



Transmitted via e-mail

April 23, 2012

Mr. David E. Wilson, Chief Executive Officer
Conservation & Liquidation Office
425 Market Street, 23rd Floor
San Francisco, CA 94105

Dear Mr. Wilson:

Final Report—Pacific National Estate Financial Statement Review, December 2011

The Department of Finance, Office of State Audits and Evaluations, has completed its review of the Pacific National Estate assigned to the Conservation & Liquidation Office (CLO) for the period January 1, 2011 through December 31, 2011.

The enclosed report is for your information and use. We appreciate the assistance and cooperation of the CLO. If you have any questions regarding this report, please contact Kimberly Tarvin, Manager, or Rick Cervantes, Supervisor, at (916) 322-2985.

Sincerely,

David Botelho, CPA
Chief, Office of State Audits and Evaluations

Enclosure

cc: Mr. Ray Minehan, Chief Financial Officer, Conservation & Liquidation Office
Mr. Ed Hahn, Vice President, Estate Finance Group, Conservation & Liquidation Office
Ms. Nettie Hoge, Chief Deputy Insurance Commissioner, California Department of Insurance
Mr. Keith Nelson, Chief, Organization Accountability Office, California Department of Insurance

FINANCIAL STATEMENT REVIEW

Pacific National Estate Conservation & Liquidation Office For the Period January 1, 2011 through December 31, 2011

Prepared By:
Office of State Audits and Evaluations
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EXECUTIVE SUMMARY

The California Department of Insurance (Department) takes a leading role to conserve, rehabilitate, or liquidate licensed California financially distressed and insolvent insurance enterprises under appointment by the Superior Courts. The Department's involvement helps secure consumer interests and provide for a stable, consistent insurance market.

The Conservation & Liquidation Office (CLO), created in 1994 to be the successor of the Conservation & Liquidation Division of the Department, is appointed by the California Insurance Commissioner (Commissioner) to oversee the affairs of financially impaired insurance enterprises domiciled in California. Financially impaired insurance enterprises are usually subject to a period of court supervised conservation under CLO administration. During this time, the CLO, along with the regulators, explore opportunities for rehabilitation. Financially distressed life insurance enterprises are frequently conserved, with policyholder liabilities and related invested assets transferred to a third party acquirer. However, for the vast majority of financially distressed property and casualty insurance enterprises, the enterprises will not be conserved, but liquidated.

For enterprises liquidated, the Commissioner, acting through the CLO, assumes title of the enterprise's assets. The insurance enterprise offices are closed, all outstanding policies are cancelled, and the process of obtaining and liquidating the enterprise's remaining assets begins. The books and records of the enterprise are acquired by the CLO for use during this process. The goal of liquidation is to apply the money acquired from liquidating the enterprise's assets toward the enterprise's debts and outstanding insurance claims. Upon issuance of a liquidation order, the CLO issues a notice to all interested parties, including the enterprise's policyholders, creditors, and shareholders. The notice requests proofs of claim be filed with the CLO in order to participate in a distribution of assets. An enterprise subject to a conservation or liquidation order is referred to as an estate. The costs of the CLO administration are borne by the estate of the insolvent entity. For estates with no assets, the California Insurance Fund supplements the costs. The process of conservation and subsequent liquidation can take several years.

The Commissioner, under California Insurance Code section 1060, is required to transmit an annual report of information on the estates under his supervision to the Governor. These estates include those for which the Commissioner is fully responsible; those for which the Commissioner is partially responsible; those for which the Commissioner has custodial responsibilities; and those for which the Commissioner is fully responsible, but are operated separately. As of December 31, 2011, 22 open estates and 1 trust of liquidated insurers are subject to the oversight of the CLO. In 2011, the CLO made distributions totaling \$385 million.

The California Insurance Code sections 1060 and 1061 authorize and require the Department of Finance to conduct biennial examinations of the Commissioner's books and accounts in support of the annual report transmitted to the Governor.

Specifically, the objectives of the engagement were to perform a review of the open estates' Statement of Assets and Liabilities, Statement of Operations, and Statement of Cash Flows (Statements) as of December 31, 2011, in accordance with attestation standards established by the American Institute of Certified Public Accountants. An individual report for each estate reviewed, including any applicable restrictions on its use, will be issued.

Our review included those estates assigned to the CLO's Special Deputy Insurance Commissioner and considered open by the Superior Court; and did not include estates assigned to other Special Deputy Insurance Commissioners. Financial reports for estates assigned to other Special Deputy Insurance Commissioners are issued under separate cover by separate entities.

Review Results

Based on our review, nothing came to our attention that caused us to believe that the Statements for the year ended December 31, 2011 are not presented, in all material respects, in conformity with Generally Accepted Accounting Principles Liquidation Basis of Accounting.

This report is intended for the information and use of the California Department of Insurance, the CLO, and the courts, and should not be used for any other purpose. However, this report is a matter of public record and its distribution is not limited.



INDEPENDENT ACCOUNTANT'S REPORT

Mr. David E. Wilson, Chief Executive Officer
Conservation & Liquidation Office
425 Market Street, 23rd Floor
San Francisco, CA 94105

We have reviewed the Statement of Assets and Liabilities, Statement of Operations, and Statement of Cash Flows (Statements) for the Pacific National Estate for the year ended December 31, 2011. The Conservation & Liquidation Office (CLO), as assigned conservator/liquidator, is responsible for the Statements.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the Statements. Accordingly, we do not express such an opinion.

Based on our review, nothing came to our attention that caused us to believe that the Statements of the Pacific National Estate for the year ended December 31, 2011 are not presented, in all material respects, in conformity with Generally Accepted Accounting Principles Liquidation Basis of Accounting.

This report is intended solely for the information and use of the California Department of Insurance, the CLO, and the courts, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

David Botelho, CPA
Chief, Office of State Audits and Evaluations

April 17, 2012

STATEMENT OF ASSETS
AND LIABILITIES

**Pacific National Estate
Statement of Assets and Liabilities
As of December 31, 2011**

	<u>Balance</u>
Assets	
Participation in Pooled Investments, at Market	\$ 3,969,459
Accrued Investment Income	26,396
Recoverable from Reinsurers	<u>2,918,816</u>
Total Assets	<u>\$ 6,914,671</u>
Liabilities	
Accrued Administrative Expenses (Class 1)	\$ 838,185
Claims Against Policies, Including Guaranty Associations (Class 2), before Distributions	115,755,623
Early Access and Other Class 2 Distributions	(52,416,359)
California and Federal Claims Having Preference (Classes 3 to 6)	7,144
All Other Claims (Class 7)	<u>239,312</u>
Total Liabilities	<u>64,423,905</u>
Net Assets (Deficiency)	<u>\$ (57,509,234)</u>

The notes are an integral part of the financial statements.

STATEMENT OF OPERATIONS

Pacific National Estate Statement of Operations For the Year Ended December 31, 2011

	<u>Balance</u>
Revenue	
Recoveries	\$ 765,498
Total Revenue	765,498
Expenses	
Legal Expenses	13,058
Consultants and Temps	39,746
Compensation & Benefits	595
Office Expenses	1,590
Allocated Overhead Expenses	<u>151,456</u>
Total Administrative Expenses	206,445
Loss Expense	2,101,143
Taxes and Other Expenses	<u>(7,380,053)</u>
Total Expenses	(5,072,465)
Investments	
Investment Income	288,092
Investment Expenses	(10,393)
Gain (Loss) on Securities	<u>(82,350)</u>
Net Investment Income	195,349
Net Income (Loss)	<u>\$ 6,033,312</u>

The notes are an integral part of the financial statements.

STATEMENT OF CASH FLOWS

Pacific National Estate Statement of Cash Flows For the Year Ended December 31, 2011

Cash Flows from Operating Activities	
Net Income (Loss)	\$ 6,033,312
Decrease (Increase) in Recoverable from Reinsurers	18,702,501
Increase (Decrease) in Accrued Administrative Expenses	(7,384,763)
Increase (Decrease) in Unpaid Claims Against Policies, Including Guaranty Associations	(3,100,219)
Decrease (Increase) in Early Access and Other Distributions	<u>(19,000,000)</u>
Net Cash Flows from Operating Activities	(4,749,169)
Cash Flows from Investing Activities	
Decrease (Increase) in Accrued Investment Income	18,153
Cash Flows from Financing Activities	
	<u>0</u>
Net Increase (Decrease) in Cash	(4,731,016)
Cash at Beginning of Period	<u>8,700,475</u>
Cash at End of Period	<u><u>\$ 3,969,459</u></u>

The notes are an integral part of the financial statements.

NOTES TO THE STATEMENTS

1. Organization

The California Insurance Commissioner (Commissioner), an elected official of the State of California, acts under the supervision of the Superior Court (Court) when conserving and liquidating insurance enterprises. In this capacity, the Commissioner is responsible for taking possession (conservation) of the assets of financially troubled insurance enterprises domiciled or incorporated in California. An enterprise subject to a conservation or liquidation order is referred to as an estate.

The Commissioner applies to the Court for a conservation order to place a financially troubled enterprise in conservatorship. Under a conservation order, the Commissioner takes possession of the insolvent estate's financial records and real and personal property, and conducts the business of the estate until a final disposition regarding the estate is determined. The conservation order allows the Commissioner to begin an investigation that will determine, based on the estate's financial condition, if the estate can be rehabilitated, or if continuing business would be hazardous to its policyholders, creditors, or the public.

If, at the time the conservation order is issued or anytime thereafter, it appears to the Commissioner that it would be futile to proceed with the conservation of the financially troubled estate, the Commissioner will apply for an order to liquidate the estate's business. In response to this application, the Court may order the Commissioner to liquidate the estate's business in the most expeditious fashion.

In order to discharge his or her responsibility as conservator or liquidator, the Commissioner appoints special deputy insurance commissioners as agents to act on his behalf. The Commissioner has formed the Conservation & Liquidation Office (CLO) to support the activities of one of these special deputy insurance commissioners. The CLO was created in 1994 to be the successor to the Conservation & Liquidation Division of the California Department of Insurance, which was managed by State employees. The CLO is based in San Francisco, California.

2. Basis of Presentation

The accompanying financial statements of the insurance company in liquidation (the estate) have been prepared on the liquidation basis of accounting in conformity with generally accepted accounting principles. These financial statements reflect the financial position and activity of the estate, which has been assigned to the CLO by the Commissioner in his role as liquidator.

Under the liquidation basis of accounting, assets are stated at their estimated net realizable values. Liabilities are stated at their ultimate amounts and are subsequently adjusted to settlement amounts upon final distribution. A new cost basis is established as of the date of liquidation.

The valuation of assets and liabilities requires many estimates and assumptions, as there are substantial uncertainties in carrying out the provisions of the liquidation proceedings. The actual value of liquidating distributions will depend upon a variety of factors including, among others, the proceeds from the sale of the estate's assets and the actual timing of distributions.

3. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles, prepared on a liquidation basis of accounting, requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statement and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

The major estimates recorded include reserves for claims against policyholders, reinsurance recoverables on unpaid losses, and allowances for uncollectible amounts. These estimates are only partially recorded due to the unavailability of reliable or complete information.

Restatements and Reclassifications

The CLO's policy is to determine whether certain transactions require restatement of the beginning net asset (or net deficiency) balance or if the transactions represent a change in estimate and should be accounted for in the current period. The CLO considers certain factors such as the nature and date of the transaction, materiality in relation to the account category, and whether it is in the purview of the CLO's normal operating activities. Materiality is determined on an estate by estate basis.

Legacy Balances

At the time of conservation or liquidation, the CLO obtains the accounting records of the estate in order to load the account balances (legacy balances) into the general ledger system. During the liquidation process, the legacy balances on the Statement of Assets and Liabilities are researched and validated. This process may take several months to several years. Depending on the nature of the item, legacy balances that cannot be validated are either written off or adjusted through the Net Assets account.

Priority of Claims

California Insurance Code section 1033 prescribes that claims on estate assets are paid according to a priority, except when otherwise provided in a rehabilitation plan. The priority structure was last modified on January 1, 1998, and the estate's reported balances are classified in accordance with the latest priority structure.

As of January 1, 1998, the order of priority for payment is generally as follows:

Secured claims

Liabilities of the estate for which the creditor has perfected a lien against specific estate assets. These claims are generally discharged by a return of the collateral.

Administrative expenses (Class 1)

Expenses of administration.

Claims against policies (Class 2)	All claims of guaranty associations, together with claims for refund of unearned premiums, and all claims under policies of an insolvent insurer that are not claims covered by guaranty associations.
Federal claims having preference (Class 3)	Claims having preference by the laws of the United States.
California taxes (Class 5)	Taxes due to the State of California.
California claims having preference (Class 6)	Claims having preference by the laws of California.
Other claims (Class 7)	All other claims.

Upon issuance of a liquidation order covering an enterprise, the CLO publishes a notice to the enterprise's policyholders, creditors, shareholders, and all parties interested in the enterprise's assets. The notice requests that proofs of claims be filed with the CLO before the final filing date published in the notice of liquidation. The valuation of each proof of claim is determined in accordance with policy provisions and statutory requirements.

The probability of a valid claim being paid is dependent on the valuation of the claim, the order of preference of the claim, and the amount of funds remaining after other claims having higher preference have been discharged. Each priority class of claims must be fully paid before any distribution may be made to the next priority class. All members of a class receiving partial payment must receive the same pro-rata amount.

Estimate of Future Administrative Costs

Generally accepted accounting principles require financial statements of entities in liquidation provide for an estimate of future administrative costs. It is the CLO's policy not to accrue estimates of future administrative costs except when the Court has approved a final distribution order and the estate is scheduled to be closed within the following twelve months.

General and Estate-Specific Notes

The following describe the CLO's general accounting policies for asset, liability, revenue, and expense account categories for all estates for which it is responsible. Certain estates may have zero balances or no transactions in the categories listed below for the period covered by this report.

See Notes 4, 5, and 6 for specific information and disclosures regarding the estate covered by this report.

ASSETS:

Cash and Cash Equivalents

Cash and Cash Equivalents consist of cash in banks, investments in money market funds and all investments with original maturities of three months or less. Investments with maturities of greater than three months, but due in one year or less, are classified as short-term investments.

Restricted cash is segregated in accordance with restrictions imposed by court order, a loan or security agreement, California statute, or escrow agreements, and is generally unavailable for administrative expenses (See Note 4A).

Pooled Investments

All investments, including short-term investments and debt and equity securities, are stated at fair value, which approximates market value. Market values are those provided by the depository trust institution in possession of the securities at the balance sheet date or through brokerage institutions. Where market values are not readily determinable, book values are used.

The majority of the invested assets of the estates are combined for investment purposes into an investment pool, divided equally between two investment management firms. Each of the participating estates owns a percentage of the pool based on its proportionate share of the fair value of the pool's net assets. The net assets are valued at fair value on a monthly basis and estate ownership is computed monthly based on contributions and withdrawals by participating estates. Realized and unrealized gains and losses are allocated monthly based on the estate's ownership percentage in the pool at month-end.

Pooled investments may be considered restricted (See Note 4B).

Non-Pooled Short-Term Investments

Non-Pooled Short-Term Investments consists of investments with maturities greater than three months but less than one year and are funds that cannot be commingled with other funds. Non-pooled investments are held by a custodian bank, and for larger non-pooled investment accounts, an investment manager oversees the investment.

Non-pooled investments are stated at fair value, which approximates market value. Market values are those provided by the depository trust institution in possession of the securities at the balance sheet date or through brokerage institutions. Where market values are not readily determinable, book values are used.

Restricted investments are either restricted by court order, held in trust, or represent a deposit whose use is restricted by statute (See Note 4C).

Accrued Investment Income

Accrued Investment Income represents monthly estimates of interest and dividends earned on cash and investments held by the estate. For pooled investments, interest accruals are allocated based on the estate's percentage of ownership in the pool. Non-pooled interest accruals are on an estate by estate basis. Each month interest and dividends are accrued and posted to the estate's account. Upon receipt of the earnings, the accruals are reversed and actual amounts received are posted.

Statutory Deposits

In the normal course of writing insurance, insurance enterprises are required by state statute to deposit funds with the insurance departments of the states in which they transact business. These deposits are comprised of restricted cash and cash equivalents, short-term investments, and bonds, and are considered the domiciliary estate's investment assets by the CLO.

Upon liquidation, the statutory deposits are transferred to the CLO's control on behalf of the estate, or impounded by the various state insurance departments for the protection of

policyholders within their jurisdiction. Subject to statutory restrictions, the various receiverships may use these funds to pay administrative expenses or claims of the estate arising within their state. Administrative expenses are recorded upon notification from the various ancillary proceedings. It is uncertain whether all, a portion, or any of the domiciliary statutory deposits will be available to the CLO in satisfying the obligations of the estate's liquidation proceedings.

Funds Held by Guaranty Associations

Funds Held by Guaranty Associations represents restricted statutory deposits controlled by ancillary receivers. Upon final settlement of the insurance guaranty association (IGA) claims, any remaining excess funds will be recovered by the estate in accordance with the proper court approval and/or agreement with the IGAs.

Recoverable from Reinsurers

Recoverable from Reinsurers includes amounts recoverable from either ceded or retroceded loss and loss adjustment expense payments, as well as any assumed reinsurance premiums and reinsurance commissions due to the estates.

Reinsurance is the assumption by one insurer (reinsurer) of all or part of a risk originally undertaken by another insurer (cedent insurer). The use of reinsurance agreements does not eliminate the cedent insurer's obligation to pay losses in full. To the extent that a reinsurer is unable to meet its obligations, the insurer is liable for such defaulted amounts. The recoverable from reinsurers balance typically includes amounts related to losses incurred by the estate when it was an insurer of either direct or assumed business. The balance may also include receivables for assumed reinsurance premiums and commissions due the estate.

Generally accepted accounting principles require the CLO to record reinsurance recoverable related to all unpaid and paid claims and claim adjustment expenses to which the estates are entitled, establish an allowance for those amounts which it does not expect to recover, and perform an analysis of reinsurance contracts in relation to transfer of risk and prospective versus retroactive reinsurance.

For certain estates, the reinsurance recoverable on paid and unpaid losses or the amount of letters of credit available for reinsurers has not been fully evaluated by the CLO. The CLO records and evaluates reinsurance recoverable when the information becomes available. In some cases, part of an estate's recoverable from reinsurers represents the balance at the time of conservation. As such, the balance may not include paid claim information from all of the state guaranty associations as of year-end. Because of the difficulty in estimating the recoverable for estates with incomplete claim information, estates which have received recent actuarial examinations have used this reserve data to estimate reinsurance recoverable on unpaid losses.

Allowances are established when a reinsurer is deemed insolvent or put into rehabilitation (See Note 4D).

Salvage and Subrogation Recoverable

Salvage is the recovery made by an insurance enterprise by the sale of property which has been taken over from the insured as part of the loss settlement.

Subrogation is the substitution of one person in the place of another with reference to a lawful claim or right. The insurance carrier that paid a claim is the subrogee who seeks recovery from

the wrongdoer on the principle that the subrogee stands in the place of the one paid and is substituted in the subrogor's stead with all rights against that wrongdoer.

The right of subrogation is in effect an assignment by operation of law that occurs without the execution of any formal documents. Subrogation provisions of various compensation laws represent a statutory modification of the common law rule that a personal injury claim is unassignable.

CLO's policy is to report the salvage and subrogation recoveries net of an allowance for uncollectible amounts. The allowance is currently set at 67 percent of total potential recoveries. Therefore, the balance as reported reflects 33 percent of the total potential recoveries.

Receivables from Affiliates

Receivables from Affiliates represents amounts due from sibling or parent corporations of the estate. Amounts are reported at gross value, unless there is additional available information to substantiate an allowance or other adjustments.

Other Receivables

Other Receivables consists of settlement or judgment receivables, rent receivables, and all other types of receivables that do not correspond with another receivable category. Allowance amounts are established on an individual basis. Amounts reported reflect the CLO's best estimate of net realizable value.

Deposits and Other Assets

Deposits and Other Assets consists of prepaid expenses, funds held by reinsurance, and other assets.

LIABILITIES:

Secured Claims

Secured Claims represents liabilities of the estate for which a creditor has perfected a lien against specific estate assets and unclaimed funds payable. Unclaimed funds payable represent funds distributed to claimants which were returned as undeliverable and/or an accurate address could not be located. Unclaimed funds are eventually escheated to the California State Controller's Office or the state treasurer of the claimants last known address.

Secured Claims receive the first priority payment of an estate's assets.

Accrued Administrative Expenses (Class 1)

Accrued Administrative Expenses (Class 1) represents accrued CLO administrative expenses and reserves for federal income tax liabilities.

Generally accepted accounting principles require financial statements of entities in liquidation to provide an estimate of future administrative costs. Because the final resolution of litigation, reinsurance and other matters which impact the closure of the estate may take more than ten years to resolve, it is the CLO's policy not to accrue estimates of future administrative costs except when the Court has approved a final distribution order and the estate is scheduled to be closed within the following twelve months.

Administrative Expenses (Class 1) liabilities have the first priority payment of an estate's assets after all secured claims are satisfied.

Claims Against Policies, Including Guaranty Associations (Class 2)

Claims Against Policies, Including Guaranty Associations consists of all claims of guaranty associations, claims for refund of unearned premiums, and allowable claims not covered by the guaranty associations.

Reserves for Losses and Loss Adjustment Expenses represent the estimated balance of the ultimate settlement value of policyholder claims against the estates to the extent known by the CLO. The reserves and related salvage and subrogation are based on, in some cases, incomplete information and have not been fully evaluated by an independent actuary for claims development or for claims which have been incurred but not reported.

Due to uncertainty as to the ultimate settlement cost of policyholder claims and policyholder contract shortfalls, the effect of adjustments to the reported amounts is not presently determinable, but may have a material effect on the financial statements. It is management's intent to obtain enough reliable data from the guaranty associations, actuaries, or other sources in order to develop estimates which would support the ultimate settlement amount for each estate.

Liabilities Due to Guaranty Associations are amounts due to the California Insurance Guarantee Association and other state insurance guaranty associations for paid claims, administrative expenses, and other expenses incurred by the guaranty associations in discharging the estate's insurance policy obligations which are considered covered under the applicable state insurance code. The CLO reports information received from the guaranty associations based on the Financial Information Questionnaire (FIQ).

The FIQ is a summary of the claims payments and reserve estimates of the guaranty associations as recorded in their general ledgers and submitted to the CLO through an electronic reporting system approved by the National Conference of Insurance Guaranty Funds (NCIGF). At times, the supporting data maintained on the guaranty associations' claims database and submitted to the CLO in uniform data standard format (UDS) varies from the amounts reported on the FIQ by certain state guaranty associations. The CLO and the guaranty associations, in conjunction with the NCIGF, have been working closely to reconcile the FIQ and UDS information. Where discrepancies exist, data from the FIQ is used to substantiate the Class 2 liabilities to guaranty associations since the FIQ is the controlling report which the guaranty associations use to formally report their total losses and reserves.

Unearned Premium Reserves represent the amount of premium paid by policyholders for anticipated coverage applicable to the period after cancellation. This premium ultimately will be returned to policyholders if there are sufficient estate assets. For many estates the CLO has not fully evaluated and recorded these claims and; therefore, the ultimate settlement amount may differ materially from the amounts reported.

Other Class 2 Claims are claims in excess of their limits or types of claims not covered by the statutory obligations of the insurance guaranty associations. The CLO is responsible for adjudicating claims which are not covered by guaranty associations, and also for the administration and payment of these claims to policyholders. The CLO has not fully evaluated and recorded all Other Class 2 claims and; therefore, the ultimate settlement amount may differ materially from the amounts reported. The CLO does not have a legal right to recover these funds once disbursed.

Early Access and Other Class 2 Distributions

Estate assets may be distributed through an early access distribution, an interim distribution, or a final distribution. All distributions must receive prior approval from the Court. Distributions are made in accordance with the priority scheme described above.

Early access distributions are payments made specifically to insurance guaranty associations based on their paid losses reported to the CLO. The guaranty associations report paid losses and other information through quarterly FIQs and monthly electronically-submitted data report UDS. If the detail provided by the UDS does not match the summary provided by the FIQ, the CLO's policy is to calculate early access distributions on the lower of the paid losses per FIQ or UDS.

The Commissioner can advance a portion of an estate's assets to a guaranty association in order to pay future claim liabilities. However, the Commissioner continues to be primarily responsible to secured creditors and Class 1 creditors who have preference over amounts reimbursable to guaranty associations. The CLO maintains a legal right to these funds and may recover these advanced funds from the guaranty associations to pay higher priority claims should the need arise.

Guaranty associations do not have a greater priority than other Class 2 claimants. Consequently, when final distribution of an estate's assets is made, guaranty association claims will be treated on an equal basis with other policyholder claims at the time of final distribution, and the amount payable to the guaranty associations will be reduced by amounts previously advanced, plus interest, if applicable.

Interim distributions are payments to guaranty associations and claimants whose claims are not covered by the guaranty association. Interim or partial distributions may be ordered by the Court before the final distribution to close an estate is made. In this case, the CLO evaluates whether the estate has sufficient funds to pay beyond Class 2 claimants by calculating the ratio of assets to liabilities as a percentage of projected distributions. If there are insufficient funds to pay the lower-priority class claims, the claimants are notified through a "No Asset Letter" mailing.

Final distributions occur after the final claims have been approved by the CLO and all reinsurance and litigation matters are resolved. Final distributions are ordered by the Court to distribute the remaining assets of an estate to claimants or insurance guaranty associations, or to remit funds to the domiciliary receiver if the estate is an ancillary estate. Final distributions usually occur at the end of the estate's life cycle.

If estates have assets in excess of liabilities, the Court may award interest to claimants based on their allowed claims. This interest accrual is limited to 10 percent per year calculated for the period from the date of the liquidation order to the date of final distribution. The CLO's policy is to not accrue or pay interest unless 100 percent of all classes of claims have been paid (See Notes 4E and 4F).

California and Federal Claims Having Preference (Classes 3 to 6)

California and Federal Claims Having Preference consists of federal claims, pre-liquidation premium taxes payable to the State of California, and other California claims having preference (See Note 4F).

All Other Claims (Class 7)

Class 7 Claims represents all other claims filed against the estate which have not been defined by higher priority classes. Claimants include pre-liquidation creditors, reinsurers, and cedents. To the extent that assets remain in the estate, the shareholders will receive a distribution of the assets remaining after all other claimants are satisfied.

Generally accepted accounting principles require that Class 7 liabilities be accrued when it is probable that the liability has been incurred and the amount of the loss can be reasonably estimated. However, in cases when it appears evident that an estate has insufficient assets to fully satisfy the higher priority claims, the CLO has not recorded a balance for Class 7 liabilities. When recorded, these balances generally represent the liabilities owed at the time of liquidation or those claims evaluated by the CLO during the proof of claim process.

For estates where available assets are insufficient to pay all Class 2 claims, the CLO has intentionally not fully evaluated the lower priority proofs of claims, since to do so would incur unnecessary administrative time and expenses, reducing funds available for distribution to higher-priority claimants. Thus amounts recorded may not represent the ultimate Class 7 liabilities of the estate (See Note 4F).

REVENUES:

Premiums Revenue

Premiums Revenue represents retrospective premium adjustments and changes in unearned premiums. Income received from premiums after conservation, but not associated with an established receivable, is recorded as Premiums Revenue. Adjustments to premiums written occur primarily with workers compensation premiums. These premiums are paid in advance, and are based on estimates of the number of workers covered. At the end of the coverage period, audits are conducted to determine if the premium paid was reflective of the actual employees covered. Additional collections and refunds are calculated accordingly. Unearned premiums are premiums paid in advance, but not yet earned by the estate. These funds are due back to the policyholder and are considered Class 2 liabilities. When the Unearned Premium Reserves (Class 2 liabilities) are adjusted, the offsetting account is the Unearned Premiums Revenue account.

Recoveries

Recoveries consists of litigation recoveries and salvage and subrogation recoveries for which a receivable has not been previously established.

Other Revenue

Other Revenue primarily consists of fees collected and miscellaneous income received by the estate.

EXPENSES:

Administrative Expenses

Administrative Expenses consists of both direct and indirect expenses.

Direct expenses are directly charged to estates whenever individually attributable to the estate. These expenses consist of legal costs, consultants and contractors, salaries and benefits of employees working exclusively for a single estate, office expenses, and depreciation and capitalization of property and equipment. Reversals or reimbursements of certain legal and

litigation-related expenses incurred in prior years are recorded in current year financial statements. In certain cases, such reversals or reimbursements may exceed current year expenses, and could result in net negative administrative expenses for the year for certain estates.

Under the liquidation basis of accounting, all estate assets are generally considered in liquidation and are carried at estimated net realizable value. Revaluation of property, if any, represents changes in the carrying value during the year. Depreciation and amortization of these assets are not recorded for periods subsequent to the date of liquidation order, unless the asset remains in temporary use by the estate.

Administrative expenses not directly charged to an estate are allocated to each estate on a proportional basis. Allocated expenses applicable to all the estates include CLO employee compensation and benefits, payroll taxes, indirect legal expenses, rent, utilities, and other general overhead costs. These shared expenses are allocated to each estate based on factors derived from the direct CLO labor hours charged to each estate, and in some instances direct contractor hours charged.

In accordance with California Insurance Code section 1035, the Commissioner may petition funds from a general appropriation of the State of California Insurance Fund if an estate does not have sufficient assets to pay for administrative expenses.

Loss Expenses

Loss Expenses consists of direct, assumed, and ceded loss and loss adjustment expenses, bad debt expense, and commutations. The expenses recorded in this category generally pertain to Class 2 liabilities.

Direct, assumed, and ceded losses and loss adjustment expenses consists of payments to Class 2 claimants by the guaranty associations, Class 2 overcap claims expense paid or incurred by the CLO, and changes in guaranty associations' estimates of future policyholder claims (case and incurred but not reported (IBNR) reserves). Amounts reported are based on the FIQs received from the guaranty associations and information maintained by the CLO's claims department.

Commutation Expenses represents losses (or gains) on commuted reinsurance contracts. Generally accepted accounting principles require such gains and losses be accounted for in the year of commutation. CLO's policy is to recognize such gains and losses when the commutation agreement has been signed or the Court approves the agreement.

Federal Income Tax Expense

The treatment of estates for federal income tax purposes varies. Estates formerly taxed as property-casualty companies may qualify for exemption from federal income tax for certain years unless they are members of an affiliated group that includes other insurers. Other estates are taxed under provisions of the Internal Revenue Code applicable to life insurers or other corporations.

Estates that are members of an affiliated group allocate taxes among group members in accordance with tax sharing agreements. If no tax sharing agreement exists, members of the group reporting taxable losses are allocated the tax benefits attributable to their losses when such losses are used to offset income of profitable members. Members reporting taxable income calculate tax expense as if filing separate income tax returns. Payments of tax expenses, if any, are made in accordance with priority statutes.

Other Expenses

Other Expenses consists of all other gains and losses that do not conform to another reporting category. This includes, but is not limited to, gain or loss in retirement of escrows and changes in value of statutory deposits after release to guaranty associations.

INVESTMENTS:

Investment Income

Investment Income is comprised of interest and dividends earned on cash and investments held by the estate. For estates with investments in the pool, income is allocated based on the estate's proportional share in the pool.

Investment Expenses

Investment Expenses is comprised of investment and interest expenses related to cash and investments held by the estate. For estates with investments in the pool, the expenses are allocated based on the estate's proportional share in the pool.

Gain (Loss) on Securities

Gain (Loss) on Securities consists of long and short-term gains and losses incurred as part of the investment pool, mark to market adjustments, gains and losses on non-pooled reappraisals of securities, and gains and losses incurred on the transfer of non-pooled securities into the pool. The long and short-term gains and losses and mark to market adjustments are allocated based on the estate's proportional share in the pool. Gains and losses on the reappraisal of non-pooled securities and the transfer of non-pooled securities into the pool are reported on an estate by estate basis.

Unrealized and realized gains and losses are included as a component of net investment income. The cost of securities sold is based on specific identification and realized gains (losses) are computed based on the securities' original cost. Transfers of non-pooled investments to a pool are a sale resulting in non-pooled realized gains and losses and a noncash transfer. Transfers from one pool to the other are a sale resulting in pooled realized gains and losses and a non-cash transfer.

4. Pacific National Estate Disclosures

Pacific National Insurance Company (the Estate), a California-domiciled company, was conserved on May 14, 2003. The liquidation order for the Estate was signed on August 5, 2003. Prior to liquidation, the Estate primarily wrote workers' compensation insurance, as well as property and casualty insurance policies.

- A. The Estate held no restricted cash as of December 31, 2011.
- B. The Estate held no restricted pooled short-term investments as of December 31, 2011.
- C. The Estate held no restricted non-pooled short-term investments as of December 31, 2011.

- D. The reinsurance recoverable amount as reported in the Estate's financial statements is net of the \$100,000 allowance for uncollectible reinsurance recoverable.
- E. In 2011, the Estate made \$19,000,000 in distributions.
- F. The Estate does not have sufficient assets to pay Class 2 liabilities in their entirety. The Estate does not have sufficient assets to pay Class 3 to 7 liabilities.
- G. In 2011, the Estate reversed \$8,532,553 of reserves which had been accrued for potential Federal tax liability.

5. Litigation

There are no pending legal proceedings involving the Estate as of December 31, 2011.

6. Subsequent Events

There are no reportable subsequent events for the Estate.