



July 31, 2008

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

Dear Mr. Wilson:

Final Report—ELIC Holdback Trust Financial Statement Review, December 2007

The Department of Finance, Office of State Audits and Evaluations, has completed its review of the ELIC Holdback Trust assigned to the Conservation & Liquidation Office (CLO) for the period January 1, 2007 through December 31, 2007.

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

Sincerely,

David Botelho, 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
Mr. Keith Nelson, Chief, Ethics and Operational Compliance Office, California Department of Insurance
Mr. Dennis Ward, Chair, Audit Committee, California Department of Insurance

FINANCIAL STATEMENT REVIEW

ELICH Holdback Trust
Conservation & Liquidation Office
For the Period January 1, 2007
through December 31, 2007

Prepared By:
Office of State Audits and Evaluations
Department of Finance

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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, 2007, 25 open estates and 3 trusts of liquidated insurers are subject to the oversight of the CLO. In 2007, the CLO made interim and final distributions totaling \$563 million and closed one estate.

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 as of December 31, 2007, 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.

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

STAFF:

Susan M. Botkin, CGFM
Manager

Rick Cervantes, CPA
Supervisor

Deborah Berry
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INDEPENDENT ACCOUNTANTS 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 ELIC Holdback Trust for the year ended December 31, 2007. 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 ELIC Holdback Trust for the year ended December 31, 2007 are not presented, in all material respects, in conformity with Generally Accepted Accounting Principles.

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
(916) 322-2985

July 11, 2008

STATEMENT OF ASSETS AND LIABILITIES

ELIC Holdback Trust Statement of Assets and Liabilities As of December 31, 2007

| Assets | <u>Balance</u> |
|--|-----------------------|
| Cash and Cash Equivalents: unrestricted | \$ 262,837 |
| Participation in Pooled Investments, at market | 317,952 |
| Non-Pooled Short Term Investments, at market: restricted | 1,135,506 |
| Accrued Investment Income | <u>1,077</u> |
| Total Assets | <u>\$ 1,717,372</u> |
| Liabilities | |
| Secured Claims | \$ 71,794 |
| Unclaimed Funds Payable | 1,048,196 |
| Reserve for Administrative Expenses | <u>597,382</u> |
| Total Liabilities | <u>\$ 1,717,372</u> |

The notes to the statements are an integral part.

STATEMENT OF OPERATIONS

ELIC Holdback Trust
Statement of Operations
For the 12 Months Ended December 31, 2007

| Expenses | <u>Balance</u> |
|-------------------------------|-------------------------|
| Consultants and Temps | \$ 409 |
| Office Expenses | 1,502 |
| Allocated Overhead Expenses | <u>65,432</u> |
| Total Administrative Expenses | 67,343 |
| | |
| Investments | |
| Investment Income | 136,195 |
| Investment Expenses | (5,628) |
| Gain (Loss) on Securities | <u>(10,228)</u> |
| Net Investment Income | <u>120,339</u> |
| | |
| Net Income | <u>\$ 52,996</u> |

The notes to the statements are an integral part.

STATEMENT OF CASH FLOWS

ELIC Holdback Trust
Statement of Cash Flows
For the 12 Months Ended December 31, 2007

Cash Flows from Operating Activities

| | |
|--|--------------|
| Net income | \$ 52,996 |
| Increase (decrease) in secured claim liabilities | (2,692,643) |
| Increase (decrease) in unclaimed funds payable | (236,816) |
| Adjustments to reserve for administrative expenses | <u>2,192</u> |
| Net cash flows from operating activities | (2,874,271) |

Cash Flows from Investing Activities

| | |
|--|-------|
| Decrease (increase) in accrued investment income | (397) |
|--|-------|

Cash Flows from Financing Activities

0

Net increase (decrease) in cash **(2,874,668)**

Cash at beginning of period 4,590,963

Cash at end of period **\$ 1,716,295**

The notes to the statements are an integral part.

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 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 Superior 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 Department of Insurance, which was managed by State employees. The CLO is based in San Francisco, California.

The Commissioner ordered the conservation of Executive Life Insurance Company (ELIC) on April 11, 1991, partly due to a decline in value of its multi-billion dollar investment portfolio of high yield corporate bonds, commonly known as "junk bonds." At the time, it was the largest life insurance insolvency in United States history. ELIC had more than 350,000 policyholders when the liquidation order was signed on December 6, 1991.

On March 3, 1992, pursuant to Superior Court approval, the Commissioner consummated the sale of ELIC's junk bond portfolio. A comprehensive rehabilitation plan was adopted and became effective on September 3, 1993. As a part of the plan, the policyholders either elected to accept new coverage (opt in) from Aurora National Life Assurance Company (Aurora) or elected to opt out and terminated their policies for cash. Over the years, enhancement trusts were established as a part of the liquidation process and which at various times have been used to distribute assets to policyholders that opted out, or to Aurora to distribute cash or dividends and/or to enhance the policy values of the policyholders that opted in.

2. Basis of Presentation

During 2007, the CLO managed three trusts in addition to the ELIC estate: ELIC Holdback Trust, ELIC Opt-Out Trust, and ELIC FEC Litigation Trust. See Notes 4, 5 and 6 for specific information and disclosures regarding the trust covered by this report.

The accompanying financial statements have been prepared in conformity with Generally Accepted Accounting Principles. These financial statements reflect the financial position and activities of the trust, which has been assigned to the CLO by the Commissioner in his role as trustee.

3. Summary of Significant Accounting Policies

ASSETS:

Cash and Cash Equivalents

Cash and Cash Equivalents consists 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.

Some of the invested assets of the trusts are combined for investment purposes into an investment pool, divided equally between two investment management firms. Each of the participating trusts 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 ownership is computed monthly based on contributions and withdrawals by participating trusts. Realized and unrealized gains and losses are allocated monthly based on the trust'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 represent a deposit whose use is restricted by the terms of the agreements governing the trust. (See Note 4c.)

Accrued Investment Income

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

LIABILITIES:

Secured Claims

Secured Claims represents amounts due to policyholders which have not yet been disbursed.

Unclaimed Funds Payable

Unclaimed Funds Payable represents disbursements that were returned because claimants could not be located. These funds are eventually escheated to the California State Controller's Office.

Reserve for Administrative Expenses

Reserve for Administrative Expenses represents CLO's best estimate of administrative expenses to be incurred in closing the trust.

REVENUE:

The trust did not earn any revenue during 2007.

EXPENSES:

Administrative Expenses

Administrative Expenses consists of both direct and indirect expenses.

Direct Expenses are directly charged to trusts whenever individually attributable to a trust. These expenses consist of legal costs, consultants and contractors, and office expenses.

Administrative expenses not directly charged to an individual trust are allocated to each trust on a proportional basis. Allocated expenses applicable to all of the trusts may 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 trust based on factors derived from the direct CLO labor hours charged to each trust, and in some instances direct contractor hours charged.

INVESTMENTS:

Investment Income

Investment Income is comprised of interest and dividends earned on cash and investments held by the trust. For trusts with investments in the pool, income is allocated based on the trust'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 trust. For trusts with investments in the pool, the expenses are allocated based on the trust'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 trust'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 a trust by trust 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. ELIC Holdback Trust Disclosures

The ELIC Holdback Trust (Trust) was established in 1994 to hold ELIC assets while certain litigation challenges to the terms of the Rehabilitation Plan were pending on appeal. In 1996, the Trust was amended, with court approval, to provide that it would hold funds that would otherwise have been distributed to policyholders until certain indemnity demands that Aurora anticipated making were resolved. In 1998, when Aurora's indemnity demands were resolved, all funds in the Trust were disbursed except for funds that were due to policyholders that could not be located.

- a. The Trust held no restricted cash as of December 31, 2007.
- b. The Trust held no restricted pooled investments as of December 31, 2007.
- c. The Trust held \$1,135,506 in restricted non-pooled short term investments as of December 31, 2007.

5. Litigation

There are no pending legal proceedings involving the Trust as of December 31, 2007.

6. Subsequent Events

There are no reportable subsequent events for this Trust.