

OFFICE OF THE SPECIAL DEPUTY RECEIVER,  
REPRESENTING THE DIRECTOR OF INSURANCE  
OF THE STATE OF ILLINOIS, AS LIQUIDATOR

LEGION INDEMNITY COMPANY, IN LIQUIDATION

FINANCIAL STATEMENTS AND INDEPENDENT AUDITORS' REPORT

December 31, 2008

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Independent Auditors' Report

The Honorable Michael T. McRaith  
Director of Insurance of the State of Illinois

We have audited the accompanying statement of cash and invested assets of Legion Indemnity Company, in Liquidation, as of December 31, 2008, and the related statement of changes in cash and invested assets for the year then ended. These financial statements are the responsibility of the Office of the Special Deputy Receiver (the "OSD"), representing the Director of Insurance of the State of Illinois, as Liquidator. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the OSD, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note A, the accompanying financial statements were prepared on the basis of accounting used by the OSD for the purpose of complying with Article XIII of the Illinois Insurance Code, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, such financial statements present fairly, in all material respects, the cash and invested assets of Legion Indemnity Company, in Liquidation, at December 31, 2008, and its changes in cash and invested assets for the year then ended, on the basis of accounting described in Note A.

This report is intended solely for the information and use of the OSD management, the Director of Insurance of the State of Illinois, the Illinois Auditor General, the Governor of the State of Illinois, and the Majority and Minority leaders of the Senate and House of Representatives of the State of Illinois, and is not intended to be and should not be used by anyone other than these specified parties.

*Kerber, Eck & Braeckel LLP*

Springfield, Illinois  
June 30, 2009

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Other Locations

Jacksonville, IL • Belleville, IL • Carbondale, IL • Cape Girardeau, MO • St. Louis, MO • Milwaukee, WI

Office of the Special Deputy Receiver,  
Representing the Director of Insurance  
of the State of Illinois, as Liquidator

Legion Indemnity Company, in Liquidation

STATEMENT OF CASH AND INVESTED ASSETS

December 31, 2008

Cash and cash equivalents (Note B)	\$ 1,781,186
Invested assets (Note C)	<u>56,023,968</u>
Total cash and invested assets	<u><u>\$ 57,805,154</u></u>

The accompanying notes are an integral part of this statement.

Office of the Special Deputy Receiver,  
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Legion Indemnity Company, in Liquidation

STATEMENT OF CHANGES IN CASH AND INVESTED ASSETS

Year ended December 31, 2008

Cash and invested assets - January 1, 2008	\$ 58,619,437
Receipts	
Interest (Note C)	2,112,789
Premiums collected	1,350
Salvage and subrogation	72,716
Reinsurance receipts	3,367,188
Unearned commissions received	15,000
Gain on sale of investments (Note C)	75,367
Other income	8,085
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Total receipts	5,652,495
Disbursements	
Early access distributions (Note E)	4,396,913
Salaries	1,116,963
Professional fees	236,052
Rent	211,455
Employee benefits	307,278
Data processing	15,319
Payroll and other taxes	98,810
Investment fees	17,727
Office expenses	20,810
Postage and freight	4,823
Equipment expenses	682
Travel	2,150
Loss and loss adjustment expense	30,825
Other	6,971
	<hr/>
Total disbursements	6,466,778
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Cash and invested assets - December 31, 2008	<u>\$ 57,805,154</u>

The accompanying notes are an integral part of this statement.

Office of the Special Deputy Receiver,  
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## NOTES TO FINANCIAL STATEMENTS

December 31, 2008

### NOTE A - BACKGROUND AND BASIS OF PRESENTATION

Pursuant to the Illinois Insurance Code (the "Code"), the Director of Insurance of the State of Illinois ("Director" or "Receiver"), is appointed as Conservator, Rehabilitator, or Liquidator of domestic insurance companies which have been determined by state courts to be insolvent or to meet provisions or grounds for conservation, rehabilitation, or liquidation, as specified in the Code.

The Director, as Liquidator, marshals and liquidates the assets of the insurance company and winds down the business and affairs of the company, as approved by the state courts.

The Director is empowered by the Code to appoint a Special Deputy as his agent to supervise the conservation, rehabilitation, or liquidation of insurance companies. The Office of the Special Deputy Receiver (the "OSD"), an Illinois chartered not-for-profit corporation, supports the activity of the Special Deputy appointed by the Director, to manage the affairs of insurance companies placed in conservation, rehabilitation, or liquidation. Common expenses of the OSD are allocated to the insurance companies in receivership.

Legion Indemnity Company ("Legion") was placed in liquidation on April 9, 2003, by the Circuit Court of Cook County, State of Illinois ("Supervising Court"), and thereafter became known as Legion Indemnity Company, in Liquidation ("Estate").

Article XIII of the Code provides regulations governing insurance companies in conservation, rehabilitation, and liquidation. Section 202 of Article XIII requires that the Estate prepare a report including financial statements of cash and invested assets and cash receipts and disbursements. Section 200 of Article XIII requires an annual audit be completed for each estate under liquidation or rehabilitation, which had total cash and invested assets during the calendar year greater than \$ 500,000.

The accompanying statement of cash and invested assets includes only the cash and invested assets of the Estate, at amortized cost; the accompanying statement of changes in cash and invested assets reflects only cash transactions and the net amortization or accretion (netted with interest receipts) of invested assets held during the year; consequently, all other assets and all liabilities of the Estate are not reflected in the accompanying financial statements. This is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America ("GAAP"), and, accordingly, the accompanying statements are not intended to present the financial position and results of operations in conformity with GAAP.

Office of the Special Deputy Receiver,  
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Legion Indemnity Company, in Liquidation

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2008

NOTE B - CASH AND CASH EQUIVALENTS

Cash and cash equivalents include any cash or short-term, highly-liquid investments readily convertible to known amounts of cash, which are under the complete and direct control of the OSD and are available to the Estate. At December 31, 2008, cash and cash equivalents consisted of the following:

Cash	\$ 58,653
Money market fund	<u>1,722,533</u>
Total cash and cash equivalents	<u>\$ 1,781,186</u>

NOTE C - INVESTED ASSETS

Invested assets consist of those assets that are under the complete and direct control of the OSD, are available for liquidation by the Estate, and are being specifically held as investments. At December 31, 2008, invested assets consisted of the following:

	<u>Book Value</u>	<u>Fair Value</u>
United States government and United States government agency obligations	\$ 56,023,968	\$ 57,545,144

During 2008, net amortization of debt securities totaling \$ 656,380 was netted against interest receipts. A gain on the sale of investments of \$ 75,367 was recognized during 2008, as proceeds on the sale were greater than the book value of the investments.

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NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2008

NOTE D - STATUTORY DEPOSITS AND RESTRICTED ASSETS

In the normal course of writing insurance in various states, Legion was required by state statute to deposit funds with various state insurance departments. When Legion entered liquidation, the statutory deposits were transferred to the OSD's control on behalf of Legion, or impounded by the various state insurance departments for the protection of policyholders within their jurisdiction. Since the OSD does not have direct control over those assets held by state insurance departments or related entities, and it is uncertain whether any portion of such assets will be available to the OSD in satisfying the obligations of the liquidation proceedings, they are not considered invested assets by the OSD until complete and direct control is established.

At December 31, 2008, statutory deposits with a fair value of \$ 5,289,475 were held by the States of Arkansas, Louisiana, Massachusetts, New Hampshire, New Mexico, New York, and South Carolina.

The Estate has an interest in three escrow accounts, which were set up as various trusts for policyholders and reinsurers. As it is uncertain whether all or any portion of these funds will be available to the OSD to satisfy the obligations of the Estate, these funds are not reflected as assets of the Estate in the accompanying financial statements. The interest in these restricted assets (U.S. Government agency obligations and money market funds) at December 31, 2008, was \$ 15,368,367.

NOTE E - EARLY ACCESS DISTRIBUTIONS

Early access distributions represent payments to state insurance guaranty funds/associations for the reimbursement of expenses and covered claim obligation disbursements, pursuant to applicable provisions of the Illinois Insurance Code.



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NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2008

NOTE F - LITIGATION/SETTLEMENT

1. *American Home Assurance Company v. Smyth, Sanford & Gerard, Inc.*  
*No. 02 CV 10016 (LTS) (S.D.N.Y.)*

This is an action first commenced by American Home Assurance Company ("American Home") against Smyth, Sanford & Gerard (SS&G) and its former principals, among others, relating to SS&G's role as reinsurance intermediary with respect to a reinsurance agreement involving American Home. SS&G also served as the reinsurance intermediary with respect to the Quota Share Contract for the GMI Program. The Estate, through the Illinois Director of Insurance, as statutory and court Affirmed Liquidator of Legion Indemnity Company, in Liquidation, along with M. Diane Koken, Insurance Commissioner of the Commonwealth of Pennsylvania in her Official and Statutory Capacity as Liquidator of Legion Insurance Company, in Liquidation, was granted leave to intervene in this proceeding as Intervenor Plaintiffs to state their claims against SS&G, Douglas L. King, Carl J. Casale, Thomas C. Chiappa, Eileen Casale, Joyce King, Catherine M. Koerner, and Wilmington Trust Company, for an accounting of the GMI Program, breach of contract, conversion, constructive trust, money had and received and fraudulent conveyance. The court appointed a Trustee for the purposes of administering the assets and claims against SS&G. The Estate, pursuant to the procedures established by the U.S. District Court in the Southern District of New York, filed a claim in the proceedings in the amount of approximately \$ 1.2 million. A bankruptcy distribution in the amount of \$ 159,606 was received by the Estate on February 12, 2009.

2. *Legion Indemnity Company, in Liquidation v. Underwriting Managers, Inc. (Arbitration)*

The Liquidator commenced this arbitration after Underwriting Managers, Inc. ("UMI"), a former managing general agent ("MGA") for Legion Indemnity, refused to either pay or provide security in the amount of \$ 562,463 owed to Legion as the result of the overpayment of certain premium commissions. Pursuant to the MGA agreement, UMI retained a base commission that was adjusted periodically based upon the loss ratio of the insurance program. The Liquidator's staff has calculated the program's loss ratio and determined that pursuant to the MGA agreement the above balance is due and owing to Legion.

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NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2008

NOTE F - LITIGATION/SETTLEMENT - Continued

2. Legion Indemnity Company, in Liquidation v. Underwriting Managers, Inc. (Arbitration).  
- Continued

The arbitration hearing was completed on October 9-12, 2007 in New York. On February 5, 2008, the arbitration panel entered an award in favor of the Liquidator. The panel ordered UMI to pay the Liquidator of Legion Indemnity Company \$ 562,463 within thirty days, with interest accruing at the annual rate of 6% commencing February 1, 2005. Upon receipt, the Liquidator is directed to hold \$ 100,000 of that amount in a separate escrow account, not as a general asset of the Estate, to secure repayment to UMI in the event that a final accounting of the UMI program requires such repayment.

UMI has refused to pay the arbitration award. The Liquidator moved to confirm the award in federal court in Tyler, Texas, the federal court having jurisdiction over UMI. UMI is opposing confirmation of the award, based upon "gross mistake, bad faith and failure to exercise honest judgment." The Liquidator has filed a motion for summary judgment based upon the applicable authority of the Federal Arbitration Act.

3. Arrowhead General Agency, Inc. v. Legion Indemnity Company, In Liquidation  
Circuit Court of Cook County, IL 02 CH 06695.

Arrowhead General Agency, Inc. ("Arrowhead"), a former managing general agent for Legion Indemnity, filed a declaratory judgment complaint in the liquidation proceedings. Arrowhead's complaint seeks a declaration that contingent profit commission due under certain of Legion Indemnity's reinsurance agreements is not an asset of the Estate, and that the totality of the circumstances surrounding execution of the reinsurance contracts demonstrate that Arrowhead, rather than the Estate, is the intended beneficiary of such contingent profit commission payments from the reinsurers. The Liquidator's motion to dismiss Arrowhead's complaint was granted by the trial court on August 22, 2008. Arrowhead's motion for reconsideration was denied on December 10, 2008. Arrowhead's notice of Appeal was filed on January 10, 2009.

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Legion Indemnity Company, in Liquidation

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2008

NOTE F - LITIGATION/SETTLEMENT - Continued

4. Legion Indemnity Company, in Liquidation v. Burns & Wilcox  
Northern District of Illinois, 06 C 4799.

The Liquidator has brought this suit to obtain a proper accounting and recover agent balances due from a former Legion agent. Legion's pre-liquidation receivable before set-offs or other credits was \$ 3,000,000. Upon completion of discovery, it appears that Burns & Wilcox owes \$ 650,000 after applying valid set-off rights. Burns & Wilcox filed a counterclaim against the Liquidator, which was dismissed pursuant to the anti-suit injunction contained in the Order of Liquidation and the Illinois set-off statute. Settlement discussions are pending.

5. *Federal Priority Issues*

The United States government has previously asserted that insurance companies may be directly liable to the U.S. government where it has incurred a loss. The U.S. government has asserted that its right to distribution of the Estate's assets in these situations is superior to that of other creditors, although that position was rejected, in part, by the United States Supreme Court in the case Department of Treasury v. Fabe, decided in June 1993. The United States Government or any of its agencies may be eligible for a claim distribution on an allowed claim under the statutory asset distribution schedule, 215 ILCS 5/205(1).

The amount of the liability, if any, cannot be determined at this time.

The Receiver is reviewing federal priority claims and has undertaken discussions with the U.S. Department of Justice, or will at the appropriate time.

6. *Declaratory Judgment and Other Direct Actions*

The Receiver has and will in the future continue to assert the Supervising Court's anti-suit injunction in lawsuits where declaratory judgment and other direct actions have been filed against the insurance company. In certain instances, these lawsuits have been dismissed without prejudice while in other situations the lawsuits were stayed pending the resolution of the receivership proceedings.