California State Auditor

BUREAU OF STATE AUDITS

Department of Insurance:

Its Conservation and Liquidation Office Continues to Collect and Distribute Proceeds From the Liquidation of the Executive Life Insurance Company

October 2006
2005-115.1

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CALIFORNIA STATE AUDITOR

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October 19, 2006

2005-115.1

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

Dear Governor and Legislative Leaders:

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

The report concludes that the insurance commissioner (commissioner) has received over $1.1 billion in litigation proceeds from two significant legal matters on behalf of the ELIC estate since 1991. To recover these proceeds, the estate has expended over $165 million in litigation costs. The department's Conservation and Liquidation Office (CLO) has designated and distributed part of roughly $988 million in proceeds to policyholders and guaranty associations. The commissioner anticipates receiving more litigation proceeds, which the CLO will distribute in the future.

As of May 2006 the CLO was holding $18.4 million from the ELIC estate because it lacked the information that it needs to distribute the funds, such as policyholder addresses. If the CLO still lacks the information that it needs to distribute the funds at the time it closes the ELIC estate, it will transfer the funds to the State Controller's Office as unclaimed property and the funds will ultimately again be transferred to the department for safekeeping until the rightful owners claim them. As of September 2006 the CLO estimates that it will close the ELIC estate in late 2008.

The commissioner hired outside counsel with the knowledge of the Office of the Attorney General to handle the conservation and liquidation of ELIC as well as recent civil fraud litigation. In addition, based on our review of a sample of the CLO's contracts with both outside counsel and others, the terms of the agreements were reasonable and the fees were generally comparable to fees paid by other public entities or were reasonable for the types of services rendered.

The audit committee also asked us to determine how much money policyholders have received and are yet to receive, the percentage of policyholders who have recovered their entire investment, and the percentage of the loss to ELIC policyholders that will be recovered. The data needed to complete these and other tasks reside with Aurora National Life Assurance Company (Aurora), ELIC's successor. We are in the process of obtaining this data from Aurora and will issue an additional report addressing these and other topics once Aurora makes the data available to us.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

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SUMMARY

Audit Highlights . . .

Our review of the Department of Insurance's (department) management of the Executive Life Insurance Company (ELIC) estate and related litigation indicates the following:

- ☑ *The insurance commissioner (commissioner) has received over $1.1 billion in litigation proceeds from two significant legal matters on behalf of the ELIC estate since 1991. The estate has expended over $165 million on litigation costs to recover these proceeds.*
- ☑ *The department's Conservation and Liquidation Office (CLO) has designated and distributed part of roughly $988 million in proceeds to policyholders and guaranty associations. The commissioner anticipates receiving more litigation proceeds, which the CLO will distribute in the future.*
- ☑ *As of May 2006 the CLO was holding $18.4 million from the ELIC estate because it lacks the information that it needs to distribute the funds, such as policyholder addresses.*

continued on next page . . .

RESULTS IN BRIEF

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

Executive Life Insurance Company (ELIC) was a multibillion-dollar life insurance company that had its principal legal residence in California and operated in the State from 1962 to 1991. According to a report issued by the chief deputy insurance commissioner in 1994, ELIC invested 55 percent to 60 percent of its portfolio in high-yield, noninvestment-grade corporate bonds, also known as junk bonds, during the 1980s. The industry average for this type of investment typically ranged from 7 percent to 11 percent.[1] In late 1989 the junk bond market experienced a significant decline in value, and by early 1991 the commissioner determined that ELIC's financial statements were grossly overstated and that the company was insolvent. On April 11, 1991, acting on a court conservation order, he took over the operation of ELIC.

The commissioner has received more than $1.1 billion in litigation proceeds from two significant legal matters on behalf of the estate since 1991. The first concerned alleged civil and criminal fraud in the purchase of ELIC's junk bond portfolio and insurance business. The second concerned the failure of ELIC and the bankruptcy of its corporate parent, the First Executive Corporation. The ELIC estate has expended more than $165 million on litigation costs to recover these proceeds. The CLO has designated and distributed part of almost $988 million in proceeds to policyholders and guaranty associations.[2] The commissioner also anticipates receiving more litigation proceeds, which the CLO will distribute in the future.

[1] Noninvestment-grade bonds are a grade assigned by bond rating agencies such as Standard & Poor's.

[2] Guaranty associations are entities established to cover the obligations of insolvent insurers by paying policyholders' covered claims where appropriate.

- ☑ *The commissioner hired outside counsel with the knowledge of the Office of the Attorney General to handle the conservation and liquidation of ELIC as well as recent civil fraud litigation.*
- ☑ *Based on our review of a sample of the CLO's contracts with both outside counsel and others, the terms of the agreements were reasonable and the fees were generally comparable to fees paid by other public entities or were reasonable for the types of services rendered.*
- ☑ *The data needed to determine how much money policyholders have received and are yet to receive, the percentage of policyholders who have recovered their entire investment, and the percentage of the loss to ELIC policyholders that will ultimately be recovered resides with Aurora National Life Assurance Company (Aurora), ELIC's successor. We are in the process of obtaining the needed data from Aurora. We will analyze this data and issue an additional report addressing these and other topics when Aurora makes the data available to us.*

Once the CLO closes the estate, it will initially transfer any remaining funds that could not be paid to policyholders, because of a lack of information or legal reasons, to the State Controller's Office as unclaimed property. Ultimately the funds are transferred again to the department for safekeeping until the rightful owners claim them. As of May 2006 the CLO was holding $18.4 million from the ELIC estate that eventually may be transferred.

The commissioner used outside counsel to represent him in the ELIC estate conservation and liquidation as well as the recent civil fraud litigation. Generally, the Office of the Attorney General (attorney general) acts as legal counsel for California state agencies. Before 1996 the law gave the commissioner discretion to use the attorney general or outside counsel in delinquency proceedings. In 1996 the law changed, requiring the commissioner to use the attorney general's legal services or to obtain that office's approval to hire outside counsel. He hired outside counsel with the knowledge of the attorney general to handle the conservation and liquidation of ELIC as well as the recent civil fraud litigation. Based on our review of a sample of the CLO's contracts with both outside counsel and others, the terms of the agreements were reasonable and the fees generally were comparable to fees paid by other public entities or were reasonable for the types of services rendered.

We have not determined how much money policyholders have received and are yet to receive, the percentage of policyholders who have recovered their entire investment, or the percentage of the loss to ELIC policyholders that ultimately will be recovered. The data we need to complete these and other tasks reside with Aurora National Life Assurance Company (Aurora), ELIC's successor. With the assistance of the department, we are in the process of obtaining the needed data from Aurora. We will analyze this data and issue an additional report addressing these and other topics when Aurora makes the data available to us.

The ELIC estate is still open. The closing has been delayed because the commissioner is involved in two disputes surrounding proceeds from the civil litigation. In September 2006 the CLO estimated that it would close the ELIC estate in late 2008.

AGENCY COMMENTS

The CLO generally agreed with our audit conclusions but has a different interpretation of our conclusions regarding the reliability of certain of its data. ■

INTRODUCTION

BACKGROUND

Under the direction of its commissioner, the Department of Insurance (department) is responsible for regulating the insurance companies, brokers, and agents operating in the State. By state law, the insurance commissioner (commissioner) is an elected position serving a maximum of two four-year terms. The California Insurance Code (code) gives the commissioner broad powers to supervise the department and to perform all duties under law regulating the business of insurance in the State. As part of its regulatory authority, the department is responsible for protecting policyholders, beneficiaries, and the public from losses due to the insolvency of insurance companies (insurers) authorized to conduct business in California. Insolvency is a financial condition in which an entity is unable to meet its financial obligations and, in the case of an insurer, is unable to pay claims when they are due.

THE CONSERVATION AND LIQUIDATION OFFICE

Definition of Terms

Conservation: Upon a superior court's order, the commissioner takes over the operations of an insurance company licensed in California and conducts a thorough examination of its books and records.

Rehabilitation: If the commissioner determines that the insurance company can be rehabilitated, meaning its identified problems can be corrected, he eventually will return day-to-day management to the company.

Liquidation: If the commissioner determines the insurance company cannot be rehabilitated, he closes it, converts its assets into cash, and applies for a court order to distribute its assets to parties having a financial interest in the estate.

Source: Conservation and Liquidation Office Web site http://www.caclo.org

The commissioner established the Conservation and Liquidation Office (CLO) to assist the department in fulfilling its responsibility to protect California residents from losses due to the insolvency of insurers. Section 1011 of the code authorizes the commissioner, on obtaining a court order, to take possession of the real or personal property, books, records, and assets of an insurer and to conduct, as conservator, as much of the insurer's business as he deems necessary. Once the commissioner obtains a court order, the CLO takes a leading role to conserve, rehabilitate, or liquidate financially distressed or insolvent insurers. See the text box for a definition of conservation, rehabilitation, and liquidation. As of October 2006 the CLO was responsible for managing 25 insurance companies, which it refers to as estates.

Order of Asset Distribution

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

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

After the CLO has liquidated the assets of an estate, the commissioner must apply for a court order to distribute the assets to policyholders, creditors, and other interested parties in the order required by the code. See the text box for the sequence required in 1991.

THE EXECUTIVE LIFE INSURANCE COMPANY

The commissioner ordered the conservation of the Executive Life Insurance Company (ELIC) in April 1991.[3] Between April 1991 and September 1993, he took steps to rehabilitate and partially liquidate the estate. In August 1993 the conservation court approved a rehabilitation plan for the estate and in September 1993 the California Supreme Court rejected applications for appeal, allowing the plan to take effect. This rehabilitation plan authorized the liquidation of all of ELIC's remaining assets, provided policyholders the option to continue their policies with a successor insurer, and specified how policyholders would share in the liquidation of the company's assets. From June 1991 to November 1993, a special deputy appointed by the commissioner was responsible for the day-to-day oversight of the company at ELIC's office building in Los Angeles. The commissioner appointed another special deputy who managed the ELIC estate from November 1993 through July 1997. On August 1, 1997, the CLO assumed responsibility for managing the ELIC estate.

Events Leading to the Conservation of ELIC

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

[3] Between the time shortly before ELIC's conservation in 1991 and October 2006, five different individuals have held the position of insurance commissioner. See the Appendix for a partial timeline relating to ELIC and the different individuals who served as insurance commissioner during that period.

guaranteed investment contracts, which were sold to municipalities as investments for bond proceeds; and pension guaranteed investment contracts, which were sold to pension funds. Even though some of ELIC's products were known as contracts, we refer to all of ELIC's customers as policyholders.

To help cover claims against it, an insurance company will invest the premiums it receives; ELIC was no different in this respect. However, according to a report issued in 1994 by the chief deputy insurance commissioner (chief deputy), ELIC was unique among large insurance companies in that during the 1980s it typically invested 55 percent to 60 percent of its portfolio in high-yield, noninvestment-grade corporate bonds, also known as junk bonds. Junk bonds are labeled noninvestment according to the grades established by bond rating agencies, which rate bonds according to their investment worth. The noninvestment grade falls below the four highest grades used by these rating agencies. ELIC's concentration of junk bonds was much higher than industry averages at the time, which was typically 7 percent to 11 percent. Because of its investment strategy, ELIC was able to offer interest rates on its insurance products that were two to eight points higher than rates earned on U.S. government treasuries, a main source of investment in the insurance industry.

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

The chief deputy's report further stated that in early 1991 the commissioner began scrutinizing ELIC's holdings. Analyses of its junk bond portfolio revealed that the insurer's financial statements, which had valued the bonds at $6 billion, were

greatly overstated; according to the department's analysis the portfolio's market value was closer to $3.5 billion or $4 billion. With the lower valuation, ELIC's obligations far exceeded its assets. In addition, its independent auditors would not express an opinion on its parent corporation's financial statements because they had substantial doubt as to whether the FEC was a going concern. Acting on a conservation court order, the commissioner took over the operations of ELIC on April 11, 1991.

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

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

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

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

Liquidation of Assets—Conserving and Liquidating the ELIC Estate

After conserving ELIC, the commissioner took steps to rehabilitate and partially liquidate the estate. He conducted a complex bidding process; obtained court approval to sell ELIC's junk bond portfolio; identified Aurora National Life Assurance Company (Aurora), a company based in the United States and established by a consortium of French companies, as a successor for ELIC's insurance business; and entered into an agreement with the National Organization of Life and Health Insurance Guaranty Associations (national guaranty organization) to augment its statutory coverage with enhanced coverage of certain policyholder losses. The text box explains the role guaranty associations play. The commissioner also drafted a rehabilitation plan, which outlined terms significant to the sale of ELIC's assets, terms and conditions for restructuring ELIC's policy obligations, and how policyholders would share in the liquidation of ELIC's assets that were not transferred to Aurora. After significant debate and modifications, the conservation court approved the rehabilitation plan, which took effect in September 1993.

The rehabilitation plan provided for the restructuring of ELIC's policies to eliminate the differential between the value of ELIC's assets at the time of the sale and the value of its liabilities under the terms of the original insurance policies. The required restructuring reduced the value of each policy and adjusted certain policy terms such as surrender rights. The rehabilitation plan also provided each policyholder with an in-force policy at the time of the sale, the option to opt in to the plan or to opt out. By opting in, the policyholder (opt-in policyholder) continued his or her insurance coverage

with the new insurer, Aurora; remained eligible to recover some or all of any reduction in the policy's value through payments from the national guaranty organization; and could share proportionately in the liquidation of ELIC's remaining assets. A report issued by the chief deputy in 1994 states that policyholders elected to opt in to the rehabilitation plan 92 percent of their eligible policies. Policyholders who opted out (opt-out policyholders) terminated their policies in exchange for a reduced cash payment. The opt-out policyholders were eligible to share proportionately in the liquidation of ELIC's remaining assets, but were not eligible to recover from the national guaranty organization any reduction in their policy value.

For the sale of its business to Aurora, the ELIC estate transferred substantially all its investment-grade securities and operating assets to Aurora to support its liabilities under the restructured policies. The transferred assets also supported the initial cash payments made to the opt-out policyholders; however, some assets remained in the ELIC estate after the sale. These assets, depending on their characteristics, were placed in one of three liquidating trusts: the ELIC Trust, the ELIC Real Estate Trust, and the Base Assets Trust. Over time the three trusts converted those assets to cash, which subsequently was distributed to the opt-in and opt-out policyholders. All three trusts have served their purposes and are now closed.

The ELIC estate also has received proceeds from two significant legal matters. These proceeds represent assets that the opt-in and opt-out policyholders share. Specifically, the estate was a party to litigation against the directors and officers of FEC, Michael Milken,[4] Drexel, and others. The litigation surrounded ELIC's junk bond investments and the FEC's 1991 bankruptcy. Later, in 1999, the commissioner filed a civil lawsuit against the consortium of French companies (referred to in our report as Altus, the name of one of the defendants) that bought ELIC's junk bond portfolio and formed Aurora to purchase ELIC's insurance business. The commissioner alleged that a group of French investors illegally purchased the ELIC assets by hiding the true controlling ownership of their group, which included Credit Lyonnais, a major French bank. The alleged involvement of Credit Lyonnais violated federal banking laws, which did not allow banks to have ownership interests in insurers, and state

[4] Michael Milken worked at the investment bank of Drexel Burnham Lambert, Inc., and greatly expanded the use of high-yield debt (junk bonds) in corporate finance and mergers and acquisitions.

insurance laws, which did not allow government-owned entities to have ownership interests in insurers. The CLO has distributed some of these proceeds and anticipates making additional distributions.

Management of the ELIC Estate From 1991 to the Present

Between 1991 and July 1997, parties outside the department were responsible for the ELIC estate. Various trustees administered the ELIC Trust, the ELIC Real Estate Trust, and the Base Assets Trust as specified in each trust document. In addition, the commissioner appointed two separate special deputy insurance commissioners to administer the ELIC estate from June 1991 to November 1993 and November 1993 through July 1997, respectively. The CLO took administrative responsibility of the ELIC estate in mid-1997 and continues to administer it today.

Currently, both the CLO and Aurora share the responsibility for making policyholder distributions. The CLO distributes funds as necessary to the opt-out policyholders. This group decided not to participate in the rehabilitation plan. As a result, they are due only their share of the liquidation of assets. Aurora is typically responsible for making necessary distributions to the opt-in policyholders. Members of this group elected to continue their insurance with Aurora and are effectively Aurora's customers. When funds are available for distribution, the CLO calculates the relative share due the opt-in (66.1 percent) and opt-out (33.9 percent) policyholders and forwards the opt-in policyholders' share to Aurora for distribution.

The commissioner is involved in two disputes surrounding proceeds from the Altus litigation, which has delayed the ELIC estate's closing. As of September 2006 the CLO estimated that it would close the ELIC estate in late 2008.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (audit committee) directed the Bureau of State Audits to review the department's management of the ELIC estate and related litigation. The audit committee asked us to determine the funds paid into and out of the ELIC estate, including the use of litigation proceeds with a particular focus on litigation costs. Additionally, the audit committee asked us to examine whether it was feasible for the department to use counsel from the Office of the Attorney General (attorney general) to represent it in litigation

arising out of the ELIC estate and, to the extent possible, to calculate what the cost would have been to use that counsel. The audit committee also asked us to review the terms of the department's fee agreements with outside counsel and others relating to litigation arising from the ELIC estate and determine whether the terms of those agreements were reasonable and in accordance with state law, rules, and regulations. We focused our review on the CLO because it was administering the ELIC estate and acts on behalf of the department in most of these areas.

As part of our review of the ELIC estate, we evaluated the funds the CLO still holds because it lacks all the information necessary to release the funds. We obtained data from the CLO's Trust Administration System for the Opt-out Trust and the Holdback Trust. We explain these two trusts more fully in the Audit Results section of this report. The CLO uses this system to track the disposition of policyholder funds for these two trusts. To understand the system, we interviewed CLO staff and reviewed relevant documentation. We then evaluated the system's reliability according to generally accepted government auditing standards developed by the United States Government Accountability Office (GAO standards). See the text box for the definitions of data reliability. One aspect of our tests was determining the reliability of the dollars held in the Opt-out Trust and the Holdback Trust that the CLO may transfer to the State Controller's Office. Based on our tests we concluded that the data for these two trusts were of undetermined reliability. We considered various alternative methods in attempting to evaluate the accuracy of the dollars held in these two trusts, and determined that it was not viable for us to test the accuracy of the data. Two alternatives were not viable due to the weakness in the CLO's internal controls over its general ledger, which were identified in a Department of Finance audit released in May 2005 testing controls as of July 2004. The information in the system used to calculate distributions to policyholders is based on the CLO's accounting records, primarily its general ledger. Because the data are not available from another source, we include it in Tables 4 and 5 on pages 21 and 24, respectively.

Definitions of Data Reliability

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

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

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

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

To determine the amount held in the FEC Litigation Trust, a trust established to receive FEC litigation proceeds, we reconciled the amounts earmarked for distribution to policyholders with

amounts deposited and withdrawn from designated bank accounts. We also traced a sample of policyholder payments to canceled checks. Finally, we compared the balance remaining in the accounts to the dollars held by the FEC Litigation Trust.

In order to identify how the CLO used state and federal litigation proceeds, we first identified how much money the CLO received, focusing on the Altus and FEC litigation matters, which represented more than 99 percent of all litigation proceeds. To determine the amount of Altus litigation proceeds, we used court documents and settlement agreements the CLO provided. Much of the FEC litigation proceeds were recorded and tracked on the FEC Litigation Trust spreadsheet (spreadsheet). We assessed this data following GAO standards and determined that it was sufficiently reliable for the purposes of this audit. For the remaining FEC litigation proceeds, we relied on work done by other auditors, reviewing an ELIC Trust audit report as well as source documents. When relying on work done by other auditors, GAO standards require us to take certain measures to establish a sufficient basis for relying on that work. In this case, we reviewed both the accounting firm's external quality control review report and the audit report itself and were satisfied that we could rely on the work.

We used the CLO's accounting reports to identify Altus litigation expenses and some FEC litigation expenses. We assessed this data, following GAO standards, and found the data to be sufficiently reliable. To identify other FEC litigation expenses, we used the spreadsheet and the ELIC Trust audit reports combined with source documentation. In our testing of the spreadsheet, we noted two litigation expense categories: (1) contingency fees and (2) other legal fees and expenses. Based on our data reliability testing, the contingency fee and certain other legal fees and expense data totaling $84 million are sufficiently reliable, but additional legal fee and expense data recorded during calendar years 1994 through 1997 amounting to nearly $1 million are not sufficiently reliable for the purposes of this audit. However, because the additional data are not available from another source, we include it in our Audit Results.

To identify any expenses incurred by other state agencies, we reviewed CLO records to identify invoices from or payments to any other state agencies and verified whether any of these expenses were paid from the ELIC estate. The CLO did not use ELIC funds to pay any other state agency, including the attorney general.

The audit committee also requested that we calculate how much the CLO has spent on the civil issues in the Altus litigation, including many of the same types of expenses already discussed. However, expenses for the civil suit cannot be segregated from those spent on the criminal suit. The CLO asserts that nearly all Altus litigation expenses were related to the civil suit and that the United States Attorney's Office for the Central District of California (U.S. attorney), who prosecuted the criminal case, and the department's legal counsel, together with the contracted outside counsel who prosecuted the civil suit, shared mutually beneficial information relevant to both the civil and the criminal suits where it was legally and ethically acceptable to do so. Due to this mutually beneficial arrangement, the CLO cannot quantify the amount spent on the criminal case. Therefore, we are reporting litigation expenses for both the criminal and civil suit together.

To determine whether it was feasible for the department to use counsel from the attorney general's office to represent it in litigation arising out of the ELIC estate, we reviewed the relevant laws; interviewed staff at the CLO, the department, and the attorney general's office; and reviewed correspondence among the three parties. We could not perform the part of the objective that asked us to approximate the cost if the department had used the attorney general as counsel because the CLO is not required to nor did it summarize and maintain the data in a manner that would have made this calculation practical.

To determine whether the terms of fee agreements the CLO entered into with outside counsel and others related to the litigation arising from the ELIC estate were reasonable and in accordance with laws, rules, and regulations relating to such fee agreements we reviewed materials published by the State Bar of California and *Successful Partnering Between Inside and Outside Counsel*, a joint endeavor of the American Corporate Counsel Association and West Group, a legal information company. We assessed 13 agreements the CLO had entered into relative to the guidance we had identified. We also compared the rates in each agreement to contracts with similar firms that we had reviewed as part of our audit of the Los Angeles City Attorney's Office.[5]

The audit committee also directed us to determine how much money policyholders have received, how much money policyholders will receive in the future, and what percentage of policyholders have received "full and complete recovery"

[5] *City of Los Angeles: Outside Counsel Costs Have Increased, and Continued Improvement in the City's Selection and Monitoring Is Warranted*, Report 2004-136, January 2006.

based on the funds that have been paid into and out of the ELIC estate. In addition, we were asked to determine how the CLO has used funds it received from state and federal litigation, particularly those designated for covering policyholder losses, and the percentage of the projected loss to policyholders that the litigation proceeds will recover. The data we need to complete these objectives, particularly with respect to opt-in policyholders and payments made to the national guaranty organization, reside with Aurora, the successor insurer to ELIC. Aurora has not yet made its data available to us for analysis, so we could not present the results in this report. With the assistance of the department, we are in the process of obtaining the needed data from Aurora. We intend to issue a subsequent report on the results of those analyses after we have received the necessary data and other information from Aurora. ■

AUDIT RESULTS

SOME LITIGATION PROCEEDS WERE USED TO PAY FOR LEGAL COSTS, DISTRIBUTIONS TO POLICYHOLDERS, AND PAYMENTS TO GUARANTY ASSOCIATIONS

Since conserving the Executive Life Insurance Company (ELIC) in 1991, the insurance commissioner (commissioner) has received more than $1.1 billion in litigation proceeds and the related interest from two significant legal matters. The first concerned alleged civil and criminal fraud in the purchase of ELIC's junk bond portfolio and insurance business. The second concerned the failure of ELIC and the bankruptcy of its corporate parent, the First Executive Corporation (FEC). The ELIC estate spent more than $165 million on litigation to recover these proceeds. The commissioner has designated and distributed part of the roughly $988 million in proceeds to policyholders and guaranty associations and anticipates receiving and distributing more litigation proceeds in the future.[6]

1999 Civil Suit Defendants

- Altus Finance
- Artemis, Artemis Finance, and Artemis America
- Aurora National Life Assurance Company
- CDR Enterprises
- Consortium De Realisation
- Credit Lyonnais
- Francois Pinault
- Jean-Claude Seys
- Jean Francois Henin
- Jean Irigoin
- MAAF Assurances
- MAAF Vie
- Mutuelle Assurance Artisinale De France
- New California Holdings, Inc.

The Commissioner Has Used Some of the Altus Litigation Proceeds to Pay Legal Costs

In February 1999, in response to the alleged fraudulent purchase of the ELIC junk bond portfolio and insurance business, the commissioner filed a civil lawsuit against Credit Lyonnais, a French bank; Altus Finance; and a number of other defendants, as shown in the text box. In 2005, some defendants chose to settle with the commissioner; however, some of this litigation is ongoing as the commissioner has appealed the court's decision against one defendant. While the commissioner's civil lawsuit was pending, the United States Attorney's Office for the Central District of California (U.S. attorney) conducted a criminal investigation, which resulted in grand jury indictments and the filing of a criminal suit against many of the same defendants. In its suit, the U.S. attorney alleged the defendants made false statements to federal banking regulators

[6] Between the time shortly before ELIC's conservation in 1991 and October 2006, five different individuals have held the position of insurance commissioner. See the Appendix for a partial timeline relating to ELIC and the different individuals who served as insurance commissioner during that period.

in connection with the acquisition of junk bonds and ELIC's failed insurance business. The U.S. attorney settled its suit in 2003, requiring some defendants to compensate the commissioner on behalf of ELIC policyholders. We refer to both the civil and criminal suits as the Altus litigation because Altus Finance was the first defendant listed in the commissioner's civil suit.

From May 2004 through June 2006, the commissioner recovered $730.3 million from both the civil and the criminal suits for the benefit of the ELIC estate. Table 1 is a breakdown of the litigation recoveries. Since receiving these proceeds, the ELIC estate has earned $12.1 million in interest, which is not reflected in the table. Most of the litigation proceeds—$516.5 million (71 percent)—came from the commissioner's August 2005 settlement with the CDR parties.[7] The court approved the CDR settlement in November 2005, and the CDR parties have paid the full amount owed.

TABLE 1

Altus Litigation Proceeds by Type and Amount Through June 30, 2006 (in Thousands)

Sources	Civil or Criminal Suit	Amount
CDR settlement amount	Civil	$516,500
Artemis settlement fund	Criminal	110,000
Aurora settlement amount	Civil	78,750
MAAF default judgment/ settlement amount	Civil	25,000
Altus litigation proceeds total		**$730,250**

Sources: Settlement agreements, court documents, and bank transaction reports.

The commissioner also received $110 million from the U.S. attorney's settlement of its criminal suit. According to the final settlement agreement, the funds that Artemis was ordered to pay would act as a credit toward judgments and settlements against it in the commissioner's civil suit. In the civil suit, the commissioner received a judgment against Artemis for $241 million. The $110 million criminal award offset this amount,

[7] This group of defendants in the civil suit included Credit Lyonnais, Caylon Americas (formerly known as Credit Lyonnais USA), Caylon Securities (USA) Inc. (formerly known as Credit Lyonnais Securities, Inc.), Consortium De Realisation, CDR Creances, and CDR Enterprises.

TABLE 2

Breakdown of Altus Legal Costs by Type
Calendar Years 1998 Through 2005 and January Through March 2006

Category	1998	1999	2000	2001	2002	2003	2004	2005	(Jan–Mar) 2006	Totals
Outside counsel—legal fees and expenses	—	$804,848	$667,526	$1,031,871	$1,778,617	$8,756,030	$11,710,094	$45,632,154	$42,698	**$70,423,838**
Outside counsel—contracted experts, consultants, and witnesses*	—	20,161	915,610	447,287	606,551	375,071	2,410,254	1,594,164	26,192	**6,395,290**
Other experts, consultants, and witnesses	—	26,915	41,247	5,000	61,872	273,931	696,331	137,972	—	**1,243,268**
Department of Insurance—legal fees	$62,270	18,836	18,996	7,080	178,413	58,761	5,314	16,315	177	**366,162**
National Organization of Life and Health Insurance Guaranty Associations—reimbursement for legal fees and expenses	—	—	—	—	—	—	—	1,857,339	33,374	**1,890,713**
Totals	**$62,270**	**$870,760**	**$1,643,379**	**$1,491,238**	**$2,625,453**	**$9,463,793**	**$14,821,993**	**$49,237,944**	**$102,441**	**$80,319,271**

Source: Conservation and Liquidation Office accounting records.

* Outside counsel was reimbursed for expenses it incurred in contracting with experts, consultants, and witnesses.

resulting in $131 million owed to the commissioner on behalf of the ELIC estate. We discuss this $131 million in a later subsection. The remaining amounts listed in Table 1 on page 14 have been paid.

The commissioner hired a number of law firms, experts, consultants, and witnesses to assist him in the pursuit of the Altus litigation proceeds. This litigation cost the ELIC estate more than $80.3 million through March 2006.

The commissioner hired a number of law firms, experts, consultants, and witnesses to assist him in the pursuit of the Altus litigation proceeds. As previously shown in Table 2, this litigation cost the ELIC estate more than $80.3 million through March 2006. Of this amount 88 percent, or $70.4 million, was paid to outside counsel for fees and expenses, which includes $54.4 million for contingency fees (generally set as a percentage of the recovery from a suit). We further discuss contingency fees in a later section of the report.

In an April 2005 agreement, the commissioner pledged to reimburse the National Organization of Life and Health Insurance Guaranty Associations (national guaranty organization) for legal fees and expenses it incurred assisting him in presenting and prosecuting the Altus case, limiting the agreement to the aggregate sum of $3 million. As a result of this agreement, the commissioner paid the national guaranty organization $1.9 million from the ELIC estate. The ELIC estate also incurred $366,000 for Department of Insurance (department) legal fees. Although the commissioner retained outside counsel to represent him in the Altus matter, the department's attorneys collaborated with the outside counsel and thus incurred costs in the course of litigating this case. The ELIC estate continues to incur more Altus litigation costs because of an ongoing appeal as well as other costs associated with arbitration, both of which are discussed in subsequent subsections.

The Assertion by the Commissioner's General Counsel That the $110 Million From the Criminal Suit Has Not Been Used to Pay for Attorney's Fees and Costs Appears Reasonable

Concerns have been raised regarding the proper disposition of $110 million from the settlement of the criminal lawsuit (the U.S. attorney's Artemis settlement). The 2003 settlement agreement stipulates that funds disbursed as a result of the criminal lawsuit could be used to pay for litigation costs only with the specific approval of the district court. When we asked the commissioner's general counsel whether any of the $110 million received in May 2004 from the criminal suit had been used to cover litigation costs without approval, he stated that, " . . . the Commissioner (or CLO) have not used any of the $110 million obtained from the U.S. attorney's Artemis settlement account to pay attorneys' fees or costs." He went on to say, ". . . the ELIC estate has received more than enough from other sources with which to pay the attorneys' fees and costs it has incurred in the litigation." In our review of the

CLO's records, we found that it paid outside counsel $4 million in December 2003 and $10.3 million in May 2004 for a total of $14.3 million, which constituted a contingency fee of 13 percent of the $110 million recovery from the criminal suit. Based on the CLO's unaudited balance sheet, which was created from data in its general ledger, the ELIC estate had more than $30 million in cash and investments on hand as of December 31, 2003. This would seem to support the general counsel's assertion that the estate had sufficient funds beyond the $110 million to pay outside counsel. However, as noted in the Scope and Methodology, we were unable to rely on the CLO's general ledger because of the internal control weaknesses identified by the Department of Finance.

The CLO Has Distributed Some of the Altus Litigation Proceeds to Policyholders and Guaranty Associations

In February 2006 the CLO distributed just over $211 million to the opt-out policyholders. However, the portion designated for distribution to the opt-in policyholders, $418 million, has been complicated by a disagreement between the commissioner and the national guaranty organization.

Distribution of the Altus litigation proceeds is taking place in stages. In February 2006 the CLO distributed just over $211 million to the opt-out policyholders.[8] However, the portion designated for distribution to the opt-in policyholders, $418 million, has been complicated by a disagreement between the commissioner and the national guaranty organization. The enhancement agreement with which both parties concurred specifies payments the national guaranty organization will make to opt-in policyholders to bridge the gap between their original ELIC policy values and the restructured values. In return, the national guaranty organization is entitled to share in recoveries that the estate receives. However, the two parties disagree on the portion of the Altus proceeds the national guaranty organization is entitled to; they are currently in binding arbitration to settle the matter.

The CLO estimates spending nearly $4.8 million in costs associated with the arbitration. Pending the outcome of the arbitration, which was anticipated to begin in October 2006, the commissioner has arranged for a limited distribution to the opt-in policyholders. In October 2006 Aurora planned to distribute an estimated $95.7 million to these policyholders from the $126 million the CLO provided it. Based on its calculations of the opt-in policyholders' proportional share, Aurora will return any funds not needed for the distribution to the ELIC estate. These funds will remain there until the arbitration is concluded, which the CLO believes will be in December 2006. In May 2006 the commissioner also paid the national guaranty organization $46 million from

[8] Some payments were withheld temporarily pending further documentation of entitlement or verification of address or delivery instructions.

the estate as specified in a May 2005 agreement between the two parties. However, he will credit the $46 million against future distributions owed to the national guaranty organization as determined in the ongoing arbitration.

In June 2006 the commissioner received $25 million of Altus litigation proceeds on behalf of the ELIC estate and has not yet distributed these funds. They resulted from a settlement agreement with Mutuelle Assurance Artisanale De France (also known as MAAF Assurances) and MAAF Vie (together known as MAAF). In December 2005 the court entered a default judgment against MAAF for $28 million; however, according to the ELIC estate trust officer (a CLO employee), the commissioner had difficulty collecting from the defendant because of its French origins. To resolve the issue, the commissioner agreed to settle for $25 million. The CLO anticipates distributing this amount at the conclusion of the commissioner's appeal, which is discussed in the next subsection.

The CLO Anticipates Receiving Additional Altus Litigation Proceeds

In addition to those Altus litigation proceeds already received, the special deputy insurance commissioner (special deputy), who is also the chief executive officer of the CLO, asserts that the ELIC estate likely will receive $131 million to $700 million more, depending on the outcome of an appeal the commissioner has made regarding punitive damages the court initially dismissed. In July 2005 a jury awarded the commissioner $700 million in punitive damages (in the civil suit) against Artemis. However, the judge refused to include the punitive damages in his October 2005 judgment because he found that the award was inconsistent with state law. In June 2006 the commissioner appealed the court's decision, and the special deputy assesses the probability as likely of receiving a recovery of $131 million to $700 million. At this time, the CLO does not know when the appeal will conclude. However, it estimates that the costs associated with the appeal will be $180,000 plus contingency fees associated with additional recoveries up to a maximum of $49 million.

The special deputy assesses the probability as likely of receiving a recovery of $131 million to $700 million.

Also, the judge awarded the commissioner a judgment of $241 million against the same defendant, Artemis. The court reduced the total judgment by the $110 million previously awarded to the commissioner in the criminal suit discussed in the previous subsection. Thus, the commissioner is owed a net amount of $131 million on behalf of the ELIC estate. However, the court has held up this award pending the outcome of the

commissioner's appeal of the $700 million in punitive damages. According to his appeal, if the commissioner wins and the punitive damages are reinstated, he will forgo the $131 million judgment.

Finally, the commissioner could collect up to $3.8 million from a default judgment against Jean Francois Henin (Henin). In March 2006, as part of the settlement with MAAF, the commissioner entered into an agreement with Sierra National Insurance Holdings (Sierra), which separately filed suit against the same defendants, assigning Sierra his rights to a $10.8 million judgment against Henin. According to the CLO, because of Henin's French citizenship and lack of assets in the United States, it would have been costly and time-consuming to try to collect on the judgment with no assurance of success. Further, the CLO asserts that MAAF was unwilling to settle with the commissioner unless Sierra also settled its claim, and during the course of those negotiations, Sierra was demanding more money than MAAF was willing to pay. In order to bridge the gap and ensure that the commissioner would obtain the $25 million from MAAF discussed previously, he agreed to assign to Sierra his rights to the Henin judgment. According to the agreement, if Sierra is able to collect from Henin, the commissioner will receive 15 percent of the net recoveries up to $3.8 million. The special deputy assesses the likelihood of collecting from the agreement with Sierra as remote.

Proceeds From the Litigation Surrounding the Failure of ELIC and the Bankruptcy of the FEC Have Been Distributed to Policyholders and Others and Used for Litigation Costs

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

Between September 1992 and March 2006 the commissioner recovered more than $346.7 million in FEC litigation proceeds and earned an additional $45.3 million in interest income on behalf of the ELIC estate.

Between September 1992 and March 2006 the commissioner recovered more than $346.7 million in FEC litigation proceeds and earned an additional $45.3 million in interest income on behalf of the ELIC estate. Table 3 on the following page shows the proceeds the commissioner received from each defendant.

TABLE 3

FEC Litigation Proceeds by Defendant
Calendar Years 1992 Through 2006

Defendants	Amount
Michael Milken	$202,995,140
Drexel Burnham Lambert, Inc.	95,237,809
FEC's directors, officers, and accountants	48,492,528
Total	**$346,725,477**

Sources: Attorney's letters, ELIC Trust audit report, and the FEC Litigation Trust spreadsheet.

In pursuing the FEC litigation proceeds, the ELIC estate incurred litigation costs in the form of contingency fees and in other legal fees and expenses. The estate paid nearly $85 million in FEC litigation costs, roughly 94 percent of which were contingency fees.

For the FEC litigation, the CLO deposited the proceeds into two separate trusts: the FEC Litigation Trust and the ELIC Trust. One of the purposes for the separate trusts was to distribute the proceeds to ELIC policyholders. In October 2002, $72.3 million was designated from the FEC Litigation Trust for distribution to policyholders. The opt-out policyholders' proportional share of these proceeds was $28.1 million; the opt-in policyholders' share was $44.2 million.[9] Of the opt-in share, the national guaranty organization received $27.9 million.

Distributions also have been made from the ELIC Trust; however, based on the CLO's records, we could not determine exactly how much of those distributions originated from FEC litigation proceeds. The available audited financial statements did not distinguish between proceeds originating from the FEC litigation and other trust activities when those proceeds were distributed to policyholders. However, for the trust in total, $114.4 million was distributed to the individual opt-out policyholders and $171.4 million was sent to Aurora for distribution to the individual opt-in policyholders, some of which may have been paid to the national guaranty organization.[10]

[9] A small portion (less than $1 million) also was designated for policyholders who surrendered their policies or allowed them to lapse before or during the conservation of ELIC.

[10] As stated in the Scope and Methodology section, data concerning distributions to opt-in policyholders and payments to the national guaranty organization reside with Aurora and have not yet been made available to us.

THE CLO IS HOLDING FUNDS THAT EVENTUALLY MAY TRANSFER TO THE DEPARTMENT AS UNCLAIMED PROPERTY

Distribution Trusts

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

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

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

As of May 2006 the CLO was holding $18.4 million in funds from the ELIC estate, some of which ultimately may escheat to the department. Escheatment is a process agencies may follow to transfer unclaimed money and property to the State until it is claimed by the rightful owners or the owners' heirs. The CLO is attempting to resolve issues hindering it from distributing payments such as obtaining valid policyholder mailing addresses and resolving legal issues. When it closes the estate, it will transfer to the State Controller's Office (state controller) any funds still not distributed. The CLO estimates that it will close the estate at the end of calendar year 2008. Under the State's unclaimed property laws and regulations, the remaining funds would again be transferred from the state controller to the department within six months after the estate closes.

In settling the estate, the rehabilitation plan provided for a series of trusts to hold and liquidate ELIC assets—as described in the Introduction—and the commissioner established a separate series of trusts to distribute funds to policyholders, as described in the text box. The three distribution trusts from the estate remain open, and Table 4 details the number of policies and the total dollars held within each of the three trusts.

TABLE 4

Summary of Policy Counts and Undistributed Amounts Held in Trusts as of May 2006

Trust	Number of Policies	Dollars Held
Opt-Out Trust	6,203	$14,575,781
Holdback Trust	6,292	2,104,800
FEC Litigation Trust	28,254	1,685,849
Totals	**40,749**	**$18,366,430**

Sources: Conservation and Liquidation Office's Trust Administration System, Opt-out and Holdback databases, bank statements, and other accounting documentation.

Note: As mentioned in the Scope and Methodology, we could not determine the reliability of the data included in this table related to the Opt-out and Holdback Trusts. However, we include the data in our Audit Results due to the lack of another source.

If the CLO still lacks the information it needs to release the funds it is holding when it closes the ELIC estate, it initially will transfer the funds to the state controller. Following Section 1517(b) of the California Code of Civil Procedure, within six months of the CLO closing the estate, the state controller will again transfer the funds to the department's Insurance Fund. Although Section 12937 of the Insurance Code authorizes the commissioner to pay some types of expenses with the transferred funds, at no time does the law extinguish policyholders' rights to claim their property from the department. To claim these funds, the policyholder must contact the department and provide the required information.

The CLO Does Not Release Funds if It Lacks Certain Information

The CLO places holds on policies if it does not possess key information enabling it to make payment. Key information includes valid policyholder addresses and documented ownership information; in some cases it involves the resolution of legal issues.

The CLO places holds on policies if it does not possess key information enabling it to make payment. Key information includes valid policyholder addresses and documented ownership information; in some cases it involves the resolution of legal issues. For example, address holds occur when letters the CLO sends to policyholders are unanswered or are returned as undeliverable, and when checks are returned as undeliverable or are never cashed. Similarly, the CLO places ownership holds on policies when a divorce or death makes it unclear who owns the policy. In other instances, it places holds on policies until legal issues can be resolved. The most common type of legal hold occurs when a third party claims the right to payments that otherwise would go to a policyholder. For example, as part of the commissioner's negotiations over ELIC's insolvency, the national guaranty organization agreed to augment its statutory coverage with enhanced coverage of certain policyholder losses. In return, it received what is referred to as subrogation rights—claims to future payments made on the policies. For the majority of the legal holds, further research needs to take place regarding the amount of these subrogation rights.

The CLO is not obligated by law to perform outreach activities to obtain the information it needs to distribute funds. When the commissioner decides to liquidate an insurance company, Section 1063.7 of the Insurance Code requires him to mail a notice to the last known address of all persons reasonably expected to have an interest in claims against the insurer. Also, the ELIC Rehabilitation Plan (rehabilitation plan) required the commissioner to mail a notice to all policyholders regarding their right to participate. However, beyond these two notifications, the CLO does not have an ongoing obligation to track down policyholders or third parties who have subrogation rights.

Despite having no legal obligation, the CLO has implemented processes for gathering the information needed to remove policy holds. These include mailing correspondence to policyholders requesting updated contact information, fielding telephone inquiries from policyholders concerned about receiving their payments, contacting policyholders or their relatives by telephone to gather updated contact information, and contracting with external search firms to identify policyholders' current addresses. For example, before its February 2006 distribution of $211 million to opt-out policyholders, the CLO hired a firm to search for current addresses of policyholders for which it had determined the addresses it had were invalid. The CLO then sent notifications to the new addresses that the policyholders were eligible to receive distribution funds and required them to confirm their addresses by responding to the letter. Once a policyholder or a third party with subrogation rights provides the documentation needed to process payments, the CLO releases held funds.

The CLO Already Has Marked Nearly $2 Million for Transfer, With More Likely Because of Issues With Address and Ownership

As shown in Table 5 on the following page, the CLO has noted more than 20,000 policies totaling nearly $2 million as subject to transfer. The ELIC Trust Officer (trust officer), who is responsible for the day-to-day operation of the estate, said that claims staff would take no further action to resolve the holds on these policies unless a policyholder contacts the CLO to provide updated information. Of the 20,000 policies likely to be transferred, 14,225 have balances of less than $2. These are policies that lapsed or were surrendered before or during ELIC's conservation, meaning the policyholders did not make the required payments or cashed in their policies, which resulted in the policies being canceled before September 1993 when the rehabilitation plan took effect. The trust officer further stated that, given the minimal dollar amount per policy, these balances will not be paid and the money is slated to be transferred.

Of the 40,749 policies that the CLO has on hold, 18,000 policies totaling more than $8.3 million have address or ownership issues.

Of the 40,749 policies shown in Table 5 that the CLO currently has on hold in the three trusts, 18,000 policies totaling more than $8.3 million have address or ownership issues, and the CLO is likely to transfer most of the funds associated with these policies as well. Specifically, the trust officer stated it is unlikely that additional work to locate many of these policyholders will succeed. However, according to the trust officer, the CLO also plans to work with Aurora to attempt to resolve the address- or ownership-related holds within the FEC Litigation Trust. Aurora was planning an October 2006 distribution of funds. The trust

TABLE 5

Why Funds Are Being Held

Trust	Designated for Transfer		On Hold Due to Address Issues		On Hold Due to Ownership Issues		On Hold Due to Legal Issues		On Hold Due to Other Issues		Totals	
	Policy Count	Dollars Held	Policy Count	Dollars Held	Policy Count	Dollars Held	Policy Count	Dollars Held	Policy Count	Dollars Held	Policy Count	Dollars Held
Opt-Out Trust	1,241	$1,481,636	4,321	$3,713,455	104	$2,343,945	515	$6,992,547	22	$ 44,198	6,203	$14,575,781
Holdback Trust	4,715	498,687	894	884,805	158	141,658	51	37,096	474	542,554	6,292	2,104,800
FEC Litigation Trust	14,225	13,534	12,525	1,287,859	4	389	1,500	370,935	unknown	13,132	28,254	1,685,849
Totals	**20,181**	**$1,993,857**	**17,740**	**$5,886,119**	**266**	**$2,485,992**	**2,066**	**$7,400,578**	**496**	**$599,884**	**40,749**	**$18,366,430**

Sources: Conservation and Liquidation Office's Trust Administration System, Opt-out and Holdback databases, bank statements, and other accounting documentation.

Note: As mentioned in the Scope and Methodology, we could not determine the reliability of the data included in this table related to the Opt-out and Holdback Trusts. However, we include the data in our Audit Results due to the lack of another source.

officer stated that the CLO would work with Aurora to determine if it has more current information on ownership and addresses for policyholders. The trust officer also stated that the CLO will transfer any outstanding policyholder funds after the FEC Litigation Trust is closed if it is unable to resolve such issues.

The trust officer also stated that it is likely many of the legal holds shown in the table will be resolved before closing the ELIC estate. For the most part, the national guaranty organization or another third party that has made payments to policyholders must certify the amounts it has paid in order for the CLO to release the funds. The trust officer stated that if the third parties do not provide the certifications before estate closure, the CLO likely will release the full amounts to the policyholders rather than transfer the funds. Similarly, the trust officer does not anticipate transferring policyholder funds that are held for other reasons (noted in the "Other Holds" column in Table 5), such as cases in which Aurora has notified the CLO that it overpaid a policyholder. According to the trust officer, the CLO will likely pay Aurora the funds it is owed before closing the estate.

THE COMMISSIONER'S STATUTORY OBLIGATION TO USE THE OFFICE OF THE ATTORNEY GENERAL AS COUNSEL HAS CHANGED OVER TIME

The commissioner hired outside counsel for the ELIC conservation and liquidation, as well as the recent civil fraud litigation, with the attorney general's knowledge.

The commissioner used outside counsel to represent him in the ELIC estate conservation and liquidation as well as the recent civil fraud litigation. Typically, the Office of the Attorney General (attorney general) acts as legal counsel for California state agencies. Before 1996 the law gave the commissioner discretion to use the attorney general or outside counsel; however, effective January 1, 1996, the Legislature amended the law, requiring the commissioner to use the attorney general's legal services or to obtain that office's written approval to hire outside counsel. We verified that the commissioner hired outside counsel for the ELIC conservation and liquidation, as well as the recent civil fraud litigation, with the attorney general's knowledge.

Before January 1, 1996, the Government Code explicitly allowed the commissioner to use outside counsel in delinquency proceedings instead of the attorney general without first having to obtain consent.[11] For all other types of legal proceedings, the commissioner had to obtain the attorney general's written consent.

[11] The Insurance Code, Section 1064.1(b), defines a delinquency proceeding as one commenced against an insurer for the purpose of liquidating, rehabilitating, reorganizing, or conserving that insurer.

Effective January 1, 1996, Senate Bill 87 (Chapter 893, Statutes of 1995) amended the Government Code to no longer allow the commissioner to use outside counsel at his or her own discretion in delinquency proceedings. Instead it now requires the commissioner to obtain written consent from the attorney general if he or she wishes to use outside counsel.

From April 1991 through July 1997, the commissioner, as the conservator of the ELIC estate, took charge in ELIC's rehabilitation and liquidation. Throughout this time period, he engaged outside counsel, primarily the law firm of Rubinstein and Perry, to assist him with the rehabilitation. Since these activities constituted a delinquency proceeding, the commissioner had no statutory duty to use the attorney general or to obtain consent to use outside counsel. Nonetheless, he kept the attorney general apprised of his activities and notified that office of his intent to engage Rubinstein and Perry for delinquency proceedings arising out of the ELIC estate.

In February 1999, after learning of the fraud perpetrated by a number of French companies in the purchase of ELIC's business and bond portfolio, the commissioner filed suit against those entities while under the representation of outside counsel. By 1999, state law clearly required the department to make exclusive use of the attorney general as counsel or to obtain written consent to use outside counsel in all instances. The attorney general consented to the commissioner's use of outside counsel in a letter dated June 4, 1999. Although this written consent came four months after the commissioner filed the Altus suit, the attorney general had constructively consented to the use of outside counsel because the commissioner had kept the office apprised of his actions and we saw no evidence of objection.

THE OUTSIDE COUNSEL FEE AGREEMENTS AND OTHER SERVICE AGREEMENTS WE REVIEWED HAVE REASONABLE TERMS AND FEES

To assist with the ELIC litigation, the CLO contracted with outside counsel and entered into agreements for other services. The terms of the 13 agreements we reviewed were reasonable, and the fees were generally comparable to agreements entered into by other public entities for outside counsel or were reasonable in view of the California Rules of Professional Conduct that attorneys must follow.

The 13 agreements spanned seven years and included 10 agreements for legal services and three agreements for other services. In the legal services agreements, the CLO contracted for legal advice and representation. The CLO's agreements for other services were with three individuals who had information and knowledge specific to the ELIC estate, its conservation and liquidation, and subsequent sale. We reviewed each agreement for certain key elements identified by Successful Partnering Between Inside and Outside Counsel (Successful Partnering). Successful Partnering, a joint endeavor of the American Corporate Counsel Association and West Group, a legal information company, is a comprehensive work detailing key aspects of the relationship between inside and outside counsel. It draws on legal experts and research from across the United States and has been updated since its publication in 2000 to reflect recent developments in the legal field. We also reviewed the agreements to determine if they complied with the rules of professional conduct that attorneys must follow.

In contracting with outside counsel, the State Bar of California sets out arrangements that must be avoided, such as conflicts of interest and sharing fees with those who are not attorneys or other attorneys in certain circumstances. Successful Partnering describes the various fee arrangements with outside counsel that are common, such as hourly rates and contingency fees. According to Successful Partnering, hourly rate is a classic model of billing characterized by an hourly rate assigned to each member in the law firm for a given project and multiplied by the number of hours invested in the project. Successful Partnering describes contingency fee arrangements as "value billing" typically, the contingency model ties legal fees to a percentage of the monetary award, if any. In this arrangement, the attorneys assume the risk of receiving no fee or a very minimal fee if their client does not receive a monetary award.

Factors in Determining the Reasonableness of a Fee

- The time and labor required, the novelty and difficulty of the questions involved, and the skill necessary to perform the legal services properly.
- The likelihood that acceptance of a particular employment will preclude other employment by the attorney.
- The fee customarily charged in the locality for similar legal services.
- The time limitations imposed by the client or by the circumstances.
- The nature and length of the professional relationship between the attorney and client.
- The experience, reputation, and ability of the attorney or attorneys performing the services.
- Whether the fee is fixed or contingent.

Source: American Bar Association's "Model Rules of Professional Conduct" in *Successful Partnering Between Inside and Outside Counsel.*

Successful Partnering refers to the American Bar Association's Model Rules of Professional Conduct (model rules) in determining whether an attorney's fee is reasonable. (See text box.)

Based on our review of 13 of the CLO's agreements, we found that each of the 10 legal services agreements contained a conflict-of-interest clause.

Further, we did not find any inappropriate fee arrangements among attorneys and any other participants in the 13 agreements we sampled.

The hourly rates for legal services provided by outside counsel were generally within the range of hourly rates charged by law firms of similar size and reputation in complex litigation.

Nine of the legal services agreements specified an hourly rate fee structure. We compared the rates charged in these nine agreements to the rates of four contracts for firms of a similar size, reputation, and locality. We also considered the model rules and assessed the rates for partners and associates separately. Among the firms the CLO retained for legal services between 1999 and 2006, the partners' rates ranged from $300 to $560 per hour; the comparison agreements included partner rates between $295 and $400. Associates' hourly rates in the CLO agreements ranged from an average of $95 to $331 per hour; the comparison agreements reflected associate rates of $220 to $226 per hour. Based on our comparison, we concluded that the hourly rates for legal services provided by outside counsel were generally within the range of hourly rates charged by law firms of similar size and reputation in complex litigation. A few hourly rates were outside that range, but in view of the individual's specialty, experience, and reputation, we believe the fees are consistent with the model rules. For example, an hourly rate of $500 was negotiated under a legal services agreement with Erwin Chemerinsky, a law professor and nationally recognized legal expert in the area of federal jurisdiction and appellate practice. Similarly, we found a rate of $560 for a partner in another legal services agreement. However, that partner is a nationally recognized and highly regarded expert in bankruptcy law. Given those credentials, these hourly rates were reasonable. Finally, we found that the higher rates for associate counsels were consistent with rates for the services of senior associates of law firms of similar reputation, expertise and locality.

The CLO entered into one contingency fee agreement for legal services related to the French litigation. This agreement was with the CLO's lead counsel, Thelen Reid and Priest (Thelen Reid). The agreement provided Thelen Reid with the right to reimbursement for actual out-of-pocket expenses, such as the costs of experts, investigators, and financial advisers as the litigation proceeded; in addition, the CLO was to pay Thelen Reid the following amounts:

- 13 percent of all proceeds between $0 and $150 million
- 7 percent of all proceeds between $150 million and $300 million
- 5 percent of all proceeds between $300 million and $500 million
- 7 percent of all proceeds above $500 million

Although the total contingency fee paid Thelen Reid was substantial—$54.4 million—the arrangement was consistent with the best practices identified by Successful Partnering, which suggests that contingency fee arrangements provide attorneys with added incentives to bring their clients successful results as the law firm shares the risk of no recovery.

Although the total contingency fee paid Thelen Reid was substantial—$54.4 million—the arrangement was consistent with the best practices identified by Successful Partnering, which suggests that contingency fee arrangements provide attorneys with added incentives to bring their clients successful results as the law firm shares the risk of no recovery. Moreover, the CLO retained ultimate authority to negotiate a settlement, provided the settlement would not result in Thelen Reid receiving less than 80 percent of the legal fees it incurred without the law firm's consent. This clause mitigated any concerns that might be raised about the tendency of contingency fee agreements to shift control of the litigation to the attorneys. Thus, we concluded that the Thelen Reid fee arrangement was reasonable in light of the criteria identified by Successful Partnering.

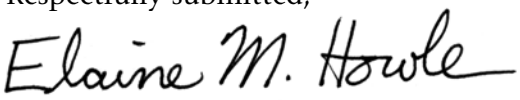
The agreements for other services we reviewed were designed to compensate the individuals for their time in sharing information relating to their experiences and knowledge of ELIC and for providing testimony in the Altus litigation. Two agreements were with individuals who previously had provided the department with legal advice relating to the ELIC rehabilitation. The department agreed to compensate these individuals for further explaining advice they previously provided and for time spent preparing for and attending their own depositions in the Altus litigation. The agreements make it clear that the CLO is not compensating the individuals for their testimony in that litigation. The third agreement was with a former officer of Altus, an individual who has unique knowledge relevant to the Altus litigation. Similar to the other agreements, this one makes it clear that the individual is being reimbursed only for reasonable and necessary expenses incurred in connection with testimony or other interviews provided in the Altus litigation, and for time spent preparing for the interviews and testimony. The rules of professional conduct permit attorneys to pay expenses that are reasonably incurred and for loss of time by witnesses in attending or testifying in litigation. Our legal counsel reviewed these agreements and concluded they comply with the rules.

We also reviewed the agreements for other services for the reasonableness of the rates paid. As explained earlier, two of the agreements were with individuals who previously had provided the department with legal advice relating to ELIC. We compared their rates with the rates paid under the other legal services agreements we reviewed, and we found the rates to be consistent. As explained previously, the rates for legal services provided by outside counsel were within the range of hourly

rates charged by law firms of similar size and reputation in complex litigation. The department agreed to reimburse the former officer of Altus for the time he actually spent preparing for interviews, testimony, depositions, or trial at the rate of $250 per hour with a cap of 75 hours. The agreement limited the hourly rate for legal expenses the witness could claim to $325 per hour, with a cap of $50,000. Given the nature of the former officer's position and the complexity of the litigation, these rates appear reasonable.

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

Respectfully submitted,



ELAINE M. HOWLE
State Auditor

Date: October 19, 2006

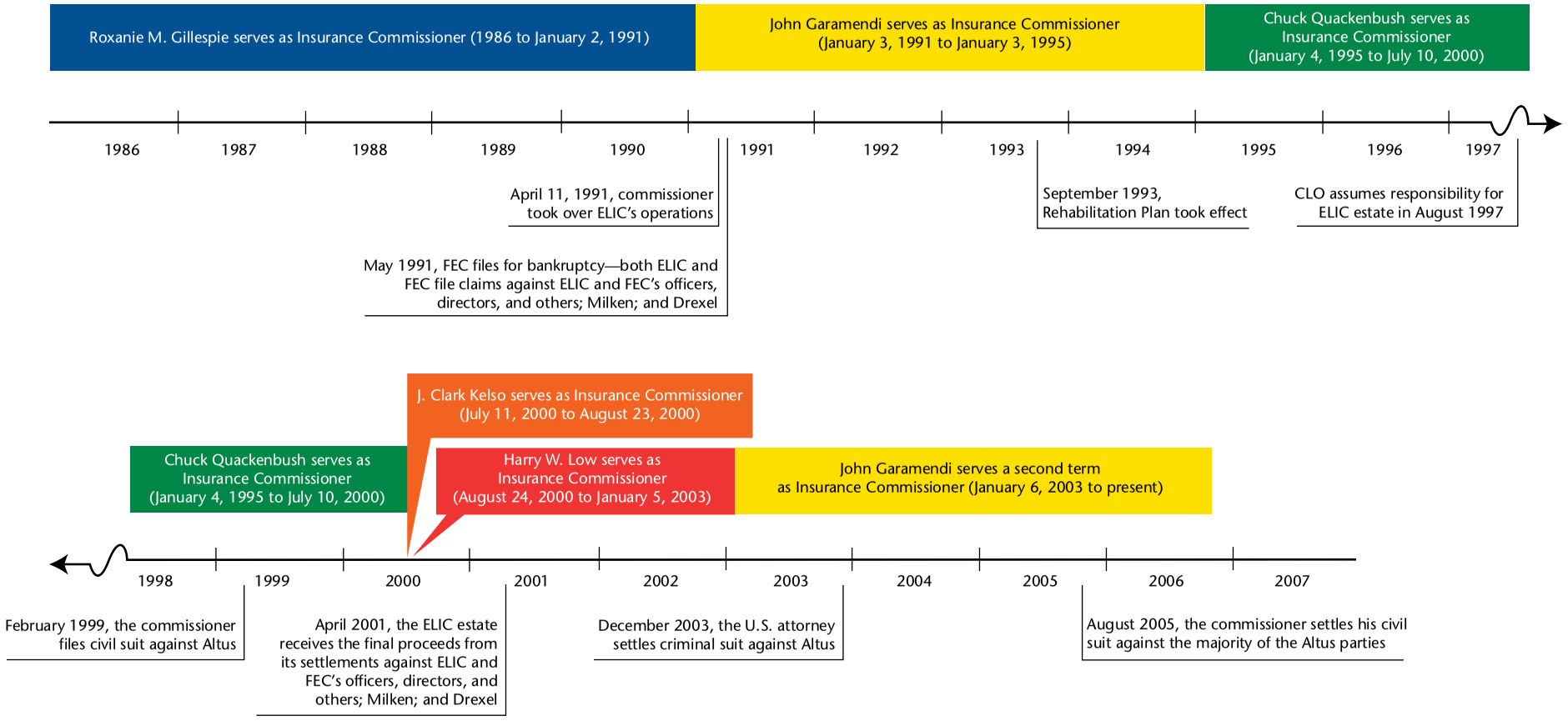
Staff: Doug Cordiner, CGFM, Deputy State Auditor
Sharon Fuller, CPA
David Edwards
Lane W. Hendricks
Thy Vuong

APPENDIX

In the years leading up to Executive Life Insurance Company's (ELIC) conservation to its current status of being administered by the Department of Insurance's Conservation and Liquidation Office, a total of five different individuals have held the position of insurance commissioner as shown in the Figure on the following page.

FIGURE

Event Timeline Associated With the Executive Life Insurance Company



ELIC = Executive Life Insurance Company

FEC = First Executive Corporation

CLO = Conservation and Liquidation Office

U.S. attorney = United States Attorney's Office of the Central District of California

Agency Comments provided as text only.

Conservation and Liquidation Office
P.O. Box 26894
San Francisco, California 94126-0894

October 5, 2006

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

Dear Ms. Howle:

We acknowledge receipt of your letter dated October 2, 2006 addressed to Commissioner Garamendi and copied to me. Included with your letter were two draft copies of the recently concluded Phase 1 audit report on Executive Life Insurance Company, in liquidation.

In line with your invitation, we have taken this opportunity to enclose our responses on the diskette provided by your office. Our responses reference the section, page and paragraph that they refer to.

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

Sincerely,

(Signed by David E. Wilson)

David E. Wilson
Chief Executive Officer &
Special Deputy Insurance Commissioner
Conservation and Liquidation Office

Enclosures

* California State Auditor's comments begin on page 37.

Conservation and Liquidation Office
P.O. Box 26894
San Francisco, California 94126-0894

October 5, 2006

Elaine M. Howle
State Auditor
Bureau of State Audits
555 Capitol Mall; Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

I am pleased to provide our response to the Bureau of state Audits ("BSA") draft audit report entitled, Department of Insurance: *Its Conservation and Liquidation Office Continues to Collect and Distribute Proceeds From the Liquidation of the Executive Life Insurance Company."*

The following are our responses:

Section: "Scope and Methodology"

- Page 14: paragraph 2 states, "Based on our tests we concluded . . . we include it in Tables 4 and 5."*

Commissioner's response:

We understand the BSA auditors' conclusion that the general ledger data relative to the Holdback and Opt-out trusts is of undetermined reliability due to results of the July, 2004 internal control review performed by Department of Finance Office of State Audits. Commissioner Garamendi requested that this review be performed due to his concerns about the operation and internal control environment of the CLO when he took office in 2003. Subsequently, Commissioner Garamendi hired a new Chief Executive Officer and Chief Financial Officer who reorganized and upgraded the financial department staffing. CLO reviewed the findings of the July 2004 examination in detail and has corrected the issues raised by the findings where appropriate. Two additional audits were also performed subsequent to the examination referred to above; one of which was a complete internal control review consistent with the requirements of the Sarbanes-Oxley COSO standards, and the other was a review of specific aspects of CLO operations. The results of both indicate a substantially improved internal control environment.

With respect to the reliability of the balances due policyholders from the FEC Litigation, Holdback and Opt-out trusts, the CLO believes that the dollar amounts shown in the general ledger and the policyholder sub-ledgers are reliable. The Department of Finance internal control review did not contain any significant findings relating to the handling of ELIC funds or the

* Text refers to page numbers in an earlier draft version of the report.

balances in these accounts, and the BSA does not state that it has any reason to believe that these balances are inaccurate. The original funding of these trusts came by bank wire transfer. These balances are regularly reconciled to bank statements, the general ledger and to the policyholder detail sub ledgers. The BSA representatives were able to independently verify the dollar value of the FEC Litigation trust policyholder sub ledger by reference to bank statements and other data. The fact that the BSA was able to independently verify that the balance in the FEC Litigation sub-ledger was accurate, and then was able to confirm that the FEC Litigation sub-ledger total balance agreed to the general ledger provides some evidence supporting CLO's view that the general ledger balances are reliable.

- Page 15: Paragraph 5 states, "To identify other FEC litigation expenses . . . we include it in our audit results."

Commissioner's response:

BSA successfully reviewed in excess of 99% of total legal fees, including contingent fees and found no improprieties in the expenses tested. Its conclusion is based on three coding errors in the categories of expenses to which certain contingency fees and other legal expenses had been assigned. These coding errors and the categorization of expenses generally had neither an impact on the ultimate amounts which were available and distributed nor did BSA find that they did.

Section: "The CLO is holding funds that it may eventually transfer to the department of insurance as unclaimed property."

- Page 28: paragraph 1 states, "As of May 2006 the CLO is holding funds from the ELIC estate . . . after the estate closes."

Commissioner's response:

We agree with the BSA conclusion that, as the law requires, the Commissioner was holding $18.4 million as of the closing date of the BSA report. This amount represents 1.22% of the $1.5 billion distributed to policyholders. The Commissioner has distributed nearly 99% of the funds from these trusts and continues to be successful in locating policyholders so that their funds can be distributed to them. Subsequent to the BSA review, an additional $6.8 million has been paid to policyholders, reducing the total noted in the report to $11.6 million.

Sincerely,

(Signed by David E. Wilson)

David E. Wilson
Chief Executive Officer &
Special Deputy Insurance Commissioner
Conservation & Liquidation Office

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COMMENTS

California State Auditor's Comments on the Response From the Conservation and Liquidation Office

To provide clarity and perspective, we are commenting on the response from the Conservation and Liquidation Office (CLO). The numbers below correspond to the numbers we have placed in the margin of the CLO's response.

1. The CLO asserts that it has corrected where appropriate the issues raised by the Department of Finance in its review of internal controls affecting the CLO's general ledger. The CLO cites two additional audits that were performed subsequent to the Department of Finance's review, and states that the results of both indicate a substantially improved internal control environment. While we acknowledge that the CLO has taken certain steps to address the Department of Finance's concerns by taking a variety of actions to strengthen its internal controls, neither of the subsequent audits it cites performed testing of the CLO's internal controls related to financial reporting, which would include testing the controls over its general ledger. Therefore, until the internal controls associated with the CLO's general ledger are tested and found to be sound, we stand by our conclusion on page 9 that the remaining balances in the Trust Administration System's Opt-out and Holdback databases are of undetermined reliability. It is our understanding that the Department of Finance is scheduled to complete its testing of these controls in February 2007.

2. The CLO mischaracterizes our methodology when it states that we were able to confirm that the First Executive Corporation (FEC) Litigation Trust sub-ledger total balance agreed to the general ledger. We did not rely on the CLO's general ledger in our testing. Instead, as we stated on pages 9 and 10, to determine the amount held in the FEC Litigation Trust, we reconciled the amounts earmarked for distribution to policyholders with amounts deposited and withdrawn from designated bank accounts, and traced a sample of policyholder payments to cancelled checks. We then compared the balance remaining in the bank accounts to source documentation to verify the dollars held by the FEC Litigation Trust.

- We disagree. As we state on page 10, based on our testing the additional legal fee and expense data recorded during calendar years 1994 through 1997, amounting to nearly $1 million, are not sufficiently reliable for the purposes of this audit. Specifically, we found two legal expense transactions that were not included in the legal expense data the CLO provided us, making the data incomplete and also making it possible that actual expenses could be greater than the data indicated. We have no way of knowing if there are other legal expenses that should have been included but were not. Also, we were unable to locate source documents for four expense transactions in the data the CLO provided us. Without reviewing the source documents for these expenses, we have no way of knowing if the amounts contained in the data file are accurate. Therefore, the CLO's statement that our office has reviewed over 99 percent of total legal fees is inaccurate since the nearly $1 million in question is not sufficiently reliable and could actually be greater than the data indicated.

- The CLO's statement is incorrect. We did not conclude that the commissioner was holding $18.4 million as the law requires. Rather, our statement on page 21 was that, as of May 2006 the CLO was holding $18.4 million in funds from the ELIC estate, some of which ultimately may transfer to the Department of Insurance as unclaimed property. The CLO also asserts that $1.5 billion has been distributed to policyholders, including $6.8 million of funds held because of issues hindering their distribution. As we state on pages 2, 11, 12, and 20, data relating to the amounts of money received by policyholders as well as other issues reside with Aurora National Life Assurance Company and have not yet been made available to us. Once we obtain this data, we will issue an additional report that independently verifies the amount received by policyholders, among other topics.

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