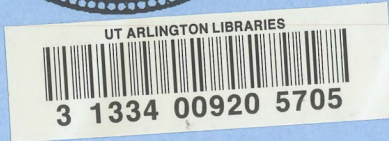


OFFICE of the STATE AUDITOR  
AUSTIN, TEXAS



**AUDIT OF THE RECEIVERSHIP PROCESS**

*Lawrence F. Alwin, CPA*  
*State Auditor*

**MARCH 1994**

**SAO Report Number 94-097**

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March 30, 1994

## Members of the Legislative Audit Committee:

Controls used by the Texas Department of Insurance's Liquidation Oversight division over the liquidation of insurance companies were generally weak during fiscal year 1993. Weak controls indicate a risk that overall liquidation costs are too high. We noted several instances of high costs such as excessive special deputy receiver fees. Controlling and keeping costs low is important because taxpayers pay a substantial part of liquidation costs. The cost to taxpayers is measured, in part, by assessments on the insurance industry. During calendar year 1993, these assessments totaled \$126 million. State tax laws allow insurance companies to deduct their assessments dollar for dollar against insurance taxes, generally over ten years. As a result, taxpayers are ultimately paying for this portion of the cost to liquidate estates. Every dollar saved by making the liquidation of insurance companies more efficient is one less dollar paid by taxpayers.

In addition to the impact on taxpayers, controls over the liquidation process are important because significant amounts of money are involved. The Department, through its Liquidation Oversight division, was responsible for monitoring more than \$126 million in cash disbursements paid in fiscal year 1993 to policyholders and as costs to liquidate insolvent companies. This involved oversight responsibilities over 31 special deputy receivers and 102 estates. An estimated \$375 million in estate assets and \$821 million in unpaid claims remain as of August 31, 1993.

This report identifies increased earnings and cost savings opportunities of approximately \$565,000. Recommendations in this report cover the Texas Department of Insurance (Department) and two guaranty associations (Property Association and Life Association). We also recommend further study by the Department to consider using existing Treasury Department expertise in seeking owners of \$6,500,000 in unclaimed funds and abandoned property. A portion of this may be available to transfer to general revenue.

We thank the Department for its help during this engagement.

Sincerely,

Lawrence F. Alwin, CPA  
State Auditor

LFA:vib/asc/rmn

# AUDIT OF THE RECEIVERSHIP PROCESS

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## Audit of the Receivership Process

### BACKGROUND

The 72nd Legislature, Second Special Session (1991) privatized the liquidation of insurance companies. Many entities were affected by this statutory change. In addition to the Texas Department of Insurance (Department), also involved are the two largest guaranty associations, as well as special deputy receivers who are appointed by the Commissioner of Insurance. These and other entities are described further in Table One, page six.

Liquidation Oversight, a division of the Department, has the primary responsibility to oversee the liquidation of insolvent insurance companies. This responsibility consists of three key components: the selection, monitoring, and evaluation of those contracted to liquidate insurance companies (Figure 2). The actual steps to liquidate a company are completed by the contractors (special deputy receivers) and their subcontractors.

Since privatization started in September 1991, the Department has created an oversight process, closed many older estates, and dissolved the former Liquidation Division. During our fieldwork, the Department made a series of improvements to Liquidation Oversight policies and procedures.

For the period covered in this audit, the status of controls within Liquidation Oversight reflected, in part, the early developmental stage of a new process. Also, early decisions to restrict staffing to four full-time analysts limited Liquidation Oversight's ability to adequately perform the oversight role. Sufficient staffing to review expenditures is important because of the way that the courts approve costs. Any estate expenditure is automatically approved by the courts as required by statute if no objections are raised. Liquidation Oversight is the primary entity that reviews monthly expenditures for reasonableness on a routine, monthly basis.

## Audit of the Receivership Process

### EXECUTIVE SUMMARY

Controls used by the Texas Department of Insurance's Liquidation Oversight division over the liquidation of insurance companies were generally weak during fiscal year 1993. Weak controls, coupled with a few instances of high costs, such as excessive special deputy receiver fees, indicate a risk that overall liquidation costs are too high. Controlling and keeping costs low is important because taxpayers pay a substantial part of liquidation costs. Every dollar saved by making the liquidation of insurance companies more efficient is one less dollar paid by taxpayers.

The cost to taxpayers is measured, in part, by assessments on the insurance industry. During calendar year 1993, these assessments totaled \$126 million. State tax laws allow insurance companies to deduct their assessments dollar for dollar against insurance taxes, generally over ten years. As a result, taxpayers are ultimately paying for this portion of the cost to liquidate estates. Assessments are made when assets of estates are insufficient to pay covered claims.

In addition to the impact on taxpayers, controls over the liquidation process are important because significant amounts of money are involved. The Department, through its Liquidation Oversight division, was responsible for monitoring more than \$126 million in cash disbursements paid in fiscal year 1993 to policyholders and as costs to liquidate insolvent companies. This involved oversight responsibilities over 31 special deputy receivers and 102 estates. Special deputy receivers and their subcontractors were paid an estimated \$14.3 million to administer and liquidate estates during fiscal year 1993. An estimated \$375 million in estate assets and \$821 million in unpaid claims remain as of August 31, 1993.

Our audit concluded that Liquidation Oversight should make improvements to contain costs and strengthen oversight of the liquidation process. We found that:

- \* The process to select special deputy receivers and other professionals that provide services to the estates does not reflect the benefits of price competition.
- \* Controls to monitor and reduce costs, such as verifying contract compliance, have been ineffective.
- \* Liquidation Oversight should develop additional performance measures that evaluate the process overall and also at the estate level. Some performance measures currently in use, such as the cost to recover estate assets, can be effective indicators of performance.
- \* The Department does not have an established procedure for coordination and early involvement of all oversight entities to accelerate the process and reduce costs.

The two guaranty associations (Life Association and Property Association) are making progress in their mission to pay covered claims of insolvent insurance companies. Significant policies and procedures, including most elements of strategic planning, are complete. The Boards of Directors are active and include public representation. An issue for further study for both Associations is



## **Audit of the Receivership Process**

determining the need for a more proactive filing of objections to excessive costs reported by special deputy receivers.

The Property Association can add to first-year progress by improving controls over third-party administrators and reporting performance measures to increase their public accountability. The Property Association, at the time of our review, did not have effective policies and procedures to detect and correct inadequate claims processing by an outside subcontractor. The Property Association was completing its 1994 strategic plans, but had not incorporated the reporting of performance measures.

The Life Association can add to first-year progress by reporting performance measures to increase their public accountability and improving complaint resolution procedures. The Life Association completed strategic plans for 1993 and 1994, but had not incorporated the reporting of performance measures within these plans.

Our report identified estimated savings opportunities of \$565,000. The Department can earn an additional \$525,000 annually for the estates by obtaining higher yields on cash invested with the State Treasurer. We also suggest the Department pursue a statutory change involving court approval of transactions. Estimated savings of \$40,000 annually are available to the estates by raising the existing \$1,000 threshold to \$10,000 where court approval of transactions is required.

We also recommend further study by the Department to consider using existing Treasury Department expertise in seeking owners of \$6,500,000 in unclaimed funds and abandoned property. A portion of this may be available to transfer to general revenue.

Overall progress during fiscal year 1993 includes increased closings of estates, creation by the courts of a Receivership Master position, and development of the guaranty associations as claims paying entities. More estates closed in fiscal year 1993 (40 estates) than in any prior year. Court records show that even more will close in the first half of fiscal year 1994 (45 estates) alone. A significant reason for the increase in estate closings is due to the involvement of the Receivership Master position. The Receivership Master has helped control costs and facilitates the overall process by holding quarterly status conferences with each special deputy receiver for each estate. This increases the accountability of the special deputy receiver by monitoring progress towards closing of the estate. This increase in judicial oversight is supplemental to the primary control provided by Liquidation Oversight.

### **Commissioner of Insurance's Response to the Executive Summary**

*As Commissioner of Insurance, it is my goal to make the receivership and liquidation oversight processes efficient, effective and model programs for the benefit of policyholders and taxpayers. The receivership and oversight processes are complex and massive undertakings. As the State Auditor indicates in this report, special deputy receivers paid more than \$126 million in cash disbursements during fiscal year 1993 and were responsible for managing an estimated \$375 million in receivership estate assets as of August 31, 1993. TDI views the challenge to make*

## **Audit of the Receivership Process**

*these processes models for state government as a partnership with the State Auditor's Office (SAO).*

*The State Auditor's Office (SAO) began their annual statutorily required audit of the receivership process in February 1993 shortly after the inception of the Liquidation Oversight (Oversight) program in January 1993. Receivership privatization has involved a learning process for the SDRs, SAO and the Texas Department of Insurance (TDI). TDI appreciates the guidance and recommendations made by the SAO during this time period. Many of the recommendations made in this report were implemented during the audit or have been implemented subsequently.*

*Some of the major accomplishments of Oversight and Contracting are as follows:*

- Establishment of reporting standards to be followed by the SDRs. For example, in May 1993, the SDRs were required to adopt the modified-accrual method of accounting to more accurately match monthly expenses with the period in which they were incurred.*
- An audit program was developed to be followed by the Oversight analysts when reviewing the monthly reports. This audit program was provided to the SDRs to make them aware of how their performance was to be measured.*
- Two SDRs whose performance was substantially below standards set by the program were terminated and another SDR withdrew upon receiving negative feedback from Oversight regarding his performance.*
- Three experienced auditors were added to the Oversight staff to provide supervision and guidance to the analysts. This increase in personnel has resulted in thorough reviews of each SDR report.*
- Oversight began conducting on-site visits to the SDRs' offices in November 1993.*
- Oversight has completed a risk-ranking of the SDRs and selected five SDRs to receive an independent audit during fiscal year 1994.*
- In November 1993, the SDRs began receiving written feedback on their performance on a monthly basis.*
- For those estates where there is very little activity but the estates cannot close (for example, environmental claims are pending), Oversight has instituted reduced reporting requirements to limit these estates' costs.*
- The selection of SDRs was initially based upon individuals, entities, or firms with the best probability for success. After a year of continuous guidance from TDI, many SDRs are now very proficient and their cost of doing business is steadily being reduced.*

*TDI's responses to the report will address each recommendation and the commentary supporting the recommendations.*

## Insurance Liquidation Process

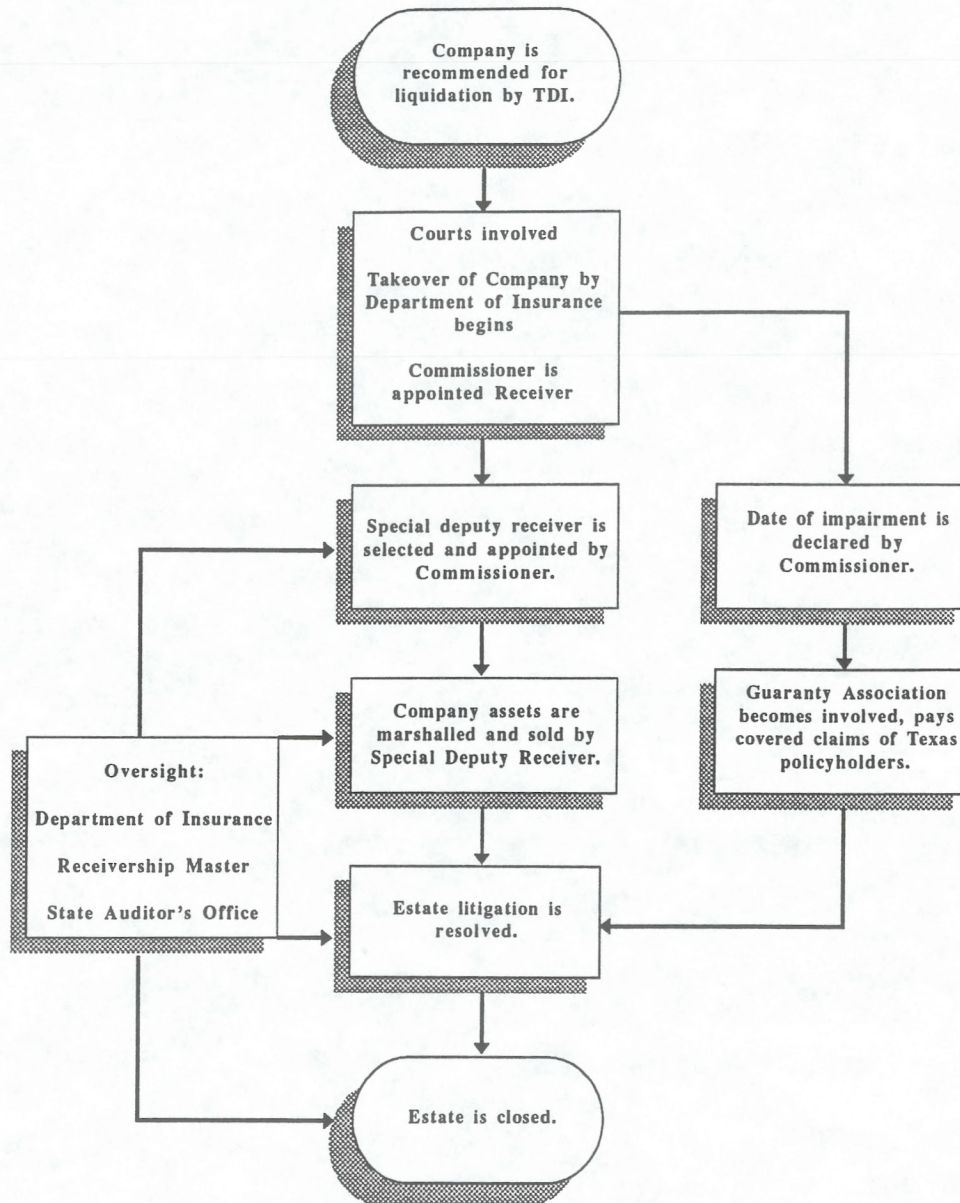


Figure One

The Department, through its Liquidation Oversight division, was responsible for monitoring 31 special deputy receivers and 102 estates. An estimated \$375 million in estate assets and \$821 million in unpaid claims remain as of August 31, 1993.

**Audit of the Receivership Process**

**Table One  
Entities Involved In The Insurance Liquidation Process**

Entity	Basic Responsibility
<b>Texas Department of Insurance</b>	
Liquidation Oversight	Department of Insurance division responsible for the monitoring and evaluation of special deputy receivers.
Contract Administration	Department of Insurance division responsible for developing and executing contracts with special deputy receivers.
Conservation Division	Department of Insurance division responsible for rehabilitating insurance companies. Recommends companies for liquidation.
Receiver	The Commissioner of Insurance, also referred to as the Liquidator.
<b>Private Sector Contractors</b>	
Special deputy receivers	Private sector individuals or firms, appointed by the Commissioner of Insurance, who are responsible for liquidating insolvent insurance companies.
Subcontractors	Private sector individuals or firms, hired by special deputy receivers, that provide professional services to an estate, such as legal, accounting, and asset recovery services.
Third party administrator	Private sector firm that provides claim processing services. Hired by guaranty associations.
<b>The Courts</b>	
Receivership Master	Representative of the court that provides judicial oversight and monitors the status of liquidations. Appointed by the Court.
<b>Guaranty Associations</b>	
The Texas Life, Accident, Health and Hospital Service Insurance Guaranty Association (Life Association)	The guaranty association responsible for paying covered policyholder claims against insolvent life, health, accident, and hospital service insurance companies.
The Texas Property and Casualty Insurance Guaranty Association (Property Association)	The guaranty association responsible for paying covered policyholder claims against insolvent property and casualty insurance companies.

## **Audit of the Receivership Process**

### AUDIT FINDINGS

Controls used by the Texas Department of Insurance's Liquidation Oversight division over the liquidation of insurance companies were generally weak during fiscal year 1993. Weak controls, coupled with instances of high costs such as excessive special deputy receiver fees, indicate that overall liquidation costs are too high. Controlling and keeping costs low is important because taxpayers pay a substantial part of liquidation costs. Every dollar saved by making the liquidation of insurance companies more efficient is one less dollar paid by taxpayers.

The cost to taxpayers is measured in part by assessments on the insurance industry. During calendar year 1993, these assessments totalled \$126 million. State tax laws allow insurance companies to deduct their assessments dollar for dollar against insurance taxes over time. As a result, taxpayers are ultimately paying for this portion of the cost to liquidate estates. Assessments are made when assets of estates are insufficient to pay covered claims.

In addition to the impact on taxpayers, controls over the liquidation process are important because significant amounts of money are involved. The Department, through its Liquidation Oversight division, was responsible for monitoring more than \$126 million in cash disbursements paid in fiscal year 1993 to policyholders and as costs to liquidate insolvent companies. This involved oversight responsibilities over 31 special deputy receivers and 102 estates. Special deputy receivers and their subcontractors were paid an estimated \$14.3 million to administer and liquidate estates during fiscal year 1993. An estimated \$375 million in estate assets and \$821 million in unpaid claims remain as of August 31, 1993.

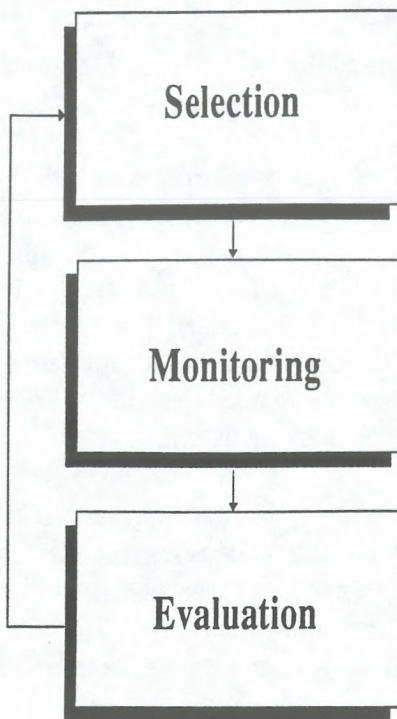
The process to liquidate insurance companies is complex (Figure One, page five) and involves many entities (Table One, page six). Liquidation Oversight has the primary responsibility to oversee the liquidation of insolvent insurance companies. The oversight responsibility consists of three key components: the selection, monitoring, and evaluation of those contracted to liquidate insurance companies (Figure 2, page eight). The actual steps to liquidate a company are completed by the contractors (special deputy receivers) and their subcontractors.

The following recommendations are directed to the entities with significant liquidation responsibilities. These are the Texas Department of Insurance (Department, Issue I below) and two guaranty associations (Life Association and the Property Association, Issue II, page 27).

## Audit of the Receivership Process

- I. **The Department of Insurance should improve the major controls within Liquidation Oversight; this involves the selection, monitoring, and evaluation of those hired to liquidate insurance companies, as well as coordination and cost saving opportunities**

**Figure 2  
Overview of the  
Department of Insurance Oversight Process**



The Department uses a formal bid solicitation process to solicit, screen, and select special deputy receivers.

Liquidation Oversight reviews monthly expenditures, other transactions, and business plans prepared by special deputy receivers.

Liquidation Oversight develops conclusions about the cost and time needed to liquidate an insolvent insurance company, and performance of the special deputy receiver. The division may take action for poor performance such as termination of the contract.

- A. **The selection process for special deputy receivers and their subcontractors does not emphasize price competition and management experience and ability**

The selection process should be improved through a greater emphasis on price competition, and increased emphasis on evaluation of special deputy receiver candidates' management experience and ability. The selection process should result in the appointment of a special deputy receiver who had the best combination of expertise and estimated cost to liquidate a given estate. The special deputy receivers are selected by, and serve at the pleasure of, the Commissioner.

## Audit of the Receivership Process

### 1. The Department used inadequate business plans to select special deputy receivers

Information initially provided by the Department to prospective special deputy receivers is inadequate to prepare meaningful business plans. As a result, applicants could not provide an estimated total administrative cost to liquidate an estate in their original business plans. The inability to compare special deputy receiver applicants on total estimated cost reduces the effectiveness of price competition in the selection process. Price competition is important because the Insurance Code requires the Commissioner to use a "competitive bidding process" in the selection of special deputy receivers.

The Conservation division possesses, or has access to, most of the information needed to prepare a meaningful business plan. This more complete information is not provided to the applicants. The "Chamber letter" is the primary way of conveying any information from the Conservation division to Liquidation Oversight. This letter is a narrative of information about an insolvent company. However, the completeness of the Chamber letter varies by estate. As a result, the information provided to potential special deputy receivers is inconsistent.

We surveyed an informal sample of individuals who had applied to be special deputy receivers. Four of the eight individuals contacted indicated that the information they received from the Department was inadequate to prepare a meaningful business plan. Those responding were a CPA with Resolution Trust Corporation experience, two law firms with extensive insurance insolvency experience, and an out-of-state firm specializing in insolvencies.

One applicant withdrew from the bidding process due to the lack of available information. Correspondence from this applicant requested over 17 items which were not provided by the Department, including:

- the company's most recent financial statement
- the Department's most recent examination report
- the most recent reports by any actuaries
- a description of data processing facilities and systems
- a description of the insurance policies and business engaged in

## Audit of the Receivership Process

### Recommendations

We recommend that Liquidation Oversight coordinate with the Conservation division to make available the information needed to efficiently prepare an initial business plan.

We recommend that special deputy receiver applicants submit estimates of their administrative costs in total, and on a monthly basis, as part of their bid proposal to administer an estate. The Department should also consider placing additional emphasis in the negotiation process with special deputy receivers to ensure terms that reflect a final and best offer.

### Management's Response

*TDI agrees with this recommendation. Oversight and Conservation will improve coordination. TDI is exploring new ways to provide better information to SDR candidates during the bid process to facilitate more accurate initial business plans.*

*There are occasions when conditions do not allow Conservation sufficient time to gather complete company information and prepare a "Chamber Letter" that contains all required data. This generally occurs when a company is recommended for liquidation on an accelerated basis due to suspected fraudulent activities or the company's financial condition is rapidly deteriorating. Alternative procedures will be explored.*

*In instances where insurance companies are placed into liquidation with little warning, as discussed above, TDI has had difficulty selecting SDRs swiftly enough using the current bid process. TDI is exploring, with the Attorney General, the possibility consistent with competitive bidding of selecting a SDR from a "short list" when these instances arise. The "short list" would be comprised of the best SDRs and would be based upon demonstrated performance.*

*If the "short list" process does not meet the provisions of statute, we intend to request a legislative change. If there is ample notice before receivership, we will continue with the current bid process. The statutory requirement of confidentiality for Conservation will still reduce TDI's ability to secure the firmest bid figures because pertinent data and documents must be handled carefully with SDR candidates prior to receivership.*

*TDI agrees that the negotiation process is a final opportunity, before contract execution, to discuss and lock in terms that provide for the best offer favorable to the Department. Contract Administration and its*



## Audit of the Receivership Process

*counsel will place more emphasis on negotiation to obtain the final and best offer on all new receiverships.*

### **2. Most providers of legal, accounting, and other professional services were hired by special deputy receivers without adequate consideration given to the cost of services**

The Department's policy that professional services be selected by a competitive process that considers cost and qualifications has not been enforced. As a result, services may not be obtained at the lowest reasonable combination of price and expertise. Referred to collectively as "subcontractors," they include firms or individuals who provide specialized services to the estate. These providers include lawyers, accountants, consultants, real estate appraisers, third-party administrators, data processing companies, and others.

For example, a special deputy receiver hired an out of state accountant who was incurring over \$1,300 per month in travel expenses. We believe the travel expenses made this accountant expensive compared with local accounting firms. These services could be obtained for less money.

The manual prepared by the Department for use by special deputy receivers provides guidance as follows: "To acquire the most qualified contractor at the lowest possible cost, the special deputy receiver should develop a request for proposal process/document which will elicit the abilities of the proposer and the fees expected for services rendered." The special deputy receiver manual includes a sample "request for proposal" document.

### **Recommendations**

We recommend that Liquidation Oversight ensure that special deputy receivers maximize the use of competition available in the marketplace in the selection of subcontractors. This includes appropriate negotiations as to price, terms, and other matters to reach a final and best offer.

We recommend that special deputy receivers provide to Liquidation Oversight:

- a reasonable justification that subcontractor selections are in the best interest of the estate
- evidence that cost, expertise, and more than one firm was considered in the selection process

## Audit of the Receivership Process

### Management's Response

*TDI agrees with the SAO's recommendation that SDRs obtain competitive bids when hiring subcontractors. SDRs will be hired as administrators and be required to utilize a competitive bidding process when hiring subcontractors. The SDRs have a team in place to handle the takeover process, but all major activities subsequent to takeover must be competitively bid as they arise.*

*Oversight currently requires competitive bids on any subcontractors hired subsequent to execution of the SDR contract. In addition, Oversight reviews subcontractor billings to ensure that: (1) the tasks performed have been delegated to the lowest billable rate staff possible consistent with the expertise necessary for the tasks, (2) activities are reasonable and necessary for the administration of the estate, and (3) activities effectively move the estate towards closure.*

*During fiscal year 1994, Oversight began requiring all SDRs and subcontractors to be competitive with those located within the state of Texas. Therefore, travel expenses are no longer allowed for out-of-state SDRs or subcontractors.*

### **3. The special deputy receiver selection process does not emphasize applicants' management experience and abilities**

Under the current system, a special deputy receiver applicant can receive a favorable evaluation while possessing very limited management skills. Cost control and timely performance are more likely to occur where management ability is a strength possessed by the special deputy receiver. The management ability of a special deputy receiver is critical because they control the performance of attorneys, accountants, appraisers, actuaries, and others that charge and perform services for an estate.

The special deputy receiver ideally should already possess the skill and experience to be a good manager. Any special deputy receiver could eventually hire any technical skill or professional firm needed to liquidate an estate. One method to help assess management expertise is through personal interviews. The selection process did not include personal interviews during fiscal year 1993.

The evaluation score earned by special deputy receivers was a combination of questions addressing management, technical, and other matters. Based on the relative weighting of these questions used by the Department, about one third (35 percent) relates to management experience or ability. Also,

## Audit of the Receivership Process

the management score represents the special deputy receiver "team" comprised of the special deputy receiver, his employees, and any subcontractors to be hired. The score does not adequately focus on the management capabilities of the special deputy receiver as an individual.

### Recommendations

We recommend that the evaluation process used to select special deputy receivers emphasize and evaluate separately the management ability and prior liquidation experience of the individual requesting appointment as special deputy receiver.

The Department should also consider the need to conduct pre-appointment interviews of special deputy receiver applicants.

### Management's Response

*Contract Administration has drafted a revised application to capture more information on management skills and has increased the number of questions from 20 to 35. Twenty-one of the 35 questions address management skills with the remainder related to insurance liquidation. These questions can be evaluated and scored by management skills, insurance knowledge, or as a composite.*

*TDI will utilize the pre-appointment interview process when selecting a new candidate as a SDR and SDRs for unique or large estates. TDI recently used the interview process in selecting the SDR for the Employers Casualty Company receivership.*

#### **B. Liquidation Oversight controls to monitor performance of special deputy receivers and their subcontractors are not effective in cost containment**

The Department can improve cost control in the liquidation of estates by improving the monitoring of contract compliance and the quality of reporting by special deputy receivers and also monitoring legal services for the process as a whole. A risk of inadequate monitoring controls is that liquidation costs will be higher than needed and significant cost overruns will go undetected.

We identified one example that illustrated the consequences of undetected higher costs. As a result of our inquiry, one subcontractor refunded more than \$30,000 in credits or reduced fees.

## Audit of the Receivership Process

The \$30,000 in savings involved the business relationship between a special deputy receiver and a subcontractor. Total fees between these parties amounted to \$219,941 over eight months. The fees charged were for three items: administration, claims-related expenses, and accounting services. This relationship:

- \* involved a contract for accounting services, but over 54 percent of the \$219,941 was for services not included in the contract
- \* was not subject to adequate review for cost control by the special deputy receiver and included payment for pickup and delivery of business documents (billed at \$85 per hour) and routine clerical activities (billed at \$60 an hour)
- \* was not subject to competitive bidding to secure the best combination of price and expertise

Effectively, the special deputy receiver delegated a significant portion of his duties to this subcontractor. The contract did not clearly identify this arrangement, nor was the effect of this arrangement understood by Liquidation Oversight and the special deputy receiver.

### **1. Controls to verify contract compliance by special deputy receivers are not effective**

Early assessment of contract compliance is important as an effective means of detecting poor performance. Desk reviews, a procedure used by the Department to determine contract compliance, are unreliable for this purpose. Weaknesses in contract monitoring limit the ability of Liquidation Oversight to detect and correct performance problems early in the life of an estate. The cost to liquidate an insurance company is likely to be higher without adequate contract compliance.

Contract Administration, a separate division of the Department, completes the quarterly desk reviews based on information from Liquidation Oversight analysts. However, the information Liquidation Oversight provides to Contract Administration is not comprehensive. As a result, evaluation of contract compliance is performed by individuals who do not possess complete and necessary information of special deputy receiver performance.

## **Audit of the Receivership Process**

For example, we noted one desk review that contained three discrepancies between Contract Administration conclusions and information supplied by analysts in Liquidation Oversight. For example, Contract Administration concluded that:

- \* The special deputy receiver was "impressive as a bare bones manager" and "kept expenses to a minimum," despite guaranty association objections to expenditures for the month in review.
- \* "Tax returns were filed," when information about tax returns was not documented in the analyst reports.
- \* Financial statements were "completed on schedule," despite the omission of a balance sheet which lists estate assets and liabilities.

Measuring contract compliance is a fundamental part of the oversight process. Contract compliance could be evaluated more effectively by Liquidation Oversight, which has primary oversight responsibility and the knowledge to complete the task.

Contract Administration planned to supplement the quarterly desk review with a semi-annual on-site visit. To date, Contract Administration has not conducted any on-site evaluations.

### **Recommendations**

We recommend the Department assign contract compliance responsibility and on-site evaluations of special deputy receivers to Liquidation Oversight.

We recommend that on-site visits occur within 90 days of the special deputy receiver's appointment to promote early problem identification.

We also recommend that Liquidation Oversight consider having the special deputy receivers' "self report" on contract compliance using a checklist prepared by Liquidation Oversight that reflects the contract in force. Self-reporting would be subject to verification by Liquidation Oversight and review during subsequent audits.

### **Management's Response**

*TDI has steadily improved its monitoring of SDR costs and reporting quality since the inception of the Oversight program.*

## **Audit of the Receivership Process**

*Oversight has taken sole charge of evaluating SDR performance. Contracting's role in such evaluations ended in July 1993. Oversight has undertaken a more thorough review of the SDR's business plans and status reports for each estate. New tools being utilized by Oversight to evaluate SDRs are on-site visits to the SDR's offices and independent audits to be performed on SDRs. Independent audits are scheduled for five SDRs during fiscal year 1994.*

*Oversight began conducting on-site visits to the SDRs' offices during November 1993. As of the date of the audit report, Oversight has conducted on-site visits to the offices of 10 of the 28 SDRs. Oversight's plan is to conduct quarterly site visits which will accomplish the SAO recommendation of conducting site visits within 90 days after SDR appointment. Site visits have been and/or will be conducted within 90 days of SDR appointment on the following estates: Employers Casualty Company, Eagle, Cascade, Independent Security Life, Texas Insurance, Equity American Lloyds and Standard Title. Each analyst is being accompanied by an experienced auditor on the first visit to each SDR. The analysts will be conducting site visits independently after that point unless a problem arises which requires the attention of Oversight management.*

*Oversight agrees with the SAO's recommendation regarding a "self reporting" checklist for monitoring contract compliance. We will implement this recommendation during fiscal year 1994.*

### **2. Contracts used by special deputy receivers for professional services do not contain key provisions to allow control of cost or performance**

Key provisions which could aid in control of cost or performance were generally not included in contracts used by special deputy receivers. The Department did provide contracting guidance in the special deputy receivers' manual. However, the sample contracts provided in the manual also lacked key provisions that might add controls. In some cases, existing contracts represented carryover relationships from the prior Liquidation Division. The present oversight arrangement provides special deputy receivers with the primary task of controlling subcontractors' cost and performance. The quality of the contract between the special deputy receivers and their subcontractors provides a significant control opportunity for Liquidation Oversight.

The Resolution Trust Corporation (RTC) has identified the contracting area as one of high risk. Although on a smaller scale, Texas can learn from the national experiences of the RTC on the liquidation of companies. Both

## Audit of the Receivership Process

Texas and the RTC place reliance on the services of the private sector for most of their needs. The RTC believes substantial governmental reliance on the private sector without adequate controls increases the risk of waste, fraud, and abuse.

### Recommendations

We recommend that Liquidation Oversight develop improved "pro forma" contracts for use by special deputy receivers in significant relationships with professionals. Additional contract provisions could include, for example:

- \* a maximum or ceiling price
- \* deliverables and delivery dates
- \* appropriate fees for travel time
- \* allowable expenses, if any
- \* allowable markups on pass-through costs
- \* performance expectations
- \* penalties for subpar performance
- \* incentives for excellence where appropriate
- \* contract cancellation terms

### Management's Response

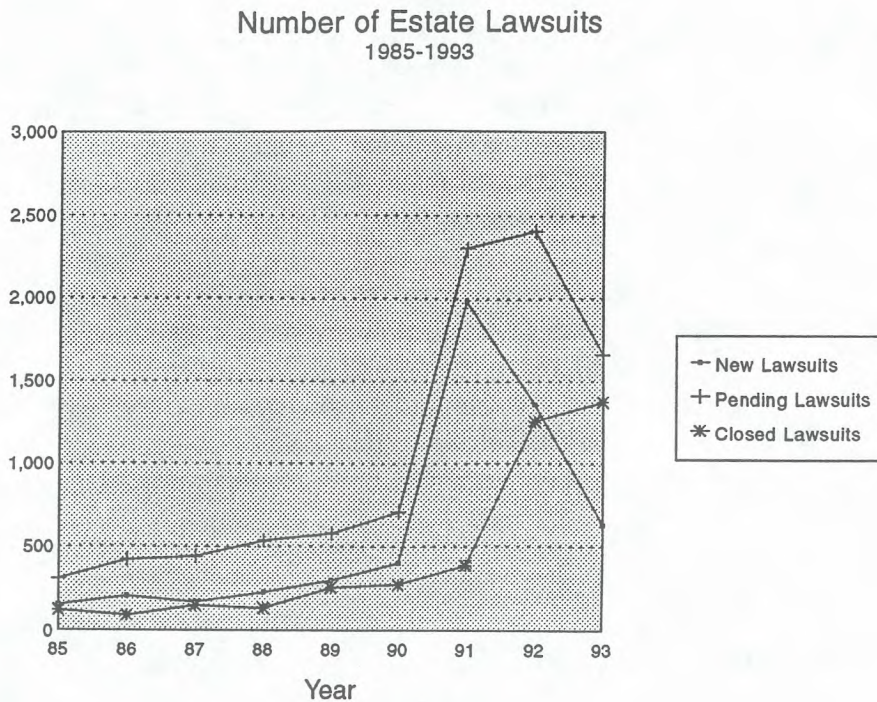
*Contract Administration has obtained a recently revised "outside counsel" agreement used and approved by the Texas Attorney General. With some modification, this agreement would be appropriate for use by the SDRs when any legal subcontractors are utilized. Most of the recommended additional contract provisions could easily be included in the agreement. Contract Administration will work with TDI counsel and the Attorney General's Office to improve these contracts.*

*However it should be noted that some subcontractor services, such as legal services and to a lesser degree reinsurance and agent balances, are not conducive to a maximum or ceiling price. There are too many unknowns, early-on in the receivership, that will prevent an accurate projection of the complexity and volume of work in these areas. TDI will explore methods of assisting the SDR in better managing the pricing of subcontractors. These methods could include requiring budgets and billings against such budgets, prior approval of exceeding such budgets or starting new work not previously contemplated. It is also possible to negotiate and execute agreements for contingency fee work and that will be pursued with the assistance of the Attorney General.*

## Audit of the Receivership Process

3. Controls that special deputy receivers provide over legal services varied from effective to ineffective in a sample of five estates; Liquidation Oversight does not collect information on legal services for all estates to provide a control for the process as a whole

Legal costs are likely to be higher in estates that are not subject to adequate review. Controls over legal services are important because there were an estimated 1,663 pending lawsuits managed by special deputy receivers as of August 31, 1993 (Figure Three). An effective review of legal services would include appropriate review of invoices by knowledgeable personnel, and an overall review of legal services by Liquidation Oversight. Special deputy receivers primarily control the cost of legal services and work directly with the attorneys at the estate level. In the case of controls provided by special deputy receivers, we identified invoice review procedures that ranged from effective to ineffective in a sample of five special deputy receivers.



**Figure Three**

**An estimated 1663 lawsuits were pending as of August 31, 1993.**

Source: Texas Department of Insurance



## **Audit of the Receivership Process**

Controls which evaluate legal services in an overall manner have not been developed by Liquidation Oversight. As a result of the lack of a centralized review of legal services by Liquidation Oversight, information about legal matters is not readily available, including:

- \* Identification of law firms that may litigate for one estate and against another estate may go undetected.
- \* Total fees paid to any one firm are not readily available.
- \* The status on use of mediation, encouraged by the Receivership Master and the Commissioner to reduce costs, is not available for all lawsuits.

The Attorney General of Texas, in an April 14, 1993, letter to all state agencies and universities, provides direction on the employment of outside counsel. This letter addresses a variety of matters, including selection and approval of outside counsel, contracts, and payment procedures. The guidance in the letter is applicable to the receivership process.

The Resolution Trust Corporation (RTC) has also, through experience, determined methods for providing control over legal services. The RTC subjects its legal counsel that bill significant fees in a year's time to a formal written evaluation.

The RTC uses several criteria to evaluate its law firms. These criteria include cost consciousness, responsiveness, case management, knowledge of billing procedures, and budgeting. We agree with the position of the Inspector General of the RTC, who stated: "Evaluations of contract performance are a basic and critical part of any contracting process. We do not believe any basis exists to exempt outside counsel from this requirement."

### **Recommendations**

We recommend that Liquidation Oversight assess the need for implementing a litigation management system. The system may include information on:

- \* total fees paid to any single law firm
- \* potential conflicts of interest
- \* status on use of mediation
- \* timely comparisons of litigation budgets to actual fees

## Audit of the Receivership Process

The system should also have compatibility with systems under independent development by the guaranty associations.

We recommend periodic evaluation of outside counsel using guidelines similar to those in use by the RTC.

We recommend that Liquidation Oversight evaluate review procedures used by special deputy receivers to monitor legal fees.

We also recommend that Liquidation Oversight consult with the Attorney General's Office for the most appropriate controls over the selection and approval of outside counsel. These would include:

- \* use of request for proposals (RFPs) to hire firms
- \* conflict of interest identification
- \* required communications from counsel
- \* allowable and nonallowable costs
- \* engagement plans
- \* contracting procedures
- \* payment procedures

### Management's Response

*Oversight reviews legal billings on a monthly basis and tracks them over the life of the estate. The SDRs are questioned by the Oversight analysts when legal billings appear to be unreasonable. If the billings are determined to be unreasonable, the expense is disallowed by Oversight.*

*Oversight will consult with the Attorney General's Office regarding a tracking system to detect situations where legal subcontractors are litigating for one estate and against another estate.*

*Oversight has started tracking fees across the estates for all participants in the SDR program. The Attorney General's letter regarding the employment of outside counsel is a useful model for how SDRs should hire counsel. Oversight is consulting with the Attorney General's Office on improved legal fee monitoring and guidance to SDRs on retention of counsel.*

*Because the majority of the lawsuits in the estates are claims-related, the SAO's recommendations for tracking the use of mediation and implementing a litigation tracking system are being evaluated by Oversight for cost/effectiveness. The Texas Property and Casualty Insurance Guaranty Association (TPCIGA) will take over processing and payment of all property and casualty claims and claims-related litigation on*

## Audit of the Receivership Process

*September 1, 1994. When the Texas Life, Accident, Health and Hospital Service Insurance Guaranty Association elected on claims and claims-related litigation in September 1992, the number of lawsuits remaining with the SDRs was very minimal. Oversight is consulting with the Attorney General's Office to determine what would be most cost/beneficial to the estates. A potential solution would be to get the SDRs on-line with TPCIGA's litigation tracking system before the September 1, 1994 election date.*

### **4. High costs and low overall compliance with reporting requirements indicate the reporting process is inefficient**

Special deputy receivers' compliance with reporting requirements was low, while the cost to the estates of reporting was high. All five special deputy receivers included in our review had reporting deficiencies, such as compliance with cost benefit analysis reporting. These estates had an average reporting cost of over \$4,350 per month.

Reporting efficiency is important because any improvements or gains made are likely to be applicable to most other estates. For instance, saving five hours a month in preparation time per estate (about a 10 percent reduction) would yield about \$100,000 in savings per year in special deputy receiver fees. This estimate is for the 23 medium and large estates active during our fieldwork.

### **Recommendations**

Liquidation Oversight has improved the reporting process during our fieldwork. We recommend that Liquidation Oversight continue to make improvements in reporting such as:

- \* developing a current reporting standards manual as a reference for Liquidation Oversight analysts and special deputy receivers and to document current reporting standards
- \* identifying efficient reporting practices of successful special deputy receivers to share their successes with other special deputy receivers
- \* requiring special deputy receivers to report costs separately by type of task (such as reporting, administration, legal, accounting, etc.)
- \* providing prompt feedback on report adequacy to special deputy receivers

## Audit of the Receivership Process

### Management's Response

*Oversight appreciates the acknowledgment in this recommendation that the reporting process has improved.*

*Oversight has supplemented its SDR manual, which details the reporting standards required of each SDR, on several occasions through update memorandums to the SDRs. Oversight plans to revise the SDR manual to incorporate these memorandums in fiscal year 1994. Oversight has requested that TDI's Information Services Division investigate a standardized accounting package for use by the SDRs. Additionally, SDRs were provided with the audit program to be followed by the Oversight analysts when reviewing the monthly reports to make SDRs aware of how their performance was to be measured.*

*Oversight has already implemented the SAO's recommendation to identify efficient reporting practices and share them with the other SDRs. During fiscal year 1993, in an effort to promote better reporting among the SDRs, an example of a well-prepared business plan and status report was sent to all of the SDRs. Oversight intends to give examples of well-prepared cost/benefit analyses to the SDRs at Oversight's March 1, 1994 meeting with the SDRs.*

*Since May 1993, Oversight has required the SDRs to segregate administrative costs into the following categories: administration, accounting and legal.*

*In November 1993, Oversight implemented a policy whereby SDRs receive written feedback regarding their monthly reports and performance within two to three weeks of receipt of the monthly reports by Oversight.*

#### **5. Liquidation Oversight did not require special deputy receivers to routinely provide cost benefit analyses as required by statute**

Failure to file cost benefit analyses was the most common reporting deficiency among special deputy receivers. Without cost benefit analyses, Liquidation Oversight is less able to determine whether cost effectiveness is considered in the planning or execution of estate activities. Excessive or inappropriate expenditures may occur with less likelihood of detection or prevention.

The purpose of a cost benefit analysis is to provide economic justification for significant transactions, such as asset recovery activities or litigation settlements. Texas Insurance Code, Article 21.28, Section 2a, requires the

## Audit of the Receivership Process

filing of a cost benefit analysis for expenditures other than funds spent for the payment of claims.

In a three-month reporting period involving a sample of five special deputy receivers, three of the five did not file any cost benefit analyses. In one instance, we found that the special deputy receiver had been serving for nine months. In that time he had not prepared any cost benefit analyses on a significant workers' compensation matter. In this case, a cost benefit analysis may have served as an indicator of future benefits to be obtained. Alternatively, it may have shown a need to stop efforts and reduce fees.

Evaluating the effectiveness of special deputy receiver operations is made more difficult because of uncertainty surrounding cost benefit analyses. Most special deputy receivers reviewed were uncertain about when and how to report cost benefit analyses.

### Recommendations

We recommend that Liquidation Oversight provide special deputy receivers with a practical definition of a cost benefit analysis and enforce the cost benefit reporting requirement. The practical definition includes the required format, information content, guidance on when cost benefit analysis reporting is required, and how Liquidation Oversight will use this as a control. As reporting by special deputy receivers improves, Liquidation Oversight can place increased emphasis on reviewing and approving planned expenditures before they occur.

### Management's Response

*The cost/benefit analysis requirement will be rigorously enforced. Oversight provided the SDRs with a sample cost/benefit analysis in September 1993 and on several subsequent occasions. As of the date of this report, the SDRs are submitting cost/benefit analyses for Oversight's review and approval on a consistent basis for all major planned activities.*

### **C. Strategic planning, which would evaluate resource needs and identify performance measures, is incomplete for Liquidation Oversight**

Liquidation Oversight did not complete strategic planning during fiscal year 1993. Two important components of strategic planning are a determination of resource needs and use of performance measures to assist in the evaluation of attainment of goals and objectives. Performance measures could be used for individual estates and for the process as a whole. The Department has developed some performance measures, such as the cost to recover estate assets. Completion of strategic planning efforts now underway would assist in two areas: a more

## Audit of the Receivership Process

complete analysis of resource needs and identification of performance measures that indicate the degree of attainment of goals and objectives.

### Recommendations

We recommend that the Department refine its evaluation of its resource needs by completing strategic planning efforts now underway. Liquidation Oversight's strategic plan should include analysis of the resources required to provide effective oversight, those resources available, and plans to resolve any differences. Additional resources, if needed, could be provided by either a temporary reallocation within the Department, or a pass-through of costs to the estates where appropriate to do so. Also, strategic planning efforts should include reporting of performance measures which indicate how well Liquidation Oversight achieves its goals and objectives. For instance, the percentage of lawsuits in mediation would be one significant performance measure.

### Management's Response

*TDI agrees with the SAO's recommendation regarding strategic planning and Oversight has drafted a preliminary strategic plan. Oversight anticipates completion of the strategic plan within 120 days.*

*Oversight currently reports monthly performance measures for the agency's Management Reporting System and the Legislative Budget Board. These reported performance measures are as follows:*

- *New estates*
- *Estates closed*
- *Total number of estates in receivership*
- *Total assets under management*
- *Total liabilities of estates*
- *Average dollar amount of insolvencies per Texas based entity*
- *Average dollar amount of insolvencies per non-Texas based entity*
- *Total cash receipts for estates*
- *Total cash disbursements from estates*
- *Ratio of canceled policies to total in force for Texas insurers*
- *Ratio of canceled policies to total in force for non-Texas insurers*
- *Dollar amount of litigation recoveries collected*
- *Legal fees on recoveries*
- *Net recoveries*
- *Average cost per estate placed in receivership*
- *Total dollar amount of insolvencies*
- *New lawsuits (defense)*
- *New lawsuits (plaintiff)*
- *Lawsuits closed*

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- *Total number of open lawsuits*

*On a quarterly basis, Oversight's performance in these areas is evaluated and any variation from expectation above a 5 percent tolerance level must be explained to the satisfaction of TDI's Planning function and the Legislative Budget Board.*

*Oversight has identified the need to have the analysts trained in auditing skills. Oversight would welcome the opportunity to have the analysts attend SAO sponsored training courses.*

### **D. The Department does not routinely coordinate the early involvement of entities involved in liquidation**

A coordinated, early involvement of all entities involved in liquidation does not consistently exist. Early involvement increases the ability to locate and recover all company assets. Late involvement by the guaranty associations increases the likelihood of lost, destroyed, or inaccessible policyholder information. As a result, company assets may not be identified and recovered. Also, claim payments will be delayed, and the cost to pay claims is likely to be higher. The entities involved early in the process include Liquidation Oversight, Conservation, the special deputy receiver, and the appropriate guaranty association.

Guaranty association involvement, measured by the date of impairment, is averaging 25 days after the beginning of the liquidation process. This occurred for the nine estates which were declared impaired during 1993. Early involvement may be possible weeks or months before the date of impairment. The guaranty associations are typically briefed about the likelihood of future insolvencies and, in some instances, have actually participated in the process informally. Guaranty association participation in the process is not formally triggered until the date of impairment as declared by the Commissioner.

A coordination problem exists with regard to control of policyholder information and records. The special deputy receiver has the responsibility to secure claims records. However, the guaranty associations have the responsibility to pay claims in a timely manner. The guaranty associations are a better choice to secure these records early in the process. The prompt, efficient payment of claims is partially dependent on timely access and control of this information.

In prior years, the Department of Insurance handled matters relating to liquidation of insurance companies almost exclusively. Coordination of roles has become more significant with the increased responsibility of the guaranty associations and the use of special deputy receivers.

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### Recommendation

We recommend that the Department of Insurance develop policies and procedures, in cooperation with the guaranty associations, which would allow an early and coordinated involvement of all liquidation entities, including the appointed special deputy receiver.

### Management's Response

*TDI agrees that an early and coordinated effort of all entities involved in the liquidation of impaired insurers would be beneficial. This strategy was implemented when Employers Casualty Company went into receivership in January 1994.*

#### **E. Increased earnings and cost saving opportunities of more than \$565,000 are identified**

##### **1. Increase annual earnings to estates by \$525,000 by increasing yields on cash investments**

Estates are earning relatively low yields than otherwise available through the Texas Treasury Safekeeping Trust Company (Treasury). Cash belonging to the estates is invested through the Treasury. Estate funds are invested in safe, low yield investments, called "repurchase agreements," earning about three percent. These are invested with maturities of one day. By extending the maturity to 90 days using other investments, the yield can increase about one half percent. If the yield was increased only one half of a percent on 75 percent of the \$140,000,000 on deposit, total earnings would increase annually by \$525,000.

### Recommendation

We recommend that the Department reevaluate the current investment strategy to increase the overall yield to the estates while maintaining a comparable or low risk. The Department should consult with Treasury representatives to identify appropriate investment alternatives.

### Management's Response

*Oversight intends to discuss with the Treasury during the third quarter of this fiscal year the possibility of investing all funds, except for the amount required for short term cash flow needs of the estates, into longer-term investments. This should produce a higher yield than the short term repurchase agreements currently being utilized by the Treasury.*



## **Audit of the Receivership Process**

2. **Save an estimated \$40,000 a year by raising the exemption from court approval on certain transactions from \$1,000 to \$10,000 (statutory change)**

Current law requires special deputy receivers to obtain court approval for all asset sales and litigation settlements of claims if the amount involved exceeds \$1,000 (Texas Insurance Code, Article 21.28, section 2(g)). Requiring court approval for these transactions increases costs to the estate by about \$400 for each transaction.

We estimate total savings of over \$40,000 a year to all estates if the threshold for approval increases to \$10,000. Making the change would also lighten the receivership court docket. Approximately 28 percent of transactions that require court approval involve amounts under \$10,000. Transactions between \$1,000 and \$10,000 would continue to be subject to review by Liquidation Oversight.

### **Recommendations**

We recommend that the Department pursue a statutory increase in the threshold for court approval of claim settlements and asset sales from \$1,000 to \$10,000.

### **Management's Response**

*TDI agrees with the SAO's recommendation that a statutory change should be pursued to increase the exemption for receivership court approval on certain transactions from \$1,000 to \$10,000.*

## **II. The guaranty associations, now established as claims paying entities, are making progress**

The guaranty associations are making progress in their mission to pay covered claims of insolvent insurance companies. Significant policies and procedures, including most elements of strategic planning, are complete. The Boards of Directors are active and include public representation.

The Legislature assigned responsibility to the guaranty associations to pay claims as part of privatization. There are two significant associations:

- \* Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association (Life Association)

## Audit of the Receivership Process

- \* Texas Property and Casualty Insurance Guaranty Association (Property Association)

They are also commonly called "guaranty associations" or "guaranty funds."

**A. The Texas Property and Casualty Insurance Guaranty Association (Property Association) can add to first-year progress by improving controls over third-party administrators and reporting performance measures**

**1. The Property Association did not have policies and procedures to provide both early detection and correction of inadequate claims processing by a subcontractor**

At the time of our audit, the Property Association did not have effective policies and procedures to detect and correct inadequate claims processing by an outside subcontractor. As a result of poor performance by a claims processor, policyholders with claims were not paid on a timely basis, and the cost as well as the incidence of litigation increased. The outside claims processing firm, also referred to as a third-party administrator, provided multiple indications of inadequate performance:

- \* Issuance of checks to policyholders with claims did not commence until 75 days into the contract.
- \* The firm did not take advantage of a six-month stay on filing of new litigation to contact potential litigants to avoid additional litigation.
- \* Only six of three hundred claim files involving litigation were worked by the outside firm.
- \* Contractually required reports were not filed with the Property Association until January, three months into the contract.

The contract began in late October, but an on-site review of the firm was not conducted until March 1993, although earlier meetings had been held and correspondence exchanged. The ultimate outcome was that this firm was terminated in June.

We noted that the Property Association eventually took effective action in this matter and has strengthened its future ability to monitor third-party administrator performance. These steps included improving the process to select, monitor, and evaluate third-party administrators, strengthening

## Audit of the Receivership Process

contract terms for future use, and hiring an additional person whose responsibilities include third-party administrator oversight.

### Recommendations

We recommend that the Property Association adopt policies and procedures for the review of ongoing third-party administrator operations, including:

- \* the scope, timing, and frequency of on-site reviews by Property Association personnel
- \* adoption of clearly defined performance standards and terms in contracts that allow for early monitoring and evaluation
- \* communication of results of periodic on site reviews to the third-party administrators
- \* annual review and renegotiation of contracts to ensure effective and efficient performance

## **2. The Property Association has not developed and reported performance measures to enhance their public accountability**

Information about guaranty association performance and attainment of its goals and objectives is not readily available to promote accountability to the public. Because taxpayers are the ultimate source of funds for the Property Association, reporting on performance levels attained is relevant information for public consideration.

The Property Association should be commended for its initial efforts at strategic planning. With its 1994 strategic plan, the Property Association is in the process of developing performance measures. In that document, the Property Association recognizes the need to define and quantify performance measures, provides for periodic evaluation of performance, and includes the need to evaluate customer service. However, this effort has not also extended to identification and reporting of performance or other outcome measures for inclusion in the strategic plan. For example, one indication of performance would provide the number and percentage of all lawsuits in mediation. Greater use of mediation indicates the likelihood of lower legal costs and can be less stressful for the parties involved. As a result, the degree of attainment of goals and objectives related to their strategic plan is not readily available.

## Audit of the Receivership Process

### Recommendations

We recommend that the Property Association:

- \* Define and report outcome or performance measures which indicate the degree of attainment of their primary mission.
- \* Include these measures as supplementary (unaudited) information with their annual financial report.

**3. Issue for further study: The Property Association should consider a more proactive involvement in filing objections on excessive costs as reported by special deputy receivers**

The Property Association filed eight objections to monthly expenditures by special deputy receivers during fiscal year 1993. This covered the monthly expenditures for 71 companies. The Property Association is usually an estate's largest single creditor and is authorized to object before the court as a "party at interest."

The Department of Insurance has primary responsibility for the oversight of special deputy receiver expenditures. However, the Property Association can perform a secondary or complementary oversight role, usually as an estate's single largest creditor. Excessive costs incurred during the liquidation of estates, which do not receive objection, will reduce remaining estate assets. These assets would otherwise be available to offset costs of the Property Association.

### Recommendations

We recommend that the Property Association consider defining its role in reviewing special deputy receiver monthly expenditures to complement Department of Insurance Oversight procedures.

### Management's Response

*We would agree with a more proactive stance so long as we complement the primary role of oversight in this area as provided by the Texas Department of Insurance and accordingly we will work toward that end. We would like to advise that since November, 1993 TPCIGA (the Property Association) counsel and accounting staff and generally our special projects director have attended all status conferences to question items, file objections and receive updates on estate progress. Prior to November, 1993 TPCIGA counsel and special projects director attended conferences along with occasional attendance by accounting. Accounting also reviews*

## Audit of the Receivership Process

*all special deputy receiver funding requests from pre-1992 estates for claims payments and claims related expenditures working out any adjustments to these requests with the special deputy receiver outside the special master conference. We have been successful in achieving meaningful adjustments to these requests and are now tracking amounts of the adjustments.*

### **B. The Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association (Life Association) can add to first-year progress by reporting performance measures and improving complaint resolution procedures**

#### **1. The Life Association has not developed and reported performance measures to enhance their public accountability**

Information about guaranty association performance and attainment of its goals and objectives is not readily available to promote accountability to the public. Because taxpayers are the ultimate source of funds for the Life Association, reporting on performance levels attained is relevant information for public consideration.

The Life Association should be commended for its initial efforts at strategic planning. However, this effort has not also extended to identification and reporting of performance or other outcome measures for inclusion in the strategic plan. For example, one indication of performance would provide the number and percentage of all lawsuits in mediation. Greater use of mediation indicates the likelihood of lower legal costs and can be less stressful for the parties involved. As a result, the degree of attainment of goals and objectives related to the their strategic plan is not readily available.

### **Recommendations**

We recommend that the Life Association:

- \* Define and report outcome or performance measures which indicate the degree of attainment of their primary mission.
- \* Include these measures as supplementary (unaudited) information with their annual financial report.

### **Management's Response**

*Management of the Association agrees that performance measures can be used effectively as one tool to monitor the success of an organization, is*

## Audit of the Receivership Process

*cognizant of its need to be accountable, and is committed to operating economically and efficiently with taxpayer funds.*

*Although not separately stated, performance measures have been included in the strategic and operational planning as well as the budgetary processes for the past two years. We believe that the success and accountability of the organization can be measured by its achievement of stated goals and is documented by the financial and management reporting that the Association does.*

*Future planning and budgeting documents will include more definitive quantitative performance measures to enhance existing measurement and reporting to help measure the attainment of the Association's primary mission.*

### **2. Complaint resolution procedures do not ensure prompt attention to policyholders**

Existing complaint follow-up procedures were not effective to ensure that all complaints had satisfactory attention. Effective monthly review procedures would have detected the lack of attention much sooner. We noted that 11 of 37 complaints (30 percent) logged with the Life Association remained unresolved as of the time of our review. The average time outstanding for these 11 unresolved complaints was 140 days. Several of the unresolved complaints were resolved quickly when brought to the Life Association's attention.

We believe that the Life Association's existing process can be effective in resolving complaints when an appropriate amount of attention is provided. Complaints are recorded in a log which would allow proper monitoring and effective resolution. The average time for the Life Association to resolve complaints (26 complaints) was 29 days. The Insurance Code requires viable insurance companies to pay claims generally in less than 60 days. We believe that, absent unusual or extraordinary conditions, complaints should also be resolved in less than 60 days.

The Life Association has the responsibility to address these complaints. However, the original cause for the complaint may not always be attributed to the Life Association.

## Audit of the Receivership Process

### Recommendations

We recommend that the Life Association:

- \* Establish a policy expressed as a goal to resolve consumer complaints within 60 days.
- \* Communicate status of the complaint to the policyholder if not resolved within a reasonable amount of time.
- \* Provide for a monthly review of the complaint log by an individual independent of the complaint process to ensure that complaints are resolved in a timely manner.

### Management's Response

*Management agrees that the Association has a responsibility to respond to complaints and believes that it has in place procedures to resolve all complaints in a timely manner. While the report notes that 30% of the complaints reviewed were not resolved in the suggested 60 days, 70% were resolved in an average of 29 days. The complaints in question arose during the period immediately following the Association's election of pre-1992 estates and the transfer of available records from the Texas Department of Insurance (Department) to the Association. Since July 1993, no complaint has been left open for more than 60 days without communication with the complainant and the average resolution period has been less than 30 days.*

*To insure that complaints are being dealt with and resolved as timely as possible, the Association has implemented monthly review procedures of the complaint log by the Executive Director of the Association, as well as monthly status reporting related to resolved and open complaints. This report will be presented to the Board at each regular Board meeting.*

3. **Issue for further study: The Life Association should consider a more proactive involvement in filing objections on excessive costs as reported by special deputy receivers**

The Life Association filed 12 objections to monthly expenditures by special deputy receivers during fiscal year 1993. This covered the monthly expenditures for 29 companies. The Life Association is usually an estate's largest single creditor and is authorized to object before the court as a "party at interest."

## Audit of the Receivership Process

The Department of Insurance has primary responsibility for the oversight of special deputy receiver expenditures. However, the Life Association can perform a secondary or complementary oversight role, usually as an estate's single largest creditor. Excessive costs incurred during the liquidation of estates, which do not receive objection, will reduce remaining assets. These would otherwise be available to offset costs to the Life Association.

The review of special deputy receiver expenditures by the Life Association is limited. Current Life Association procedures charge one individual with financial review, and reporting of objections, within 48 hours of receiving business plans from the special deputy receivers. Over two dozen business plans must be reviewed during this brief period. Although the stated procedures provide direction in the form of policy, they do not also provide sufficient guidance to employees regarding specific review procedures that may be useful.

### Recommendations

We recommend that the Life Association consider defining its role in reviewing special deputy receiver monthly expenditures to complement Department of Insurance Oversight procedures. This would include clarifying its written procedures to allow accomplishment of its role.

### Management's Response

*The Texas Department of Insurance Oversight division has statutory authority and primary responsibility for review of special deputy receiver operations and expenses. However, the Association, as a major creditor and with statutory authority, does review monthly business plans and reports filed by special deputy receivers to evaluate overall performance and does object to the expenses of the special deputy receiver or other actions by the special deputy receiver if it is believed that such actions may significantly reduce recovery from estate assets. In fact, as detailed in the State Auditor's report, the Association filed more objections on fewer estates during the period under review than any other entity.*

*The audit indicates that only one Association staff person has responsibility to review special deputy receiver monthly business plans. As part of the policies and procedures adopted and implemented during the period under examination, members of the Association's staff from the claims, legal and financial departments were involved in the review of monthly business plans. The depth of this review of each plan was determined by legal staff based on the availability of estate assets and complexity of the liquidation process.*



## Audit of the Receivership Process

*The Association, to complement the Department of Insurance Oversight procedures, will continue to review and improve its evaluation process. Since the date of the audit, estate management staff has been given responsibility to review and coordinate review of monthly business plans and to consult with the legal staff if it appears an objection is warranted. Legal staff will continue to attend and participate in status conferences held by the Special Master.*

### **III. The history of privatization is too brief to develop conclusions about how well the process is working overall; Initial costs appear to be high, however, there are indications of overall progress**

#### **A. The history of privatization is too brief to develop overall conclusions**

The experience of privatization in liquidating insurance companies is still new. There is only a limited history available to evaluate current performance levels. All special deputy receivers were appointed during fiscal year 1993 and have only a partial year of performance to evaluate. The Department appointed special deputy receivers in 60 percent (52 of 88) of the estates in February 1993 (midpoint of the fiscal year) or later.

#### **Management Response**

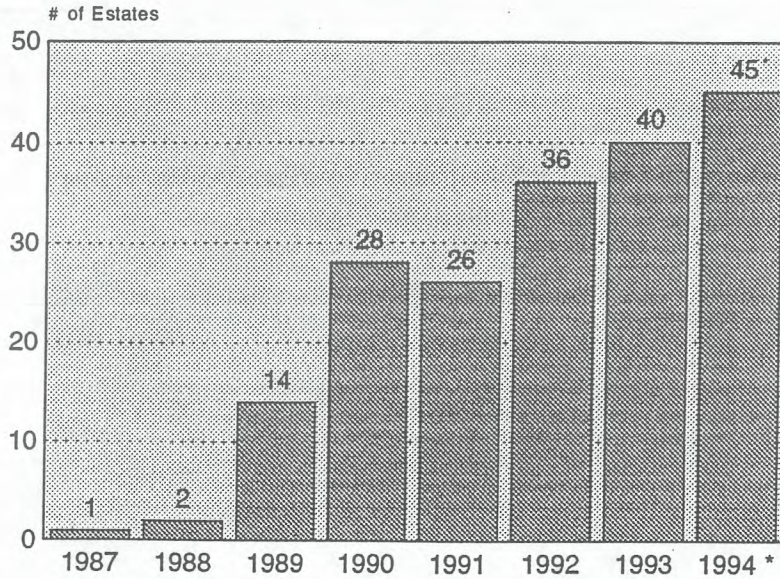
*Initially SDR administrative costs were high due to the learning process involved. SDR costs are steadily being reduced due to SDR experience and TDI guidance.*

#### **B. More insolvent insurance companies are being closed**

More estates were closed in fiscal year 1993 (40 estates, Figure Four) than in any prior year. Also, the number of estates scheduled for closing, or already closed, for the first six months of fiscal year 1994 is even higher (45 estates, Figure Five), according to the court docket of the Receivership Master.

## Audit of the Receivership Process

Estate Closings by Fiscal Year  
1987 - 1994



**Figure Four**  
More estates were closed in fiscal year 1993 than in any prior year.

\* projected through February 1994

Source: Receivership Master Docketing Files

### Management's Response

*The 40 estates closed during fiscal year 1993 were closed by the former Liquidation Division prior to January 1, 1993. Early in fiscal year 1994, the Special Master and SDRs estimated that 45 estates could be closed in the first six months of fiscal year 1994. Subsequently, problems delaying closing were found in several of the estates included in the estimate. These estates will be closed by the end of fiscal year 1994 or early in fiscal year 1995. Several estates are ready for closing after the TPCIGA elects on the claims. The TPCIGA has until August 31, 1994 to make that election.*

## **Audit of the Receivership Process**

### **C. The Receivership Master position created by the courts helps hold down costs and improves the overall liquidation process**

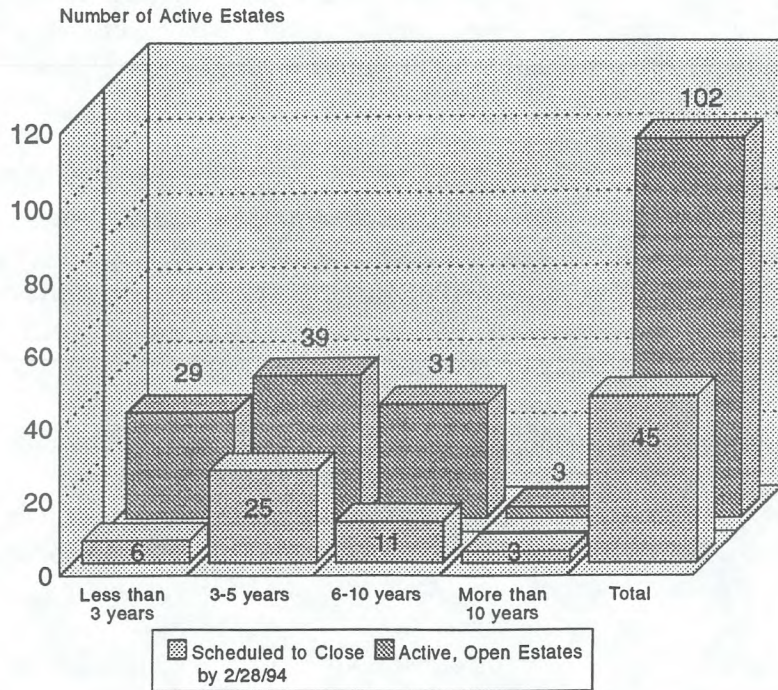
According to the Commissioner of Insurance's July 1993 report, the cost per estate per month for the Receivership Master was less than \$150. The Receivership Master is improving the process in many ways including:

- \* emphasizing the use of mediation instead of litigation
- \* providing an established forum to identify and resolve difficult problems, such as environmental claims litigation
- \* providing a judicial forum to improve special deputy receiver accountability

## Audit of the Receivership Process

### Aging in Years of Active Estates

Compared with estates scheduled to close (as of August 31, 1993)



**Figure Five**

**More than half of estates three years old or older (39 of 73) are scheduled to close in the first six months of fiscal 1994.**

Source: Receivership Master Docketing Files

### Management's Response

*TDI agrees that the Special Master has been very helpful in accomplishing the goals of the receivership process.*

## Audit of the Receivership Process

### IV. Issues for Further Study

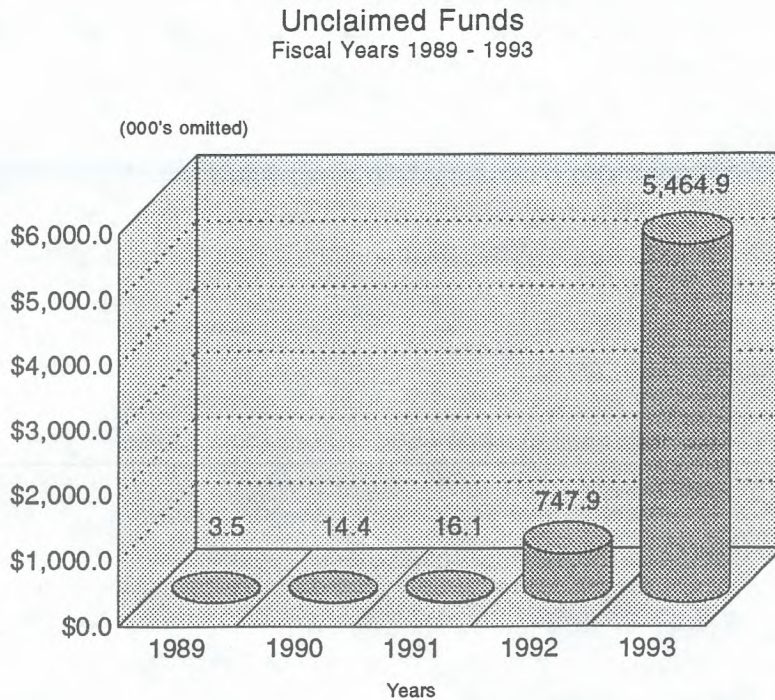
- A. The Department of Insurance should consider using existing Treasury Department expertise in seeking owners of \$6,500,000 in unclaimed funds and abandoned property; a significant portion of the \$6,500,000 may be available to transfer to the general revenue fund by fiscal year 1995 until claimed by owners**

With court approval, the monies from insolvent insurance companies that remain unclaimed after two years can become property of the State Department of Insurance. These funds can then pay expenses of the liquidator. As of August 31, 1993, more than \$6,500,000 remained as either unclaimed or abandoned property from closed estates (Figure Six). Included in this amount are an estimated 27 individuals due more than \$1,000 each.

The Treasury Department has an Unclaimed Property Division established to return abandoned property or unclaimed funds. For instance, the Treasury publishes an annual newspaper supplement listing owners of unclaimed funds. The Department of Insurance does not have the equivalent procedures or staffing to accomplish a return of significant amounts of unclaimed funds.

There is difficulty in returning all funds because the owners are not easily located. Claim checks or other disbursements that are undeliverable in the mail remain uncashed or outstanding. Current address information may be lacking due to the passage of time since liquidation proceedings began. As a result, claimants or other beneficiaries that are not located are not receiving all amounts they are due.

## Audit of the Receivership Process



**Figure Six**

**By fiscal 1995, unclaimed funds from 1992 (\$747,928) and 1993 (\$5,464,850) can be added to the abandoned property fund (\$359,618 as of August 31, 1993). Combined, this is more than \$6.5 million as of August 31, 1993.**

Source: Texas Department of Insurance

Almost \$6,000,000 of the total is from two recently closed estates which are very old, dating back to 1975. In one of these estates, a final distribution amounted to only \$78.90 per person. Mailing addresses were over ten years old, and \$2,281,321 due more than 28,000 people remains unclaimed in this one estate alone. In most estates, the amount of unclaimed funds is small. Most estates that have unclaimed funds (39 of 48 estates) have less than \$10,000 as of August 31, 1993.

### Recommendations

We recommend that the Department of Insurance consider using the expertise of the Unclaimed Property Division of the State Treasury in returning monies to rightful owners.

## Audit of the Receivership Process

We also recommend that the Department determine an appropriate maximum balance for the abandoned property fund based on budgeting and contingency planning and remit any excess funds to the State Treasurer for inclusion in General Revenue.

To accomplish the above, the Department should investigate the applicability of Title 6, Property Code (Unclaimed Property Law) to these funds. If applicable, complying with Title 6 of the Property Code would accomplish the dual goal of returning monies to rightful owners and transferring monies to the General Revenue Fund.

### Management's Response

*TDI is considering a proposal by Oversight to search for the owners of the Mobile Insurance Company (MIC) and Mobile County Mutual Insurance Company (MCMIC) unclaimed funds which comprise greater than 90 percent of the total unclaimed funds. This plan will cost approximately \$20,000 and calls for a 1-800 number and a temporary employee for 90 days to answer telephone inquiries generated from advertisements run in newspapers in all major Texas cities. TDI will also evaluate the merits of utilizing the Treasury Department's resources. Due to the extraordinary dollar amount of these unclaimed funds, Oversight is making this extra effort to locate their owners.*

*The balance in the abandoned property fund at this time is an anomaly due to MIC and MCMIC; ordinary amounts entering or leaving this fund are less than \$100,000. Therefore, TDI does not intend to explore the second recommendation at this time.*

### **B. The Department of Insurance should consider reviewing controls over contracting for services involving closed estates**

The Department should consider reviewing controls over contracting for services involving closed estates. Appropriately strong controls in this area may help avoid potential conflicts of interest and reduce costs.

Occasionally, assets may be identified and recovered after an estate has closed. Examples may include various types of accounts receivable that were not collected, despite aggressive collection efforts. Also, previously unidentified assets may be located and need to be sold. How often this occurred, and the amounts involved, were not addressed in this report.

The potential conflict may occur because special deputy receivers may be paid less than those hired to work on closed estates. This financial incentive arrangement may result in less aggressive or less successful asset recovery efforts

## **Audit of the Receivership Process**

by special deputy receivers. These assets would then be recovered at higher cost after the estate was closed.

### **Recommendations**

The Commissioner should consider using those oversight controls, hiring processes, and contract terms which are appropriate for obtaining services for closed estates to control costs and avoid conflicts of interest.

### **Management's Response**

*There is only one contract that exists for services in this area, which was entered into prior to March 1992, by the then Liquidator-Receiver. This contract is a contingent fee contract for asset recovery on certain closed estates. To date, this contractor has yielded no recoveries, and therefore no expense to TDI or the estates. It is Oversight's intention to cancel this contract. As asset recovery is now the responsibility of the SDRs, there should not be any need for TDI to enter into future contracts for similar services.*



## **Audit of the Receivership Process**

### **Appendix A: Background**

The Texas Department of Insurance's role in the liquidation of receiverships changed significantly under terms of House Bill 62, which was passed by the 72nd Legislature, Second Special Session, 1991. This legislation abolished the Liquidation Division, privatized its operations, and transferred claims-related activities from the Liquidation Division to the guaranty associations. All post-1992 receiverships were immediately affected by this legislation. Liquidation is now handled by private sector special deputy receivers selected by the Commissioner.

The Texas Department of Insurance was provided a longer period of time to privatize existing (pre-1992) receiverships. The Department was given until January 1, 1994, to privatize liquidation-related activities for pre-1992 estates. House Bill 62 allowed the guaranty associations until September 1, 1994, to assume control over claims-related activities of pre-1992 receiverships.

The Texas Life, Accident, Health, and Hospital Services Insurance Guaranty Association elected to assume control of the claims-related activities for the pre-1992 receiverships during fiscal year 1993. The Texas Property and Casualty Insurance Guaranty Association is evaluating individual receiverships to identify claims payment responsibilities that can be assumed prior to the September 1, 1994, deadline.

As of August 31, 1993, there were 102 receiverships. Of these, the Department has transferred 87 receiverships to special deputy receivers and one to a trustee. Fourteen receiverships are being closed internally by the Department.

## Audit of the Receivership Process

### Appendix B: Objective, Scope and Methodology

The Office of the State Auditor performed an audit of the insurance receivership process to fulfill certain statutory requirements. Texas Insurance Code, Article 21.28, Section 12(d) states that "The state auditor shall conduct an annual audit of the liquidator."

The scope of the audit included all relevant entities involved in the receivership liquidation process. The following entities were included:

- \* Texas Department of Insurance, Liquidation Oversight and Contract Administration divisions
- \* Texas Property and Casualty Insurance Guaranty Association
- \* Texas Life, Accident, Health and Hospital Service Insurance Guaranty Association
- \* A sample of five special deputy receivers

The Office of the State Auditor's authority to audit the guaranty associations and special deputy receivers is outlined in the Texas Insurance Code, Article 21.28 Section 12(k).

The objective of this audit was to assess the selection, monitoring, and evaluation of special deputy receivers. Both guaranty associations were reviewed to assess the reasonableness of overall expenditures and claims processing efficiency and to determine the associations' level of accountability to consumers.

The five special deputy receivers reviewed (31 total) were selected using a risk ranking methodology that considered total assets being liquidated and the complexity of their estates. Of the 13 estates managed by these special deputy receivers, nine were reviewed. These nine estates accounted for \$181 million in assets, which was over 52 percent of total assets managed by the private sector at the time of selection. The five special deputy receivers were reviewed to assist in evaluating oversight controls established at the Department.

Procedures used to accomplish our objectives included:

- \* interviews with staff and management of the Texas Department of Insurance, two guaranty associations, five special deputy receivers, and the Receivership Master
- \* review of the Texas Insurance Code
- \* review of operating instructions, procedures manuals, accounting records, court dockets, personnel and correspondence files, subcontractor files, and agency reports

### **Audit of the Receivership Process**

- \* review of reports on general bankruptcy and other related matters by the by the Resolution Trust Corporation
- \* review of previous Office of the State Auditor reports
- \* review of special deputy receiver applications, monthly business plans, and status reports

Fieldwork was conducted during April 1993 through October 1993. Our audit was conducted in accordance with generally accepted government auditing standards.

## Audit of the Receivership Process

### Appendix C: Glossary

**Abandoned Property Fund:** Unclaimed checks are deposited in the Unclaimed Fund at the Treasury. With court approval, after two years, unclaimed money is transferred to the Abandoned Property Fund. The Commissioner can use funds in the Abandoned Property Fund to pay liquidation costs not associated with a receivership.

**Assessment:** Amount levied by a guaranty association against member insurers to pay off an insolvent insurer's valid policyholder claims and the operating costs of the guaranty association.

**Conservation:** Normally, the purpose of a conservation proceeding is to conserve company assets and maintain the status quo pending final determination of the company's financial status. If the company has failed to comply with any lawful requirements of the insurance commissioner or has been found to be insolvent, and supervision is inadequate to rehabilitate the company, the Commissioner may place the company in conservation. The conservator takes charge and control of the company and initiates steps to remove the cause(s) which necessitated the conservation order.

**Covered Claim:** A covered claim is an unpaid claim of an insured or third-party claimant which arises out of and is within the coverage and not in excess of the applicable limits of an insurance policy issued by an admitted carrier and the limits of the Texas Insurance Code. The covered claim must be within the coverage limits of the policy. The amount of the claims must not exceed the limits of the policy, or limits imposed on the claim by statute.

**Estate:** The legal or equitable proceeding in which a Receiver is appointed for an insolvent company or corporation.

**Inventory of Assets:** The official listing of an impaired insurer's assets that is presented to the courts.

**Performance Measure:** Indicators that quantify the extent an agency, firm, or business met their stated objectives.

**Privatization:** The transition of insurance receivership liquidation duties from the Texas Department of Insurance Liquidation Division to the private sector, the special deputy receivers.

**Special Deputy Receiver:** A person or entity selected to serve as an agent of the Receiver (Commissioner) to administer the orderly liquidation of an insurance receivership.

**Receivership Master:** A representative of the court assigned to preside over insurance estate issues. The Master makes recommendations to the courts for judicial approval.

**Takeover Process:** The initial liquidation procedures used to take over the operations of an insolvent insurance company.

## **Audit of the Receivership Process**

**The Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association:** An association of insurers that pays valid claims of policyholders and other claimants up to the dollar limits of the policy and within ceilings fixed by state law in the event of an insurance company failure.

**The Texas Property and Casualty Insurance Guaranty Association:** An association of insurers that pays valid claims of policyholders and other claimants up to the dollar limits of the policy and within ceilings fixed by state law in the event of an insurance company failure.

**STATE OF TEXAS  
OFFICE OF THE STATE AUDITOR  
AUDIT OF THE RECEIVERSHIP PROCESS  
MARCH 1994**

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