries and that the existing employees available at conserved insurers are operating as private employees, not civil servants. Figure 3 shows the current organization structure of the division.

Figure 3 Conservation and Liquidation Division Organization Structure

In January 1994, the division had 5 civil service employees and 91 at-will employees. The division has since laid off 9 at-will employees during January and February 1994. According to the department's chief of the enforcement division, who has oversight responsibilities for the division, the work force was reduced because of the efficiency gained from newly developed accounting policies and procedures, consolidation of the division's claims units, and abolishment of the division's special receivership unit. As of April 1, 1994, the division employs 5 civil service employees and 85 at-will employees. In March 1994, the division hired a CEO and in April 1994, it hired a chief financial officer and an estate trust officer.

In addition to the division's work force, the division also engages the services of Department of Justice attorneys, private consultants, and private legal counsel for assistance in the conservation and liquidation of conserved insurers.

Scope and Methodology

The purpose of this audit was to evaluate the effectiveness and efficiency of the division's operations. In conducting this audit, we reviewed pertinent laws, regulations, and policies and we interviewed personnel of the division and other department representatives. We also met with consultants who had been retained to develop the division's accounting policies and procedures and discussed specific compensation information gathered during the course of the audit with the compensation consultants engaged by the division.

To evaluate the division's personnel practices, we reviewed the salaries paid to at-will employees at the division for calendar years 1991 through 1993 to determine their reasonableness. We also reviewed the compensation study conducted recently by Ernst & Young and interviewed its staff to determine the reasonableness of the study's methodology and the recommended salaries for all positions staffed by at-will employees. Furthermore, we reviewed the current and past practices used by the division to establish salaries, merit and promotional raises, compensation for overtime, and severance payments to its at-will employees. Finally, we determined the current and past practices used by the division in hiring at-will employees.

To determine the appropriateness of the expenditures incurred by the division for employee severance and overtime pay, we reviewed records and interviewed staff at the division. To determine the propriety of selling the assets of liquidated insurers to division employees, we reviewed the department's investigative report and records on the sales.

To evaluate the propriety of the division's expenditures for consultant services, we examined the division's practices for selecting consultants and determined how contracts were awarded. We also reviewed a sample of consultant contracts and billings to assess the reasonableness and propriety for each consultant payment. In addition, we reviewed the division's controls to prevent conflicts of interest in its hiring practices and awarding of consulting contracts.

To assess how the division estimates and controls its income and expenses, we examined the methodology used by the division in establishing its budget and reviewed how the budget is monitored. We also assessed the division's method of allocating its direct and indirect costs to the insurers in conservation and liquidation.

To determine whether the division is effectively managing the assets of conserved and liquidated insurers, we reviewed some of the division's status reports for the conservation and liquidation of the insurers under its management. We also reviewed the division's processing of claims under its control and the management of reinsurance receivables.

To determine if the division has implemented corrective actions for previously identified control weaknesses, we interviewed staff and determined the status of the corrective actions taken.

Finally, we assessed key management controls used by one of five conserved insurers managed outside the division's control. We determined the practices and management controls used by the special deputy commissioner of First Capital Life Insurance Company in conserving the insurer. From our limited review, we did not find any major deficiencies in the conservation of this insurer.

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Chapter 2 The Division Has Not Developed a Strategic Plan for the Conservation and Liquidation of Conserved Insurers

Chapter Summary

According to the California Insurance Code, the Conservation and Liquidation Division (division) is responsible for managing the property and investments of the insurers it conserves. In addition, the division is responsible for recovering all assets belonging to the conserved insurers and managing these assets so as to maximize the return to policyholders, creditors, and others having an interest in these insurers in the event that the assets are distributed following liquidation. Because of the division's responsibilities, its primary goals should be to maximize asset recoveries; maximize the productivity and cost-effectiveness of its operations; and manage the assets under its control to ensure a maximum return to policyholders, creditors, and other interested parties.

In an attempt to determine the division's goals and objectives, we reviewed the latest Annual Report of the Commissioner and the division's Performance Management Program Manual. Neither of these documents contained a discussion of the division's goals. In a March 1994 letter to the Department of Finance, the commissioner said that goals had not been developed, but would be by mid-April 1994. Additionally, in April 1994, the chief of the enforcement division told us that one of the first assignments of the division's new CEO is to develop written goals.

Because the division does not have goals, it is unable to develop objectives to reach its goals. In fact, we found that the division has not developed a meaningful annual budget and has not developed closure plans for the conserved insurers it manages. As a result, the division cannot ensure that it is effectively managing the conserved insurers under its care.

The Division Did Not Establish Management Plans To Close Any of the Conserved or Liquidated Insurers

The division does not have management plans to close many of the conserved and liquidated insurers under its management. Specifically, the division often does not have any management plans specifying goals and milestones for managing the 76 conserved insurers under its control. Without management plans projecting the necessary work to be done in conserving and liquidating the conserved insurers, the division cannot effectively determine its staffing requirements. Of 76 conserved insurers, 42 still had not been closed and their assets had not been distributed three years after the orders to liquidate the conserved insurers were approved by the court. Furthermore, for two of these estates, court-approved liquidation orders dated back more than 15 years, with the earliest court order approved in 1965.

Among these 42 insurers are 15 ancillary insurers. An ancillary insurer is an insurer that is incorporated in a state other than California. According to Section 1064.3 of the California Insurance Code, when an ancillary insurer having operations in California is conserved, the court generally appoints the commissioner as the ancillary receiver. The Code further states that, once appointed as ancillary receiver, the commissioner has the sole right to recover the ancillary insurer's assets located in California, liquidate and pay certain priority claims that have been established and allowed by the ancillary court, and pay necessary expenses of such proceedings. All remaining assets are then required to be promptly transferred to the receiver located in the ancillary insurer's state of incorporation.

In addition, according to the division, there are some estates with long-tailed liabilities which could be an obstacle to closing an estate. According to the commissioner, some of the conserved insurers that have been in conservation for more than 15 years could remain in conservation even longer because of long-tail liabilities and complex litigation. Long-tail liabilities are those that are not readily determinable because the amounts owed to claimants are related to ongoing medical conditions or other conditions that have not yet surfaced. A table detailing the 76 insurers, their states of domicile, and the date of their conservation and liquidation, if any, is provided in the Appendix.

The division has not established management plans for many of these conserved or liquidated insurers. According to a special deputy commissioner appointed by the commissioner to oversee the affairs of two conserved insurers, the division could reasonably determine within a few weeks whether a conserved insurer could be rehabilitated.

Further, when the division determines that a conserved insurer cannot be rehabilitated, the division should proceed to liquidate the assets and close the insurer.

In a March 1994 response to a Department of Finance recommendation concerning the issue of better planning for the management of conserved insurers, the commissioner indicated that the division had completed status reports on all special receiverships and would begin reviewing the remaining estates as soon as the estate trust managers were hired.

We acknowledge that the division has completed status reports for some of the insurers it manages; however, in our view, these status reports do not sufficiently set forth a plan of action for each estate. These reports do not establish milestones toward the closure of the insurers or target dates by which key actions must occur. For example, the division prepared a status report for one insurer that described the history of the insurer's problems leading to the conservation order. However, no key actions or related target dates were identified to estimate when closure of the insurer would occur. We confirmed that the estate trust managers were hired as of April 15, 1994, and according to the department's chief of the enforcement division, these managers would be responsible for reviewing all the conserved and liquidated insurers by June 1, 1994.

Section 1016 of the California Insurance Code states that if the commissioner determines that rehabilitating the conserved insurer would be futile, he may apply to the court for an order to liquidate the assets of the insurer and finalize the business of the insurer. Further, Section 1064.2(c) of the California Insurance Code requires the commissioner, as liquidator of the insurer, to immediately take such steps as are necessary to liquidate the assets of the insurer.

Without management plans, the division cannot be sure it effectively and efficiently manages the assets of the conserved and liquidated insurers and cannot ensure that it is maximizing the assets of liquidated insurers and distributing the assets at the earliest possible time without further draining the resources of the entity.

The Division Does Not Have a Meaningful Budget for Its Operations

In its December 1992 management letter on the review of the internal control structure of the division, the Department of Finance informed the commissioner that it found that the division had neither an annual budget for its operations nor written policies and procedures to be used in preparing a budget. According to the division's accounting manager, the division had not prepared annual budgets for the division before 1994.

The division has developed an annual budget for 1994, but it identifies budgeted expenditures only for the division's at-will personnel and some indirect costs and does not identify other direct costs, such as the costs of hiring consultants for the division or for specific conserved or liquidated insurers. In 1992 and 1993, the total fees paid for consultant services were approximately $4.5 million and $6.5 million, respectively. The total operating expenses, including the direct costs for the division in 1992 and 1993, were approximately $14.6 million and $14 million, respectively.

The accounting manager indicated that she prepared the 1994 budget. To determine personnel and personnel-related indirect costs for 1994, she took the division's personnel salaries at the time she was preparing the budget and added 35 percent for employee benefits to arrive at the division's 1994 personnel expenses. Further, for other indirect costs, she used the 1993 figures. However, we found that the division gave no consideration to the level of conservation or liquidation activities, workload, or the asset base in developing the budget. The division also did not estimate the costs of the contracts that it awarded for consultant services and therefore did not budget for the cost of these contracts. Finally, we question the division's ability to budget meaningfully for its operations when it does not have any management plans for the conserved and liquidated insurers.

According to the department's chief of the enforcement division, by July 1994, the division intends to develop an annual budget that will include all direct costs. In addition, the division hired an accounting firm in October 1993 to formulate accounting policies and procedures for the division. Among the accounting policies and procedures prepared by this consultant are procedures to develop an annual budget.

Our review of the newly developed policies and procedures for annual budgeting, however, revealed several deficiencies. Specifically, the new policies and procedures do not explicitly address budgeting the expenses of consultants engaged by the division that are ultimately charged to the conserved and liquidated insurers directly, such as fees for attorneys and other professionals. Furthermore, the policies and procedures do not address developing the budget based on activity measures, such as level of conservation and liquidation activities, workload, income, or size of the asset base managed by the division.

Section 1035 of the California Insurance Code states that, among other things, the commissioner shall establish the compensation of personnel and the costs of taking possession of, conserving, conducting, liquidating, disposing of, or otherwise dealing with the business and property of insurers, subject to the approval of the court. Further, Section 13403(a) of the California Government Code requires the establishment of a system of authorization and recordkeeping adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures.

Without a meaningful annual budget, the division cannot effectively monitor its total operating costs. Further, without an appropriate budget, the division does not have a mechanism to evaluate the volume and effectiveness of its spending, nor do managers within the division have an incentive to keep costs to a minimum. Therefore, the division cannot ensure that it is protecting the assets of the conserved and liquidated insurers while maximizing the return of assets to the policyholders and general creditors of these conserved and liquidated insurers.

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Chapter 3 Personnel Practices of the Division Need Improvement

Chapter Summary

The California Insurance Code gives the insurance commissioner (commissioner) the power to hire and compensate special deputy commissioners, clerks, and assistants and vest them with the power to take possession of insurers operating in a hazardous manner within the State, conduct their businesses, conserve or liquidate their assets, and otherwise dispose of or deal with the businesses or properties of such insurers. The compensation to pay these special deputy commissioners, clerks, and assistants, along with all expenses incurred by them in performing these activities, is fixed by the commissioner, subject to approval by the courts, and paid out of the assets of the conserved insurers under the control of the Conservation and Liquidation Division (division). However, despite having some formalized policies and procedures relating to its personnel practices, the division used questionable practices in the hiring of division employees and in granting merit increases and promotions.

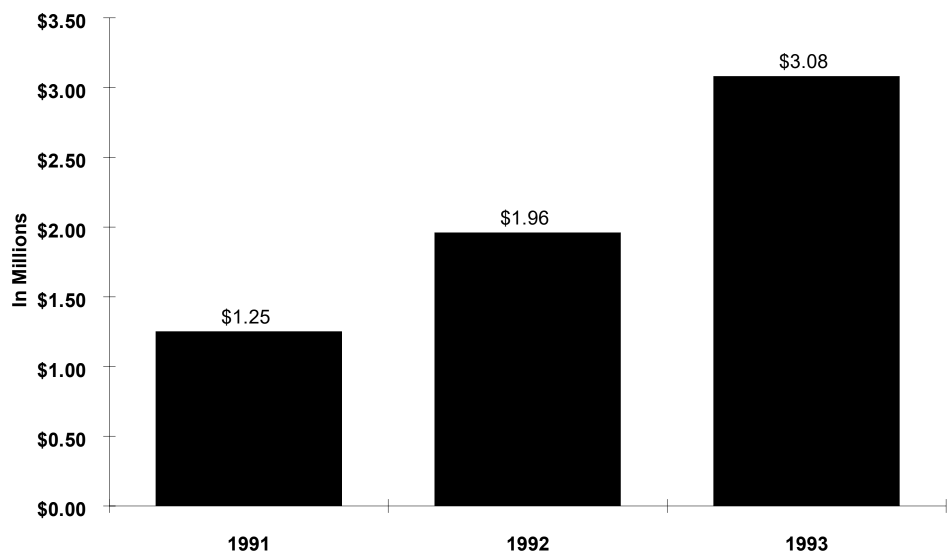
In addition, shortcomings in the division's oversight and control of overtime contributed to a 418 percent increase in the compensation paid for overtime from 1991 to 1993. Furthermore, the division's management failed to adhere to its own policies when it paid exempt employees more than $119,000 for compensatory time off (CTO) that exempt employees had accrued between 1990 and 1993. An exempt employee is an employee working in an administrative, executive, or professional capacity who, under both state and federal law, is exempt from overtime provisions. Finally, the former division managers improperly authorized the payment of approximately $90,000 in severance payments to division employees who had not severed their employment with the division.

The division has taken a variety of corrective actions to address these problems, including transferring the former division chief to a position elsewhere in the department and removing the former general manager, but additional corrective action is necessary.

The Division's Payroll Expenditures Grew at a Rapid Rate From 1991 to 1993

As shown in Figure 4, the amount that the division has spent on employee salaries, exclusive of overtime payments, has increased dramatically from 1991 to 1993. Specifically, payroll expenses for salaries increased from $1,250,000 in 1991 to $1,960,000 in 1992 (56.7 percent) and from $1,960,000 in 1992 to $3,080,000 in 1993 (57.3 percent). This growth in salary expenses can be explained by three factors: an increase in the base salary rates paid to division employees, a significant number of promotions for division employees, and an increase in the division's work force.

Figure 4 Conservation and Liquidation Division Payroll Expenditures 1991 to 1993

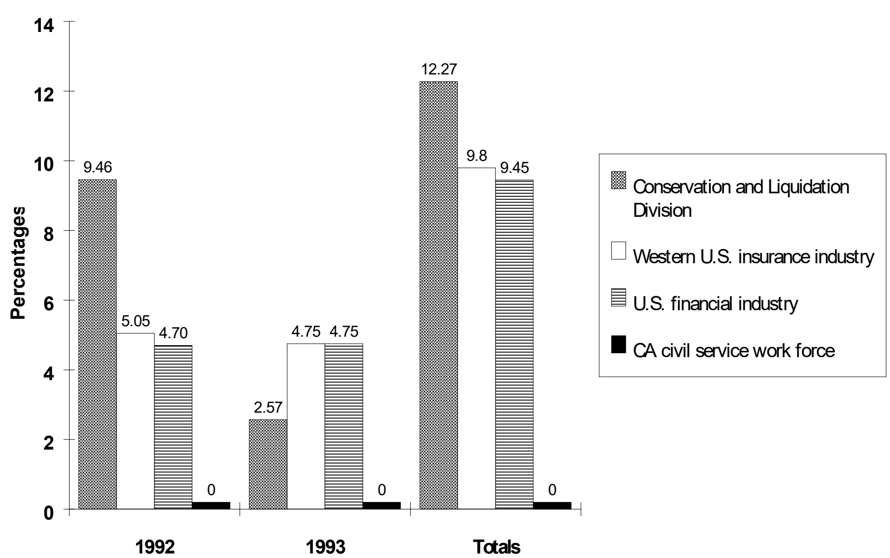


First, the base salary rates paid to division employees have increased. We performed an analysis of all at-will employees who had worked for the division during the 1991, 1992, and 1993 calendar years. We excluded any employees who had received promotions, were transferred among work units, or went from a "junior" job title to a "senior" job title during this period. According to our analysis, the base salaries of at-will employees increased by approximately 9.5

percent from 1991 to 1992 and an additional 2.6 percent from 1992 to 1993 for an overall two-year increase of approximately 12 percent. It is important to note that, since November 1993, the division has been under a hiring freeze with the exception of the hiring of a new chief executive officer in March 1994 and a chief financial officer to take effect as of May 1, 1994.

To determine if the increases in the division's base salary rates were reasonable compared to those in other industries, we obtained statistics from the American Compensation Association representing base salary increases in the insurance industry in the western United States and in U.S. financial institutions for calendar years 1992 and 1993. We also obtained base salary data from the California Department of Personnel Administration for selected California civil service groups for calendar years 1992 and 1993. As shown in Figure 5, the division outpaced the base salary increases in both the private and public sectors in 1992 while lagging behind the private sector for increases in base salary rates in 1993.

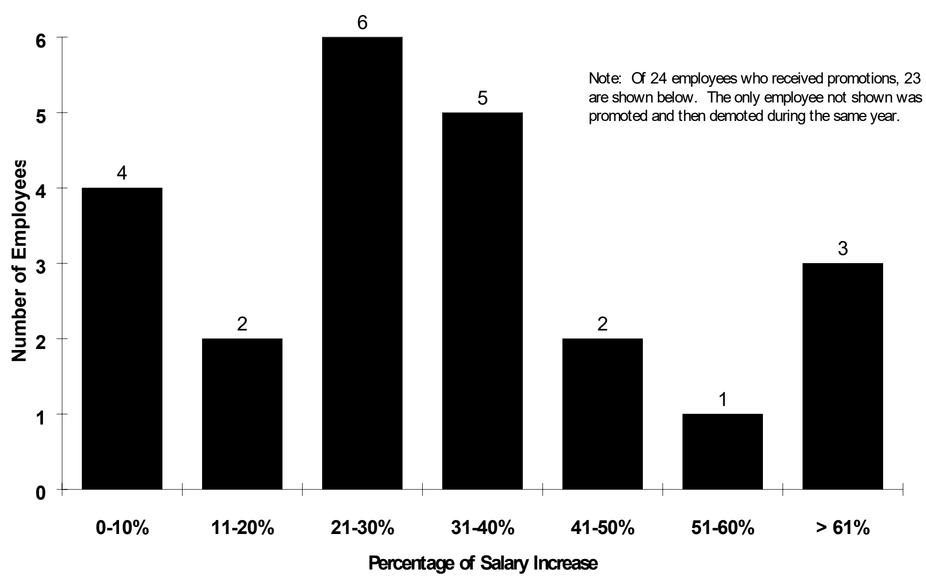
Figure 5 Comparison of Base Salary Percentage Increases



The second factor explaining the increase in the amount the division has spent on salaries is the size and number of pay increases related to promotions granted to its employees between the 1991 and 1993 calendar years. Our analysis of 24 at-will employees who worked for the division during the period from 1991 to 1993 and received promotions showed that, overall, the salaries of these employees increased 29.26 percent over those two years as a result of promotions. Salaries of promoted employees increased more than 22 percent in

1992 and an additional 5.7 percent in 1993. Expressed as a percentage of the employee's base salary, promotions received in 1992 ranged from a low of 3.16 percent to a high of more than 70 percent. During 1993, promotions ranged from 4 percent to more than 23 percent. In contrast, pay increases related to promotions expressed as a percentage of total base salaries for the insurance industry were 1 percent for 1992 and 0.9 percent for 1993. Figure 6 shows the percentage of salary increases for the 24 promoted employees from 1991 to 1993 and the number of employees receiving the respective percentage of salary increases.

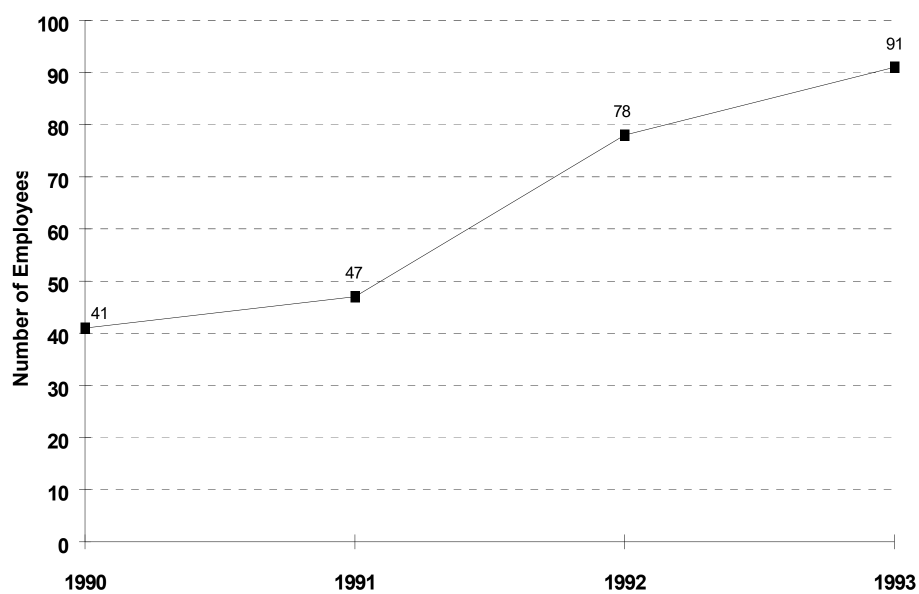
Figure 6 Conservation and Liquidation Division Percentage of Salary Increase for Promoted Employees 1991-1993



For example, in 1992, an office clerk in accounting paid at a base salary of $2,025 per month was promoted to a cash management specialist position, which pays a base salary of $3,000 per month, an increase of more than 48 percent. In another example for 1992, an administrative assistant paid a base salary of $2,875 per month was promoted to manager of special receiverships at a base salary of $4,800 per month, an increase of approximately 67 percent.

The last factor contributing to the increase in the division's salary expense over the last two years is the net increase in the division's work force during that period. From 1991 to 1993, the division hired 78 at-will employees (57 permanent and 21 temporary) and terminated 28 (20 permanent and 8 temporary), for a net increase of 50 (37 permanent and 13 temporary). The division's hiring trend for 1990 through 1993 is shown in Figure 7. The largest single-year increase occurred in 1992, when the division added a net total of 31 employees to its work force (24 permanent and 7 temporary). In contrast, in the 14 years before 1991, the division hired a net total of only 36 employees. The administration manager cautioned that the hiring statistics supplied to us by the division for the years before 1991 may not be exact. She believes that the division lacks some historic personnel data.

Figure 7 Conservation and Liquidation Division Number of At-Will Employees 1990-1993

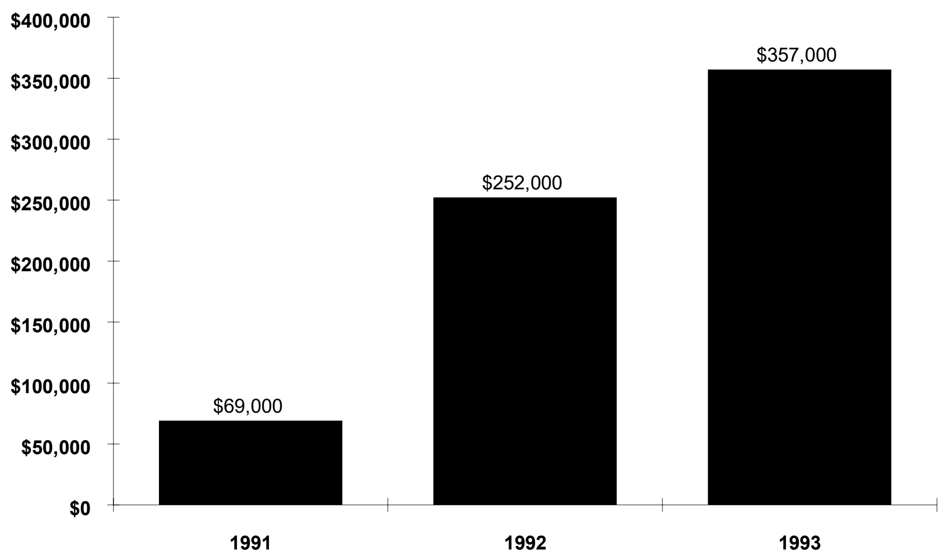


The Division's Overtime Usage Increased Significantly

Overtime payments have increased significantly from 1991 to 1993. Specifically, overtime payments for 1991 totaled approximately $69,000, while in 1993, the amount paid for overtime totaled approximately $357,000, an increase of 418 percent in two years. Figure 8 shows the division overtime expenditures in 1991, 1992, and 1993. Overtime payments for 1992 alone increased by more than $183,000 from those reported for 1991, an increase of 265 percent. For example, ten employees received overtime payments exceeding

$10,000 each in 1992, with one employee receiving almost $34,000. The latter employee's gross salary in 1992 from regular and overtime pay was approximately $101,360.

Figure 8 Conservation and Liquidation Division Overtime Expenditures 1991-1993

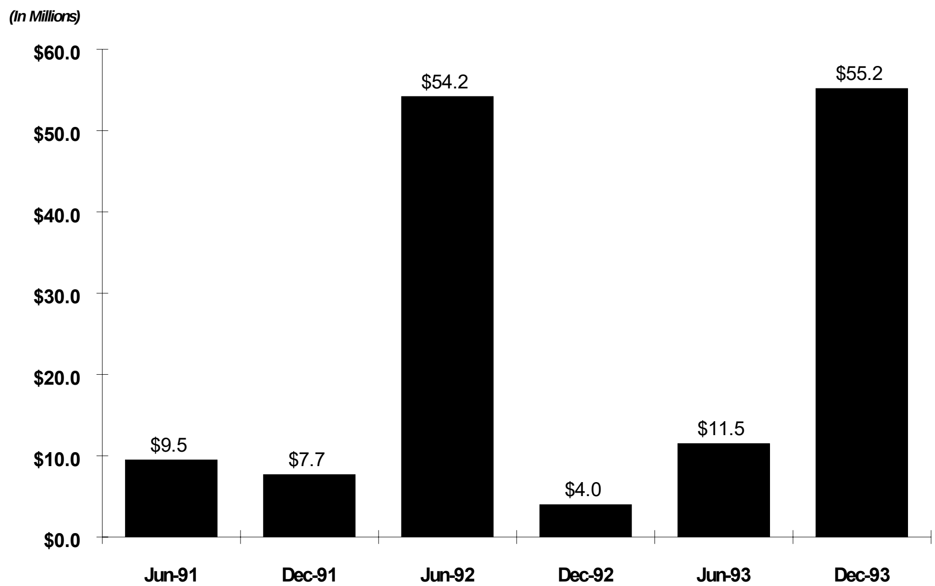


We inquired about the increased use of overtime during 1992. The chief of rate enforcement, who was the former deputy commissioner for enforcement and investigation responsible for oversight of the division during 1992, told us that he was not aware that the increase in overtime was so dramatic, but offered four possible reasons for the increase: initiation of enforcement conservations, the closure of insurer estates, an increase in the number of insurer insolvencies, and correcting the deficiencies identified by the Department of Finance as a result of its 1991 audit of the division. He stated that he believed that 1992 was the year that the Department of Insurance began enforcement conservations, which are seizures of illegal or unlicensed insurance companies. The seizures caused additional work for division employees. The chief also stated that he was pressuring the division to close estates during 1992. Closing an estate involves applying to the court for an order to liquidate the insurer and distributing the liquidated assets, the final distribution of which serves as the closure of that insurer. Finally, the chief stated that in 1991, 21 insurance companies became insolvent and came under the division's management.

However, it was during this same two-year period that the division added 44 employees to its work force and the asset base it managed declined approximately $267.4 million, from approximately $682 million in 1991 to approximately $414.6 million in 1993. These factors seem to indicate that either the division did not properly utilize the resources it had or it did not know the full extent of its workload needs. The total assets managed by the division from 1989 to 1993 are shown in Figure 2 on page 2 of Chapter 1.

In a meeting held after our fieldwork was completed, the division expressed a concern that its asset base was not the best indicator of the division's workload. To address this concern, we allowed the division an opportunity to provide us with information it felt would better characterize the division's workload. The division provided this unaudited information shown in Figure 9. These figures represent the dollar amount of distributions of liquidated insurer assets, including advances to guarantee associations to pay covered claims, funds returned to domiciliary states, and distributions to creditors for each of the six-month periods ending June and December 1991 through 1993. As the figure shows, the asset distributions for the division fluctuated widely during the period from 1991 through 1993. In the six months ending June 1991, the division distributed nearly $10 million whereas, in the six months ending December 1993, the division distributed approximately $55 million.

Figure 9 Distributions Made by the Conservation and Liquidation Division



The Division's Use of Overtime Was Not Controlled

According to its past policies and procedures, the division required written preauthorization for overtime worked during the period from March 1986 until the division discontinued this requirement in January 1992. In addition, the division required written preauthorization before working overtime that would result in an employee earning compensatory time during the period from December 1990 until this policy was discontinued in January 1992. However, neither the administration manager nor the payroll and benefits administrator was able to find any evidence that these policies had ever been adhered to. As mentioned previously, during 1991, payments for overtime totaled approximately $69,000. The overtime may have been worked without written preauthorization in contrast to the division's stated policy.

Moreover, exempt employees were allowed to earn compensatory time totaling 1,503 hours during 1991 without written preauthorization even though it was required by the division's policy at that time. An exempt employee is an employee working in an administrative, executive, or professional capacity who, under both state and federal law, is exempt from overtime provisions.

Furthermore, during calendar year 1990, exempt employees were allowed to earn 1,390 hours of overtime and were allowed to take 1,456 hours of time off work. Some of the compensatory time taken by exempt employees in 1990 had been earned in 1989. Allowing exempt employees to earn and take compensatory time was a violation of the division's policy that prohibited exempt employees from earning overtime. To quantify the cost to the conserved insurers' estates of the division's failure to adhere to this particular policy, we obtained the 1991 hourly pay rates (the earliest year for which the division could readily supply this information) for all exempt employees who earned overtime during 1990. Using these pay rates, we determined that the cost borne by the conserved estates for the 1,456 hours of compensatory time used in calendar year 1990 was approximately $27,400. Finally, we determined that at the end of calendar year 1990, exempt employees' overtime balances totaled 746 hours. Assuming that all these employees subsequently used their compensatory time off, we estimate that the additional cost to the conserved estates was approximately $14,600.

These examples illustrate occasions when the division, despite having established policies, failed to adhere to them. And as indicated, the consequences of the division's failure to adhere to established policies can be costly to the conserved insurer estates managed by the division.

We also noted instances when the division lacked effective internal controls to manage overtime. For example, the division's policies for overtime were amended as of January 1, 1992, so that written preauthorization was no longer required before employees worked extra hours. According to the current overtime policy, employees must get approval in advance of working any overtime. However, the administration manager reports that most overtime approvals are given verbally. This is not an effective way of controlling the use of overtime, especially because the division does not develop budgets based on workload indicators derived from the units within the division (see page 12 of this report for further discussion regarding preparation of budgets). Without budgetary forecasts concerning workloads, and in the absence of requiring written preauthorization for overtime, the managers of the division do not have the tools necessary to make either short-term decisions regarding the cost versus benefits derived from employees working extra hours, or long-term decisions regarding the hiring needs of the division. Furthermore, without advance knowledge of the amount of overtime requested and the ability to measure employee productivity, the managers of the division have limited ability to assess whether the use of overtime is necessary or productive and whether the productivity of employees working large amounts of overtime is being adversely affected.

These factors may have contributed to the dramatic increases in the use of overtime in 1992 and 1993, even though the division had increased its work force by a net total of 44 employees while the overall level of insurer assets under its management had declined during those two years. Moreover, a division budget designed using unit workload indicators has the added benefit of providing benchmarks for supervisors and managers to use in evaluating division employees' job performance in the areas of productivity and cost containment in a much less subjective way than has previously been the case.

Improper Overtime Payments Were Made to Employees in Violation of Stated Policies

From 1990 through 1993, former division management improperly paid its exempt employees more than $119,300 in overtime payments in violation of stated policies and procedures. The improper overtime was paid from the assets of the conserved insurers under the management of the division.

Although the division's policies and procedures regarding CTO for its exempt employees has changed, it was never the division's policy to make cash payments to exempt employees for the overtime accrued by these employees. The division's original written policy regarding this subject became effective in March 1986 and stated that exempt employees may be expected to work extra hours without receiving additional pay because the requirement for overtime work is inherent in the responsibilities of an exempt employee. This policy was changed in December 1990 to allow exempt employees to earn and accumulate CTO with the prior approval of a supervisor, who recorded the approval on a CTO authorization form. All exempt employees were required to use their CTO within one year of earning it, or it was to be forfeited. The division again changed its policy in January 1992, removing the requirements that the earning of CTO be preapproved in writing and used within one year of its being earned. However, none of these policies in their various forms allowed exempt employees to receive cash payments for their accrued CTO. Nevertheless, the managers of the division improperly paid exempt employees more than $119,300 to cash out accrued CTO. In fact, the division paid one exempt employee $1,124 in November 1990, before the division even had the policy allowing exempt employees to accrue CTO.

In September 1993, the division once again changed its policy regarding CTO. Effective October 1, 1993, exempt employees were no longer allowed to accrue CTO for hours worked in excess of 40 hours a week. Further, any CTO accrued before this most recent policy change must be taken between October 1, 1993, and December 31, 1995, or it will be forfeited. Finally, all employees who terminate employment with the division before December 31, 1995, will be paid for any CTO that they have not used by that date.

The Division Recently Adopted a Salary Schedule for Its Employees

In May 1993, the division developed a salary schedule to be used with written job descriptions that were developed previously. The schedule was divided into six salary grades, with approximately $10,000 separating the lowest and highest salaries established within each grade level. Each level was intended to correspond with various job descriptions, depending on the content of the particular job.

According to the findings of a compensation analysis conducted by a management consulting firm hired by the division, there is a wide variance in pay between the lowest and the highest paid employees in each salary grade. According to the consultant's findings, the wide salary ranges allowed the division to incorporate employees recruited from failed companies with widely varying pay practices. However, it was the consultant's opinion that these hiring practices have a very negative impact on employee morale, particularly where individuals performing similar duties are paid significantly differently. In addition, the analysis found that for employees with salaries ranging between $35,000 and $45,000 a year, individuals in jobs with much greater responsibilities were being paid the same or less than individuals in jobs with decidedly fewer responsibilities. The consultant stated that this practice was demotivating because employees in complex roles feel undervalued relative to other positions within the division.

Other Personnel Practices That Were Questionable or in Violation of Stated Policies

Our review of the division's personnel practices showed that the division engaged in other improper and questionable personnel practices. Specifically, the division improperly made severance payments to its employees. We also found that in most instances the division hired its employees without formally advertising for the positions. Finally, until recently the division did not have written job descriptions for its employees.

The Division Made Improper Severance Payments to Its Employees

Two former managers of the division improperly paid almost $90,000 in gross severance payments to employees who never severed their employment with the division. The improper payments were paid out of the assets of the conserved insurers under the management of the division. In addition, a department legal counsel estimated that the outside legal counsel retained by the department to investigate the circumstances surrounding the division's actions in making these payments will cost the conserved estates an additional $15,000.

The earliest written policy we could find regarding severance payments was in the division's employee handbook, effective as of October 1983. Under that policy, an employee with at least two years of service who was terminated by reason of a layoff or unadaptability was entitled to one week of severance pay for every year of employment in excess of one year. The employee handbook defined "layoff" as a reduction in the work force because of a lack of work. "Unadaptability" was defined as those cases where the employee lacks the proper aptitude but is trying to the best of his or her ability to meet performance standards.

On December 31, 1991, the division discontinued the severance policy, notified all employees of their severance balances as of that date, and told the employees that the division would not pay any future severance benefits other than those benefits already earned. The severance benefits already earned by division employees would be paid to them at termination. Contrary to the division's policy, the former general manager and former chief of the division decided to pay off the severance balances of 26 employees in June 1993, even though none of the employees had terminated their employment with the division as of the date of payment.

Division management's payment of these accrued severance balances to employees who had not yet severed their employment had a negative effect on the estates of the conserved insurers under the management of the division. Specifically, the cost of these payments, almost $90,000, was allocated inappropriately to the conserved estates managed by the division.

Section 1057 of the California Insurance Code states that the commissioner is deemed to be a trustee for the benefit of all creditors and other persons interested in the estate of a person against whom proceedings for conservation or liquidation are pending.

In addition, Section 16040 of the California Probate Code states that a trustee must administer a trust with the care, skill, prudence, and diligence under the circumstances at the time that a prudent person acting in a like capacity and familiar with such matters would use in conducting enterprises of a like nature.

In October 1993, the department referred the matter of these severance payments to the Los Angeles District Attorney's Office. Also, in November 1993, the division contacted all the employees who received unauthorized severance payments and requested repayment by December 15, 1993, or, if they were unable to repay in full by that date, to arrange for a repayment schedule. We reviewed the records to determine how many employees had made repayments as of March 15, 1994. According to the information we reviewed, of the original total net severance payment of approximately $72,000, just over $9,000 has been repaid. Four employees have repaid their severance payments in full and one employee has since been laid off by the division and therefore was allowed to keep the severance payment. The remaining 21 employees elected to have specific amounts withheld from their monthly salaries. The repayment rates and amounts varied. For example, two employees owing approximately $9,000 each have elected to repay in $50 monthly installments. Additionally, two employees who owe more than $3,000 each, had not made any repayments as of March 15, 1994.

We noted another instance of a questionable severance payment made by the division to an employee whom the division terminated in June 1992. The division's most recent policies and procedures state that there are no severance benefits, yet they do not address other final payments made to employees terminated by the division. However, according to the payroll and benefits administrator and the administration manager for the division, when employees are fired, as was the case for this employee, they do not normally receive pay as a replacement for proper notification or additional final pay.

Nevertheless, the former chief of the division approved the final payment of more than $11,100 to this employee. Five checks were issued: $1,442 for two weeks in lieu of notice, $2,527 for accrued vacation, $3,463 for severance pay, $3,463 as additional pay for being a manager, and $244 for payment of accrued CTO. Because this termination was not the result of a layoff or unadaptability, we question the propriety of the payment in lieu of notice, severance pay, and additional pay for being a manager, totaling $8,368.

The Division's Hiring Practices Were Questionable

According to the administration manager, before November 30, 1992, the division had no formal policies and procedures for the hiring of division employees. Even the November 1992 hiring guidelines were in the form of a memorandum and were distributed only to division managers. The memorandum, written by the former general manager of the division, stated that the hiring guidelines "might be formalized in writing later, as needed. . . ." However, the division's hiring practices were never formalized.

According to interviews we conducted with the division's manager of administration and a survey taken of division employees, the advertisement of open positions is accomplished mainly through word of mouth, with most of the employees hired having formerly worked for one of the failed companies being conserved or liquidated by the division. However, this practice of recruiting staff for the division is not acceptable for a public entity because it does not give all individuals who might be interested and qualified for the open positions an opportunity to compete for them. Further, by limiting its recruiting pool to former employees of failed insurers, the division may not have recruited the most qualified and competent employees.

The selection of division employees generally is based on a written application and interview with either a division supervisor or manager, or both. Once hired, employees of the division are required to complete a three-month probationary period during which time certain benefits are not available. After the probationary period has ended, employee performance typically is evaluated once each year. Employees also receive merit salary increases. According to our survey of division employees, merit salary increases normally are given annually. Generally, none of the employees in our survey who had been employed more than one year had been refused merit increases, which were reported to be as low as 6 percent and as high as 15 percent per year. In September 1992, the division made its first attempt to develop merit increases that were tied to performance ratings. According to the administration manager, for all merit increases received by at-will employees before that time, managers recommended the amount of the merit increases they thought appropriate and either the former chief of the division or his successor approved them.

Also, before November 1992, no written job descriptions were available for any of the positions filled by at-will division employees. In November 1992, the former general manager of the division developed job descriptions and desired qualifications for 43 of the 64 at-will employee positions in the division at that time. However, it was not until almost six months later in May 1993, that a salary schedule was developed that accompanied those written job descriptions. According to the findings of a compensation analysis conducted by a management consulting firm hired by the division in October 1993, there did not seem to be a high-performance culture at the division. The analysis stated that the employees recruited from the failed companies conserved by the division may not always be of the highest caliber. The analysis concluded that, while hiring from conserved insurers eliminates the need for initial training, retaining these employees after the winding up of the affairs of the failed insurer's estate leads to significant retraining and morale issues, including integrating different job titles and pay practices into the division. As of January 1, 1994, the division employed 5 civil service employees and 91 at-will employees.

Corrective Action Taken by the Division

Although the division has taken a variety of corrective actions aimed at the areas discussed in this chapter, we believe that additional action is needed.

Since October 1993, the division has undergone a reorganization and amended some of its existing personnel policies. For example, in March 1994, the division reinstated a requirement for written preauthorization for an employee to work overtime. Also, the division has developed a budget, developed a conflict-of-interest policy for its employees, developed new policies regarding salary administration and employee performance appraisals, developed job descriptions for all at-will job positions, and commissioned a compensation study for its executives and managers and its other employees. In addition, the Department of Insurance recently fired the division's general manager and transferred its chief to a position elsewhere in the department as a result of their authorization of the inappropriate payment of compensatory time to exempt employees and the improper payment of severance to employees who had not severed employment with the division.

Many of the corrective actions described above were taken so recently that we were unable to assess how effective they will be after they are fully implemented. However, we did review the compensation study commissioned by the division and have some concerns with the methodology that the consultants were directed to use by the division.

In its request for proposals (RFP) for conducting a wage and salary survey, the division advised prospective consultants that the purpose of the RFP was to determine a salary matrix for the division that would measure and rank the relative worth of each job. The salary matrix was to explain the meaning of midpoint, minimum, and maximum salary for each job classification and how the going salary rate for a particular job was determined. The salary matrix was to include salary ranges with multiple steps after a comparison with private industry that would include accounting for any differences caused by regional pay differences.

We reviewed the methodology used by the consultant selected to conduct the wage and salary surveys for the division's executive-level personnel, managers, and other employees. In both surveys, most of the competitive market data were from the private sector. The executive survey used information drawn from various salary studies of the insurance, banking, and financial industries representing companies with varying ranges of assets under their management and different geographic locations. The manager and employee survey drew its salary comparisons from a variety of studies representing certain groups in terms of the group's function or geographic location. Examples of the comparative studies used included an information systems compensation study; a finance, accounting, and legal compensation study; executive, middle management, and supervisory compensation studies; insurance industry studies; technician and skilled trades studies; a geographic salary study of California and sections of southern California; office support studies; and an employee benefits survey.

We interviewed the consultant in charge of both of the salary surveys to find out why the surveys mainly relied on salaries paid in the private sector. According to the consultant, the chief of enforcement and a special deputy commissioner, both of whom had acted as interim chiefs of the division, instructed the consultant on what market comparisons to use in the survey for the division. Namely, they wanted the consultant to use comparative executive salaries of insurance companies managing assets in the range of $200 million to $500 million for the executive survey and local insurance and noninsurance industries for the manager and employee survey. The consultant stated that the chief of enforcement and the special deputy wanted the consultant to survey the market they intended to recruit from, which was the private sector. The consultant also stated that she used comparative salary information from a study prepared by the California Insurance Guarantee Association (CIGA) of the insurance industry as a means of comparing lower level salaries.

All salary recommendations made by the consultant in the surveys for executive, management, and other division employees have been approved by the division. As a result, most of the division's employees will receive salary increases. Specifically, of the 68 employees and managers for which the consultant made salary recommendations, 58 will receive salary increases, 6 will receive salary reductions, and the salaries of 4 employees will remain the same. The percentage range for the approved salary adjustments of the division's managers and employees ranges from 0.75 percent to approximately 42 percent. For example, one employee formerly paid $37,212 per year was promoted into a new position and now will make $52,800 per year, while another employee who made $39,840 per year before now will make $40,637 per year. The net annual increase to the salaries of managers and employees as a result of the salary recommendations totaled approximately $100,000, or 4 percent.

The executive survey salary recommendations are for five positions that did not exist before the division's most recent reorganization. The five new positions include a chief executive officer (CEO), financial officer, operations officer, estate trust officer, and estate trust manager. The new CEO's position will replace the position held by the former chief of the division, who was a civil service employee, while the individuals filling the other four positions will perform new duties for the division.

The recommended midpoint salaries approved by the division are $195,000 per year for the CEO, $150,000 per year for the financial officer, $130,000 per year for the estate trust officer, and $115,000 per year for the operations officer. The executive salary survey also recommended a salary range of $50,000 to $80,000 per year for the five new estate trust manager positions established under the division's reorganization plan. As of March 28, 1994, the division had hired a new CEO and filled all five of the estate trust manager positions. As of April 15, 1994, the division hired a financial officer and an estate trust officer.

Although much of the methodology used by the consultant in formulating the recommended salary levels shown in the two studies seemed to us to be appropriate, we question whether the surveys should have relied so much on private sector data. Based on our review of the job descriptions developed by the division to cover the positions it employs, many seem to be similar to public sector jobs. For example, we selected 8 civil service positions that were similar to the job descriptions of the duties and minimum qualifications established for 8 of the at-will job positions of the division, as shown in Table 1. In one case, the comparable civil service job offered a higher salary both at the entry level, and at the maximum for the range. For two other of our comparative positions, the civil service rate was higher at the entry level but the division offered a higher maximum salary. Finally, there were five comparable positions for which the division offered a higher entry level and maximum salary than were offered by the civil service.

Insert Table 1

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Table 1

A Comparision Between Conservation and Liq

Salary Ranges for Selected Positi
and State Civil Service Position

Conservation and Liquidation Division Salary Range		Civil Service Classification Salary Range		Dolla Min
Administrative Assistant		**Office Technician**		
$26,900	$36,500	$23,748	$28,860	$3,15
Word Processing Operator		**Word Processing Technician**		
$21,900	$29,700	$20,508	$26,772	$1,39
Receptionist		**Office Assistant (general)**		
$19,800	$26,800	$18,660	$24,912	$1,14
Personnel Assistant		**Office Technician**		
$26,900	$36,500	$23,748	$28,860	$3,15
Warehouse Supervisor		**Warehouse Manager I**		
$29,800	$40,300	$31,752	$41,880	($1,95
MIS Supervisor		**Info Systems Tech Supervisor I**		
$34,800	$47,000	$33,336	$40,068	$1,46
Accounting Manager		**Accounting Administrator III**		
$52,800	$79,200	$61,548	$64,620	($8,74
Administration Manager		**Staff Services Manager III**		
$47,400	$71,200	$61,548	$64,620	($14,14

Notes:

Ranges are analyzed from monthly figures reported by the State Personnel Board to allow a more direct comparison to

Negative figures (indicated with parentheses) reflect higher salary levels in the civil service position classification.

Chapter 4 The Division Has Not Properly Managed Its Consultant Contracts and Its Contracts for Legal Services

Chapter Summary

We attempted to review 31 consultant contracts entered into by the Conservation and Liquidation Division (division) during 1991, 1992, and 1993. We selected for review all contracts that resulted in payments to the consultant of more than $100,000 in one year. These contracts were for professional services, such as management consulting, investment advice, and assistance in managing the day-to-day operations of conserved insurers. They also included agreements with law firms for assistance in handling the conservation and liquidation of failed insurers. In four instances, the division entered into oral, rather than written, contracts with the consultants, although the division paid $1.4 million to these contractors over the three-year period. Two of these four contracts were for legal services, one of the contracts was for tax assistance from a public accounting firm, and the fourth contract was for the services of a consultant to manage the day-to-day operations of one of the conserved insurers. The contract for tax assistance was a $100,000 verbal extension of an existing contract. In addition, the contract for the services of a consultant to manage the day-to-day operations of a conserved insurer was approved by the court after the contract had been awarded even though the contract was never put into writing.

Our review of the remaining 27 written contracts indicates that, in entering contracts with consultants or law firms, the division did not always seek competition for the contracts. In addition, the division did not incorporate key provisions into the written contracts that would have allowed the division to manage each of its consultant contracts effectively. More specifically, 8 of 27 contracts reviewed did not contain a detailed description of the work to be accomplished by the consultant or deadlines for interim or completed work. Twenty-two of the 27 contracts did not include maximum dollar amounts to be spent on the contracts, and 21 did not have provisions for periodic progress reports from the consultant, even though some of these contracts lasted for a year or more. In 17 of the 27 written contracts we reviewed, the division did not specify the ending dates of the contract. Furthermore, the division did not sufficiently review invoices submitted by the consultants before paying the invoices. Our review uncovered several instances of erroneous payments.

In response to recommendations made in 1991 regarding contracting practices, the division implemented new procedures for initiating and managing its contracts with law firms in November 1993 and with other consultants in March 1994.

Background

The division spent \$3.8 million in 1991, \$4.5 million in 1992, and \$6.5 million in 1993 on contracts for professional services. These expenditures were for consulting and attorney services related to liquidating failed insurers and the litigation associated with various liquidations, as well as other specialized services related to the operation of the division. Amounts spent on contracts for professional services are funded from the assets of conserved and liquidated insurers.

During 1991, 1992, and 1993, the period of time covered by our audit, the division did not have written procedures for awarding, managing, and paying for its contracts with outside consultants and law firms. We make numerous references in the sections that follow to sound business practices that should be followed by public entities to ensure that public contracts are properly awarded, managed, and paid for. These sound business practices should include procedures that detail those essential provisions that a consulting services contract should contain, such as a detailed description of the work to be accomplished by the consultant, provisions defining how the contracting department will review periodically the progress of the consultant, and a limit on the amount to be spent on the contract. Sound contracting procedures also describe steps that contracting departments are to follow in making progress payments to consultants. The division has a responsibility to establish controls that would enable it to effectively award, manage, and pay for services provided by its outside consultants and law firms. Also, as we point out at the end of this chapter, the division adopted procedures outlining how it will award, manage, and pay for its contracts with law firms in November 1993 and with other outside consultants in March 1994.

The Division Awarded Contracts Without Seeking Competing Proposals

In most instances, it is a sound business practice to seek competing proposals before obtaining the services of a consultant. When competition is curtailed, the contracting organization may pay more than necessary for the consultant's services. In instances when more than one source for consultant services cannot be identified, it is justified for the contracting organization to award a contract on a sole-source basis. However, the contracting organization should attempt to identify more than one contractor that can provide the needed services.

For the 27 written contracts that we reviewed, the division did not always seek competition for the services of an outside consultant or law firm. The former division chief informed us that he selected most consultants and law firms based on his familiarity with the consultant's or firm's expertise. In some cases, he selected the consultant based on the recommendation of others. Although the former division chief selected all the outside consulting firms, he did not select all the law firms engaged to work on the division's liquidations and conservations. In several instances, the department's general counsel selected the law firms. According to the department's general counsel, she and the chief deputy selected law firms based on their familiarity with the work that the department needed done and the law firm's areas of specialization. Often, the deputy attorney general assigned to assist the division with a particular legal matter would recommend a law firm to the department.

We acknowledge that many of the consultant and legal services contracts were for highly specialized services related to the conservation or liquidation of failed insurers, which could make it difficult to obtain competition. However, not all of the contracts that we reviewed were for consultants in highly specialized fields. For example, 4 of the 27 consultant contracts that we reviewed were for the services of general management consultants, who are widely available in California. Another of the contracts we reviewed was for computer consulting services, which could be provided by many qualified experts.

The Division's Contracts Did Not Always Specify All the Terms of the Agreement

Good business practice suggests that contracts be formalized in a written agreement that contains the essential provisions of the agreement. The written agreement should identify the parties to the agreement, timelines for the performance or completion of the contract, and the amount to be paid to the consultant. On the matter of payment, the written agreement should clearly express the maximum amount and the basis on which the payment is to be made. Furthermore, the written agreement should include a clear and complete statement of the work, service, or product to be performed or provided.

However, 4 of the 31 contracts that we reviewed had no written agreements, although the division paid $1.4 million to these consultants during 1991, 1992, and 1993. For 8 of the remaining 27 contracts, the written agreement did not include sufficient detail about the scope of work to be performed. The 8 contracts stated only in general terms the work to be done by the consultant and specified the hourly rate to be paid to the consultant. These agreements did not specify the schedule to be met, what progress reports were to be made, and the final deadline for the completed work. Seventeen of the 27 written contracts did not contain specific time frames for the performance or completion of the contracts, 22 did not stipulate maximum amounts to be paid on the contracts, and 21 did not have provisions for periodic progress reports from the consultants, although most of the contracts lasted for at least a year.

The Division's Process for Reviewing Invoices From Its Consultants Was Flawed

Because many contracts that the division enters into with its consultants run at least several months or, in some cases, years, the division usually makes periodic progress payments to the consultants. Most of the consultants submit monthly invoices to the division. Before paying the invoice, someone in the division who is familiar with the work produced by the consultant should approve the reasonableness and appropriateness of the invoice before it is paid by the division's accounting office. Typically, the consultants bill for their services in two categories. The consultant seeks payment for the hours spent providing services to the division, and the consultant seeks reimbursement for out-of-pocket expenses incurred while providing services to the division. Typical out-of-pocket expenses include travel, long-distance telephone calls, and photocopying. Invoices from the division's legal consultants also include such out-of-pocket expenses as the cost of legal research services or fees for the service of court documents.

To evaluate the sufficiency of the division's procedures for reviewing invoices, we selected a sample of 200 invoices that 16 of the division's consultant or law firm contractors submitted during 1993. For 9 of the 16 consultants, the division's review of the invoices was flawed. For three invoices submitted by 2 consultants, the division paid the invoices twice. For one of the same consultants, a law firm, the invoices were reviewed by an administrative assistant who had no familiarity with the work that the law firm was performing. Also, one of these consultants was reimbursed for inappropriate expenses. For 5 of the 16 consultants, the division did not require the consultant to submit a detailed breakdown, sufficient support, or actual receipts for the out-of-pocket expenses for which the division reimbursed the consultant. Finally, for 2 consultants, we found that the division paid a higher rate than the contract specified. For contracts with law firms, the division's procedure was to call the consultant to ask for more detail if a charge or an out-of-pocket item appeared questionable. However, as we discuss below, this approach was not totally effective because it resulted in the division's making questionable payments to its outside consultants and law firms.

The Division Has Made Questionable Payments to Its Outside Consultants and Law Firms

Our review of the division's contracts for consultant services and legal services produced the following examples of inappropriate or unreasonable payments:

- In three instances, the division paid for the same legal work twice. The division made these payments, totaling over $34,000, in 1993. For two of these duplicate payments, the consultant sent an invoice to the department's legal division and a courtesy copy of the invoice to the division. However, the division paid both invoices. The department has established new procedures for the review and payment of bills from outside counsel that establish a single route for these invoices. These improved procedures should prevent a repeat of this type of occurrence. The third duplicate payment of $792 resulted from a clerical error, in which an accounting clerk failed to thoroughly research the accounting records to determine if the consultant had already been paid for the services. The division has developed a desk procedure so that such omissions will not be repeated in the future. Since we brought these duplicate payments to the division's attention, the division has taken steps to recoup these payments. In fact, during April 1994, the division received reimbursement for the $792 duplicate payment.

- The division reimbursed costs for photocopying expenses that were unnecessarily expensive. It paid 15 cents per page for approximately 135,000 pages of copying that, according to our research, could have cost 6 cents per page for the first 100 pages and 3 cents per page for the remaining 134,900 pages if an outside copy service had been used. The difference between the two prices is $16,200. At our request, the department asked the law firm submitting this request for reimbursement about our concern regarding these expenses. The law firm responded that, ordinarily, it would send such a large production to an outside copy service and bill the division at a reduced rate but that the need for this photocopying was urgent and that the attorneys had to review the records as they were being copied. However, we found that on five more occasions during this same year, this law firm billed the division 15 cents per page for a total 101,000 pages of photocopying at a cost of $15,150. According to the law firm, it used outside copying services on 32 occasions since December 1990. The law firm stated that on such occasions it paid an 8 to 10 cent copy charge per page, depending on the size and time demand of the job.

- Forty-eight of the 200 invoices that we reviewed were from law firms providing services to the division. Law firms typically submit monthly invoices that present the hours that the firms spent on the division's legal work and the firms' out-of-pocket expenses. Thirty-eight of the invoices included claims for reimbursement of out-of-pocket expenses, but only 11 of the invoices contained detailed breakdowns or actual receipts for those expenses. Without such detail, the division has reimbursed its law firms for expenses that, in our view, could be excessive. Because of this shortcoming, we obtained from the consultant's accounting records the detailed breakdown for several reimbursements that we observed on these invoices. In one instance, the division paid the travel expenses of an attorney that included a $165-per-night hotel room, in-room movies and a beverage bar, expenses for the hotel's health club, and long-distance telephone calls not related to division business. Since we brought these reimbursements to the attention of the division, it has taken steps to recoup the payments for the health club, the movies, and the unrelated telephone calls. Also, according to the general counsel for the department, the department will conduct an audit of this firm's billings after this firm's work for the division is completed.

- We identified two instances in which the division's consultants were paid more than the rates specified in the contract. Payments to one of the consultants totaled $9,450 more than the rate specified for one attorney in this consultant's written agreement. According to the written contract dated October 7, 1991, the consultant was to be paid $225 per hour for one attorney. Initially, this is the rate that the consultant was paid, according to an invoice dated August 1992. However, beginning in September 1992, and continuing through May 1993, the consultant billed the division, and the division paid the consultant, at a rate of $250 per hour. According to the department's general counsel, this higher rate was agreed to orally by the department, but the contract was never formally amended to reflect this change. In the second example, the consultant was paid $325 per hour, although the contract specified the consultant's rate to be $300 per hour. In this instance, the consultant was paid $1,125 more than the rate specified in the contract. According to a department senior staff counsel, this higher rate was agreed to orally by the department, but there was no written amendment.

- One instance of a reimbursement to a law firm for a travel expense was clearly inappropriate. The division reimbursed the law firm $70 for the cost of clothing that the attorney purchased while traveling on division business.

Lack of Procedures Has Hindered the Division's Management of Consultant Contracts and Contracts for Legal Services

Although other state departments follow the contracting procedures spelled out in the California Public Contract Code and the State Administrative Manual, according to the department's general counsel, the division is not required to do so. However, the division is still responsible for properly managing those resources that it devotes to consultant contracts and contracts for legal services. The division clearly has a responsibility to establish controls that would better enable it to effectively award, manage, and pay for the contracted services of consultants and law firms. In 1991, the Department of Finance, at the completion of an audit of the division's business practices, recommended that the division establish better controls over the contracting and management of its consultants. During their review, the Department of Finance's auditors found that the division had contracted with four consultants at a cost of $150,000 without written contracts or descriptions of duties to be accomplished by these consultants.

In January 1991, the department directed the former division chief to establish better controls over the division's consultant contracts. In February 1991, the division's chief sent a memorandum to the department's chief deputy outlining a proposal for establishing a process for contracting with outside counsel. The chief's proposal discussed the process for selecting a particular law firm and the negotiation of rates with the law firm selected.

Recently, the division established two sets of written procedures for contracting with consultants. One set of procedures pertains to contracts with outside legal counsel, and the other set pertains to contracts with other professional service providers.

Corrective Action Taken by the Division

The division's procedures for contracting with outside legal counsel, which were adopted in November 1993, require the division to pre-screen law firms to ensure that they meet basic qualifications. The division places firms that meet these basic qualifications on a list of available law firms. The procedures also require law firms that contract with the division to make conflict-of-interest disclosures, provide periodic status reports, and submit case plans and budgets. The case plans and budgets provide a tool with which the division can effectively evaluate the efficiency of the legal services provided. In addition, the division has established guidelines for the use of project extensions and standards for the reimbursing of out-of-pocket expenses, including a requirement for the law firms to provide supporting detail for such expenditures.

The division's procedures for contracting with other professional service providers require the division to issue a request for proposals

(RFP) and to obtain at least three responses to the RFP. These procedures require a more complete written agreement than past division contracts, including a description of the work to be accomplished, accompanied by a deadline for completion of the work, the amount to be paid to the consultant, and the basis on which such payments are to be made. The procedures also include a method for evaluating the proposals and selecting the consultant.

Since adopting its procedures for contracting for professional services in March 1994, the division has awarded two contracts to consultants. Both of these contracts are for the services of consultants who are to assist the division in its conservation of two insurers. The division's award of these contracts and their drafting of the written agreements has improved under the division's new contracting procedures. For one of the contracts, we reviewed the process for selecting the consultant and found that the division reviewed four potential consultants before awarding the contract. This is clearly an improvement over past practices; however, the basis for selecting the consultant could have been better documented.

Chapter 5 The Division's Allocation of Costs Results in Disproportionate Charges to Conserved Insurers

Chapter Summary

During our review, we found that the Conservation and Liquidation Division (division) improperly charged costs to some insurers. Specifically, because of the division's misapplication of its method of allocating costs initially incurred by the division and later allocated to the conserved and liquidated insurers, a disproportionate share of the costs was allocated to the insurers with more assets. The division has since obtained repayments for such expenses incurred in fiscal year 1992-93. However, the division is still allocating some costs associated with conserved and liquidated insurers with few assets to conserved and liquidated insurers with more assets. The department has submitted budget documents to obtain funding for such expenses incurred in fiscal years 1993-94 and 1994-95, but these funding requests have not yet been approved.

The Division Has Misapplied Its Method of Allocating Costs

Section 1035 of the California Insurance Code requires that all expenses related to taking possession of, conserving, conducting, liquidating, disposing of, or otherwise dealing with the business and property of an insurer shall be paid out of the assets of the insurer. The Code further states that if the property of the insurer does not contain cash or liquid assets sufficient to defray the cost of the services required to be performed, the commissioner may at any time or from time to time pay the cost of these services out of the appropriation for the maintenance of the department.

However, our review of the division's cost allocation process showed that the division improperly allocated costs to conserved insurers, in particular those having more assets. The division uses a method of allocating its personnel and indirect costs to the conserved insurers based on the labor hours expended by its staff on those insurers. The division established a fictitious account called the "allocation company account" that it uses as a cost pool to collect all its payroll and indirect operating costs. These costs are then allocated to the conserved insurers that received the division's services during the previous month. Although we feel the allocation method is reasonable, we noted several instances where the division has misapplied it.

The Division Did Not Properly Allocate Its Costs

We reviewed 66 expenditures from calendar years 1992 and 1993 having a total allocated cost of approximately $940,000. We judgmentally selected a month's expenditures from each quarter during 1992 and 1993.

From our review of these expenditures, we found that the division did not properly allocate costs to the conserved insurers. Specifically, in January 1992, the division allocated two reimbursements totaling approximately $162,000 to the conserved insurers that represented a refund of unused self-insurance medical premiums and the cash balance from the closure of an account that belonged to conserved and liquidated insurers that had few assets. These funds were contributed by specific conserved insurers and should have been returned to those insurers. However, by reallocating the reimbursements through the cost allocation process when these reimbursements occurred, some insurers received more than their fair share of the reimbursements based on the labor hours for that period, while others received less than their fair share.

In addition, during 1992 and 1993, the division improperly allocated approximately $75,000 in indirect costs that applied to periods other than the period to which they were allocated. These indirect costs consisted of expenditures for services and depreciation that should have been spread over a period of months instead of being charged and allocated to the insurers all at once. Because allocation rates vary from month to month due to fluctuations in conserved insurer workloads, and because expenses sometimes were allocated in months other than the ones in which they were incurred, some insurers were being charged more than their fair share of the expenses, and others were charged less than their fair share.

The Labor Hours Used As a Basis of Allocation of Division Costs Were Not Accurate

The division based its allocation rates on the number of hours its employees spent on each conserved insurer. These hours are determined from the semimonthly time sheets that division employees submit. Each month, these time sheets are summarized by units within the division on a cost allocation worksheet to show how many hours the employees spent on each conserved insurer during that month.

Based on the hours that employees recorded on their cost allocation worksheets, the division then allocates its personnel and indirect costs to the conserved insurers.

We reviewed 35 time sheets from 7 different months during 1992 and 1993 and found that for 24 of the 35 time sheets, the time charges reported on the time sheets did not agree with the time charges recorded in the cost allocation worksheets. For example, in July 1993, a division employee charged 111 hours to a conserved insurer on her time sheet; however, the cost allocation worksheet indicated that only 38 hours were charged to the conserved insurer.

In addition, we found that some conserved insurers were charged hours on the cost allocation worksheets when no time had been reported on the employees' corresponding time sheets. For example, in October 1993, a conserved insurer was charged 19.5 hours per the allocation worksheet when the employee's time sheet for that month showed that no time was charged to that conserved insurer. We also found that some conserved insurers were not charged any time on the cost allocation worksheets when the employees' time sheets indicated that time was charged that month to the conserved insurers. For example, in October 1993, a division employee charged 27 hours to a conserved insurer per the semimonthly time sheet; however, the cost allocation worksheet did not show any hours charged to the conserved insurer that month.

Because the method used by the division to allocate costs to the conserved insurers is based on direct labor hours, a conserved insurer that is not charged for time that should have been charged will not absorb its fair share of division personnel or indirect costs. Likewise, a conserved insurer that is charged for time that should not have been charged will absorb division costs for services the insurer did not receive.

According to the division's accounting manager, the reason the employees' time sheets and the cost allocation worksheets did not match is that in April 1993, the division began using employees' time sheets from the last pay period of the preceding month and the first pay period of the current month as the basis for the current month's allocation. She indicated that before April 1993, the division used employees' time sheets for the current month's pay period to allocate the current month's costs. She also indicated that the change was made as a result of a conversation with a Department of Finance auditor regarding the way the division allocated overtime payments from the previous month. However, according to our review, there were many occasions in 1992 and before April 1993 when the division's time sheets did not agree with its allocation worksheets. Because overtime earned is not paid until the subsequent pay period, an allocation rate may be used that is not representative of the pay period when the overtime was worked. Although the observation made by the Department of Finance is valid for overtime, these costs are typically minor compared to the total costs allocated each month by the division. Therefore, by continuing to use the time sheets from a prior month's pay period to allocate the current month's operating expenses, the division is not matching the costs it incurs in a given month to the conserved insurers that benefited from the division's services that month.

The Division Improperly Allocates Its Costs of Servicing Conserved Insurers With Few Assets to Conserved and Liquidated Insurers With More Assets

The division also improperly allocated $181,000 in costs it incurred servicing conserved insurers with few assets to those conserved insurers it manages with more assets. In 1992, the division began responding to the need to conserve and liquidate unlicensed insurers and agencies with actions known as enforcement conservations or liquidations. These actions are part of an overall department objective to prevent the illegal operation of unlicensed insurers and agencies in California by gaining control of the assets, furniture, and equipment of the illegal operations to prevent them from re-entering the insurance business in California. However, after the division seizes these unlicensed insurers and agencies, it often finds that they have few assets.

From July 1992 through June 1993, the division had charged those conserved insurers with assets approximately $181,000 in expenses for services it rendered to insurers with few assets. According to the division's accounting manager, before July 1993, the division was not allocating any of the costs of the services it rendered to conserved insurers having insufficient assets to reimburse the division. Instead, the division allocated the costs it incurred servicing the insurers without assets to those conserved insurers the division managed having assets sufficient to reimburse it. As a result, the division had not attempted until recently to seek the necessary funding authority to reimburse it for the services it renders to insurers having few assets.

The department acknowledged that it had improperly allocated these costs to the conserved insurers with assets. In February 1994, the division sought funding from the department's insurance fund to reimburse the approximately $181,000 in expenses that it had overallocated to conserved insurers with more assets. The department granted the funding request in March 1994 and the division has been paid in full. Also, in January 1994, the department submitted a request for funding a budget deficiency to the Legislature for fiscal year 1993-94, in part to fund the division's ongoing services of conserving and liquidating conserved insurers with few assets. The deficiency requested for this purpose totaled approximately $623,000. However, according to the department's chief of the enforcement division, the deficiency request is still being reviewed by the Department of Finance.

In July 1993, the division began allocating its costs for rendering services to all the insurers it manages, regardless of whether or not the insurers have assets, according to their proportionate share of the costs. However, because the division does not have funds to cover the ongoing costs of conserving or liquidating conserved insurers with few assets, the insurers with more assets are still bearing a disproportionate share of the division's costs of conserving insurers having few assets. Specifically, the division is being reimbursed each month from the assets of conserved insurers to replenish the deficits created from services it renders for conserved insurers with few assets in the division's fictitious allocating account. The negative balance in this fictitious account is then allocated to those insurers having more assets at the end of each month.

Our review of a sample of 66 calendar year 1992 and 1993 expenditures allocated by the division showed that the division had allocated a total negative balance of approximately $15,000 to the conserved insurers with more assets during June and July 1993 alone. According to the department's chief of the enforcement division, the division has created a procedure to bill the department's insurance fund for payment of these deficits during the current fiscal year. He further stated that the insurance fund is obligated to pay these expenditures within the limits of the department's spending authority. Assuming the department receives approval for its budget requests, this problem will be resolved at least through fiscal year 1994-95.

When the division improperly allocates its costs for servicing insurers with few assets to those conserved insurers with more assets, the division is not ensuring that the assets of the conserved and liquidated insurers it manages are protected. Furthermore, the division is not ensuring that the assets of those conserved insurers are maximized so as to ensure a maximum return of assets upon liquidation to the policyholders and general creditors of liquidated insurers.

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Chapter 6 Other Inappropriate Practices at the Division

Chapter Summary

Our review also showed that the Conservation and Liquidation Division (division) engaged in other inappropriate practices. Specifically, we found that the division did not properly dispose of liquidated insurers' assets in a way that ensured that the assets were sold for their fair market value. Further, the division did not always process the claims of liquidated insurers promptly.

The Division Did Not Properly Handle the Disposition of Assets of Liquidated Insurers

When the insurance commissioner (commissioner) determines that it would be futile to rehabilitate a conserved insurer, he may apply to the court for an order to liquidate the assets of the insurer. When the liquidation order is received, the division, on behalf of the commissioner, will start to liquidate the assets of the conserved insurer. From 1991 through 1993, the division conducted nine liquidation sales of liquidated insurers' assets.

Because the division has the responsibility to protect the assets of a liquidated insurer and maximize the return to the policyholders and creditors, the division should adopt procedures relating to the sale of liquidated insurers' assets necessary to ensure that those responsibilities are met. These procedures should include: inventorying the assets to be sold; when cost effective to do so, establishing the fair market value of the salable assets through the use of a professional appraiser or other independent means; advertising the sale to the general public; properly assigning the duties relating to the sale so that there is no opportunity for a real or apparent conflict to occur; and ensuring that all sales are "arm's length" transactions. However, until recently the division failed to adopt such procedures.

In view of the division's not having developed procedures, we question its ability to have obtained fair market values for the assets of liquidated insurers it disposed of. These assets generally consisted of furniture and fixtures, office equipment, computers, and computer-related equipment. Specifically, during our review of the Department of Insurance's (department's) internal investigation report and other pertinent documents on the division's disposition of assets, we found that the division allowed its employees, consultants, investigators from the department's Investigation Bureau, former employees of the liquidated insurers, and friends and family members to purchase the assets of liquidated insurers.

According to the department's internal investigation, the department found that there was no evidence of criminal intent or acts of dishonesty by division employees. Further, according to the report, the main reason for allowing employees to participate in the liquidation sale was to increase participant turnout. The report also stated that even though division employees were allowed to participate in liquidation sales, the liquidated insurers probably did not suffer any financial loss because of it.

One of the nine liquidation sales that occurred between 1991 and 1993 occurred in February 1993. According to the department's internal investigative report, in this liquidation sale, the division purchased and retained a substantial amount of the furniture and equipment for its own use. The division sold furniture and equipment having a book value of approximately $131,000, according to the liquidated insurer's records, for approximately $64,000. The book value of an asset is the value of the asset as it appears on the accounting records of a company for accounting purposes and may not reflect the actual fair market value of the asset. Because of the difference in the book and sale values, the division wrote off the remaining value of approximately $67,000 as a loss on the sale of the furniture and equipment for accounting purposes. Of the $64,000 worth of furniture and equipment sold, the division purchased approximately $14,000 of it for its own use. In addition, division employees, a division contract consultant, investigators from the department's Investigation Bureau, former employees of the liquidated insurer, and friends and family members purchased approximately $6,000 worth of furniture and equipment, including more than $1,200 worth of computer equipment purchased by one of the division's contract consultants. Finally, approximately $44,000 worth of furniture and equipment was purchased by private businesses and the general public during public sales conducted by the division.

On several occasions, employees of the division and former employees of the liquidated insurers were allowed to preview and purchase items in advance of the public sales. For example, according to the department's internal investigation report, before a January 1993 sale to the public, the same division employee responsible for conducting the inventory and pricing the furniture and equipment of a liquidated insurer also arranged for the sale of some of the assets to herself, other employees of the division, and former employees of the liquidated insurer. She received and approved several bids that were submitted by these individuals and allowed them to pick up the sale items before the date of the public sale. Moreover, she approved a bid of $130 that she had submitted for herself for the purchase of 2 two-drawer file cabinets, a four-drawer file cabinet, a kitchen table, 2 kitchen chairs, and a small, damaged table. She picked up these items before the date of the public sale. She indicated that she had purchased the furniture for a friend. According to the department's internal investigation report, in June 1993 the department's chief of the enforcement division ordered the practice of allowing employees to participate in liquidation sales discontinued.

In addition to the appearance of self-dealing, the division could have attempted to sell some liquidated property sooner. For example, three oil paintings worth a total of approximately $35,000 were retained in the division office until early August 1993. One painting was hanging in a division conference room, and the other two were hanging in the office of the assistant chief of the division. The paintings were transferred to the division from an insurer whose assets were liquidated in April 1991. Transferring the paintings to the division and hanging them on the walls was questionable because the division's responsibility is to promptly sell liquidated property for the best price possible. These paintings are now securely stored elsewhere. The division made some initial efforts to sell the paintings, but as of April 1, 1994, the paintings remain unsold.

In another example discussed in the department's internal investigation report, in May 1990 before the liquidation sale, the assistant chief of the division received and approved a bid for the purchase of customized computer software and all the proprietary rights for $1,500 from a former employee of the liquidated insurer. However, according to the division employee who handled the sale, the division did not independently ascertain the value of the software before selling it to a former employee of the liquidated insurer before the public sale. Without an independent valuation of the software, the division cannot be sure that it received the fair market value for the software when it sold the software for $1,500. A division employee who used to work at the liquidated insurer before it was conserved stated that she believed that the former president of the company used one of his employees to purchase the software with the intention of marketing the software program himself. Further, the division employee stated that the development costs for the software exceeded $100,000.

According to the division employees who had handled liquidation sales in the past, the division did not have any written policies and procedures for disposing of assets of liquidated insurers. Furthermore, the division used its own employees to estimate the value of the assets of liquidated insurers. In addition, our review of the Department of Finance audit findings on the division's disposition of assets since 1991 showed that the division was aware of its internal control weaknesses in this area. However, until March 1994, the division had not addressed these weaknesses adequately.

Corrective Action Taken by the Division

In October 1993, the department referred the matter of the division's selling the assets of liquidated insurers to its own employees to the Los Angeles District Attorney's Office. In addition, the commissioner stated in his July 1993 response to a Department of Finance audit report that he had directed his staff to develop written procedures to control the disposition of assets. He indicated that the procedures should address the methodology for the valuation and sale of property, the detailed recordkeeping of inventory and disposition of assets, and controls to ensure that no fraud or self-dealing would occur and that the maximum value on the sale of assets would be achieved.

In March 1994, the division implemented the new policies and procedures regarding the disposition of the assets of liquidated insurers. Specifically, the division prohibits any of its employees, department employees, liquidated insurer employees, department contractors, and friends and relatives from purchasing assets from a liquidation sale. Further, the division's policy regarding the sale of assets states that the fair market value of items to be sold must be determined before the sale.

However, even though these procedures suggest the use of a qualified independent appraiser to value the furniture and equipment of the liquidated insurer, they are not clear as to the proper segregation of duties during sales of liquidated insurers' assets to ensure that maximum value is achieved and no real or apparent conflict occurs. Specifically, the procedures indicate only that "designated division employees" prepare for and conduct the sales and account for the receipts of the sales. They do not address the need for the proper segregation of the duties of setting up the sale, conducting the sale, and accounting for the receipts to ensure that assets are sold properly and for the maximum value. According to division employees, the division has not had a liquidation sale since the new policies and procedures were developed.

Sections 1037(a) and (d) of the California Insurance Code require the commissioner, as conservator or liquidator of an insurer taken into his possession, to act as necessary to conserve or protect the assets of the insurer and to sell or dispose of any property of the insurer at its reasonable market value.

Because the division did not develop procedures for the disposition of assets of liquidated insurers until recently, we could not determine whether it received fair market values for the assets it disposed of. Further, because the division's newly established policies and procedures do not address the proper segregation of duties during sales of the assets of liquidated insurers, the division cannot ensure that the assets of the liquidated insurers will be properly sold.

The Division Does Not Always Process Claims Promptly

When an insurer is conserved, the division acts much as an insurance company in organizing the conserved insurer's claims records and processing the claims for payment. If the insurer is in liquidation, the division will determine if the claim is covered by an insurance guarantee association. If so, the division will forward the claim to the association for payment. If the claim is not covered, the division will evaluate the claim and notify the claimant of its determination and hold the claim until the commissioner applies for and receives a distribution order from the court to conduct a final distribution of the assets of the liquidated insurer.

We judgmentally selected and reviewed one claim each from ten liquidated insurers. Five of these claims were property and casualty claims, and the remaining five were life and health claims. Six of these claims were covered by an insurance guarantee association and therefore were processed by the insurance guarantee association. However, four claims were not covered by an insurance guarantee association and were processed by the division.

Our review of the four claims that the division processed showed that it took the division from two to three years to process three of the claims. However, the division took only four months to process the other claim we reviewed. In addition, we found that for one of the claims covered by an insurance guarantee association, the division had yet to process the portion of the claim representing a $100 deductible not covered by the insurance guarantee association even though the insurance guarantee association paid the covered portion of the claim in May 1991.

Even though our sample of claims may not represent the claims processed by the division, the division ought to review its claims processing to determine if its claims staff normally takes two to three years to process a claim. If the division determines that its claims staff takes an inordinate amount of time to process a claim, it should review its staffing to ensure that claims are processed more promptly.

Sound management practices would require the division to process its claims promptly to enable the division to close the estate of the liquidated insurers promptly. The responsibilities of the division, acting as the conservator or liquidator, require that the division process claims promptly and close the estates of liquidated insurers promptly. By doing so, the division would be acting in the best interest of the policyholders and general creditors of the liquidated insurers in protecting the assets of these liquidated insurers.

Chapter 7 Conclusions and Recommendations

In conducting its activities as the conservator and liquidator of insurance companies on behalf of the insurance commissioner, the Conservation and Liquidation Division (division) is granted broad authority by the California Insurance Code and believes it is exempt from the oversight normally afforded to public agencies regarding the division's budget, expenditures, contracting and purchasing practices, and personnel and salary administration.

The division feels that adequate oversight of its operations is provided through the internal management of the department, the superior courts and judges that approve the conservation and liquidation orders, and audits conducted by the Department of Finance. However, the results of our review of the division's operations, centering on the previous three calendar years, indicate the need for more focused oversight in several of the areas discussed below.

The division has not developed a strategic management plan for closing the conserved and liquidated insurance companies it manages that includes specific goals and milestones to monitor the plan's success. Without such a plan, the division cannot effectively project its workload, project its staffing requirements, or measure its effectiveness and efficiency in managing the assets of the insurance companies under its control.

The division developed a budget for 1994, but it was not based on its activity level or performance standards, and it does not include the projected direct annual costs of the consultants it contracts with. Without a meaningful budget, the division has no way to effectively monitor its operating expenses and to provide incentives to control costs.

In the area of its personnel practices, the division failed to adequately advertise when it had open positions, thus failing to provide qualified and interested candidates an opportunity to compete for those jobs. In addition, until the latter part of March 1994, the division used questionable practices in the hiring of employees and in granting merit salary increases and promotions.

Further, the division failed to adhere to various policies it had established, and lacks other policies necessary to control overtime usage. This practice contributed to a more than 400 percent increase in overtime compensation during the last two calendar years and led to improper overtime payments to its exempt employees totaling more than $119,000.

Additionally, two of the division's former managers authorized inappropriate severance payments totaling approximately $90,000 to division employees who did not terminate their employment. Finally, the former chief of the division made a questionable payment of $8,368 to an employee fired by the division.

A review of 31 consultant contracts revealed that for 4 of the contracts, the division did not have written agreements with its consultants. Also, the division did not always attempt to obtain competition before it awarded contracts and did not always write all the essential provisions into its contracts. In addition, the division's process for reviewing invoices was flawed, leading to questionable payments to its consultants, such as three payments totaling more than $34,000 that were made twice for the same work, and reimbursements to consultants for questionable items, such as the expense of a hotel health club and long-distance calls not related to division business.

In addition, the division misapplied the method used to allocate the indirect costs it incurs in providing services to the insurers under its management that resulted in an inequitable allocation of costs. Moreover, pending a Department of Finance decision regarding a deficit funding request, the division has been unfairly allocating costs it incurs servicing insurers having few assets to those insurers having assets sufficient to reimburse the division.

Furthermore, the division did not properly handle the sale of assets in several of its most recent liquidation sales. Finally, in some instances the division did not process claims promptly.

Recommendations

To ensure that the division addresses the problems identified in our report, it should take the following specific actions:

- Establish strategic management plans that include specific goals, milestones, and time lines for all the insurance companies under its management;

- Develop meaningful budgets that are based on the level of conservation and liquidation activities of the division and that include all the division's costs, including consultants' costs, to ensure effective monitoring of the division's expenditures;

- Fully implement and follow the recently developed performance management program manual to ensure that all merit salary increases and promotions are equitable and based on employee job performance;

- Ensure that the March 1994 reinstatement of its policy requiring the prior written authorization of overtime for nonexempt employees is followed and that the proposed form be amended to include the dates that overtime will be worked and the approval date;

- Investigate the propriety and recovery of all severance payments made by the division;

- Develop policies and procedures for the hiring of division employees that ensure that all qualified candidates have an opportunity to compete for job openings;

- Ensure that future surveys conducted to adjust employee salaries include public sector comparisons where appropriate;

- Require consultants and outside law firms the division contracts with to submit detailed explanations or actual receipts with their claims for reimbursement for out-of-pocket expenses, or conduct audits of consultants' invoices to ensure that the consultants or law firms have not been paid more than what is due;

- Ensure that expenses that are identifiable to particular conserved or liquidated insurers are charged to those conserved or liquidated insurers;

- Ensure that the time recorded by division employees on the cost allocation worksheet is accurate and agrees with the time reported by them on their time sheets for the period of allocation;

- Ensure that the conserved and liquidated insurers that have borne a disproportionate share of past division expenses, particularly the expenses related to the cost of conserving and liquidating insurers with few assets, are reimbursed;

- Secure funds to cover the ongoing costs of conserving and liquidating insurers with few or no assets;

- Ensure that qualified independent appraisers are used, whenever it is cost effective, in the valuation of assets of liquidated companies before such assets are sold;

- Ensure that division employees follow the newly developed policies and procedures in the disposition of assets that prohibit self-dealing and ensure that assets are sold at fair market value; and

- Ensure that there is proper segregation of duties in inventorying the assets of liquidated insurers, conducting the sales, and accounting for the receipts from the sales of liquidated insurers' assets.

To ensure that proper oversight of the division's operations are provided, we recommend that a followup review of the division be conducted by the Bureau of State Audits or by another independent auditor in one year. This review should include the following:

- Assess the effectiveness of the corrective actions recently taken or planned by the division;

- Review of the division's consulting contract practices;

- Review the quality of the division's efforts in preparing budgets and management plans for the insurers it manages; and

- Review the adequacy and effectiveness of the division's internal accounting and administrative controls.

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

Respectfully submitted,

KURT R. SJOBERG
State Auditor

Date: May 5, 1994

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