

DOCKET NO. CV-02-814173-S

SUPERIOR COURT

**THE CONNECTICUT SURETY
COMPANY, CONNECTICUT SURETY
CORPORATION, CONNECTICUT SURETY
INSURANCE AGENCY, INC., FUNDS
MANAGEMENT, INC., CONNECTICUT
SURETY INSURANCE AGENCY OF
ARIZONA, INC., BONDS II SURETY
GROUP, INC. AND CONNECTICUT SURETY :
INSURANCE AGENCY OF NEVADA, INC., .
IN LIQUIDATION**

**JUDICIAL DISTRICT OF
HARTFORD**

AT HARTFORD

MAY 17, 2004

LIQUIDATOR'S SECOND REPORT

To the Superior Court for the Judicial District of Hartford at Hartford, Connecticut, comes Susan F. Cogswell, Insurance Commissioner of the State of Connecticut, in her capacity as Liquidator (the "Liquidator") of The Connecticut Surety Company, Connecticut Surety Corporation, Connecticut Surety Insurance Agency, Inc., Funds Management, Inc., Connecticut Surety Insurance Agency of Arizona, Inc., Bonds II Surety Group, Inc. and Connecticut Surety Insurance Agency of Nevada, Inc., and presents her Second Report pursuant to Connecticut General Statute § 38a-920, paragraph 28 of the Order of Liquidation entered by the Court on May 17, 2002, and paragraph 26 of the Order for Substantive Consolidation entered by the Court on May 29, 2003, for the period commencing May 17, 2003 and ending May 16, 2004 as follows:

1. The Connecticut Surety Company ("CSC") was a Connecticut-domiciled surety company that issued commercial and contract surety and fidelity bonds. CSC's principal offices were located at 100 Pearl Street, 16th Floor, Hartford, Connecticut. CSC was a wholly-owned subsidiary of the Connecticut Surety Corporation, a Delaware corporation (the "Holding

Company"), and was part of the Connecticut Surety Insurance Company holding company system that included the Connecticut Surety Insurance Agency, Inc. ("CSIA"), the Connecticut Surety Insurance Agency of Arizona, Inc. ("CSIA-AZ"), the Connecticut Surety Insurance Agency of Nevada, Inc. ("CSIA-NV"), Bonds II Surety Group, Inc. ("Bonds II"), and Funds Management, Inc. ("FMI") (The Holding Company, CSIA, CSIA-AZ, CSIA-NV, Bonds II and FMI are collectively referred to as the "Affiliates"). CSC was licensed to transact the business of insurance in Connecticut, 25 other states and the District of Columbia. CSC's gross written premium for 2001 was \$2,052,486.

2. CSC and the Affiliates operated as an integrated organization, sharing office space, personnel and cash management systems. CSC issued virtually all of its bonds through its four Affiliate agencies, CSIA, CSIA-AZ, CSIA-NV and Bonds II (collectively, the "Affiliate Agencies").

3. The Affiliate Agencies also issued and administered surety bonds on behalf of Star Insurance Company ("Star"), Redland Insurance Company ("Redland"), Acceptance Insurance Companies ("Acceptance") and others which had licenses to write surety bonds in states where CSC lacked such licenses (collectively, with CSC, the "Sureties"). As part of underwriting bonds, CSIA (or one of the other Affiliate Agencies) would collect premium on bonds issued or renewed in the name of the Sureties and remit the premium to the Sureties or their reinsurers less a ceding commission. In addition, in connection with the issuance and administration of surety bonds for the Sureties, CSIA obtained and held collateral security provided by the principals for the benefit of the Sureties.

A. Events leading up to these proceedings.

4. As a result of a regular quarterly review of CSC's financial reports, the Connecticut Insurance Department (the "Department") became concerned about CSC's financial condition. The Department thereafter conducted on-site examinations of CSC and identified both operational and financial problems at CSC. The Department determined that CSC could not continue to operate in the manner in which it was operating, and accordingly issued an order of supervision (the "Supervision Order") for CSC on June 26, 2001.

5. Shortly after the entry of the Supervision Order, the Holding Company undertook to find a purchaser for CSC and the Affiliate Agencies. In late 2001, the Holding Company determined to enter into a transaction with Capitol Indemnity Corporation ("Capitol"), a subsidiary of Alleghany Capital Corporation. The Holding Company, on behalf of itself, CSC and the Affiliate Agencies, entered into an asset purchase agreement (the "Asset Purchase Agreement") with Capitol. Under the terms of the Asset Purchase Agreement, Capitol purchased from the Holding Company certain tangible assets and software and an option to purchase the stock of CSC. Capitol also assumed certain lease and payroll obligations of CSC.

6. Simultaneously with the Asset Purchase Agreement, Capitol entered into a Renewal Rights Agreement (the "Renewal Rights Agreement" and, together with the Asset Purchase Agreement, the "Capitol Transaction") with the Holding Company, CSC and CSIA, whereby Capitol purchased the right to renew surety bonds (the "Old Bonds") that had previously been issued through CSIA on behalf of the Sureties. Since the Capitol Transaction, Capitol has issued hundreds of bonds (the "Replacement Bonds") that have replaced certain of the Old

Bonds. The Replacement Bonds continue to cover the identical risk of the Old Bonds being replaced.

7. The Department was aware of the negotiations leading up to the Capitol Transaction and approved of the Capitol Transaction. The Department expected that after the closing of the Capitol Transaction, it would commence rehabilitation proceedings with respect to CSC.

8. On February 6, 2002, a consensual Order of Rehabilitation (the "Rehabilitation Order") was entered which placed CSC into rehabilitation proceedings pursuant to Conn. Gen. Stat. §§ 38a-903 -- 38a-961, inclusive, and appointed the Insurance Commissioner of the State of Connecticut as rehabilitator (the "Rehabilitator") of CSC.

9. Following the entry of the Rehabilitation Order, the Rehabilitator and her staff continued to investigate the financial condition of CSC and attempted to marshal its assets for the purpose of running off its liabilities in the ordinary course of business. During this period, the Rehabilitator became aware of claims and liabilities that had not previously been reserved or recorded in CSC's financial statements. In addition, the Department determined that it would be unable to readily access substantial cash deposits that were being held by other state insurance regulators as a condition to CSC doing business in those states. The Department determined that it was highly uncertain whether CSC would have sufficient assets to continue to pay claims and liabilities in the ordinary course. Accordingly, the Rehabilitator determined that it was in the best

interest of CS C's policyholders, its creditors, and the estate of CSC to commence a liquidation proceeding for CSC.

10. On May 17, 2002, the Court entered an Order of Liquidation (the "Liquidation Order") with respect to CSC. The Liquidation Order provided, among other things, for the Liquidator (i) to maintain or immediately take exclusive possession and control of all property of CSC, wherever located, and to liquidate the same pursuant to the provisions of Connecticut law; and (ii) to take such actions as the nature of the case and interests of the policyholders, CSC's creditors, the stockholders of CSC, and the public may require. Pursuant to the Liquidation Order, all CSC bonds were cancelled effective June 16, 2002 if not previously cancelled. The Liquidation Order also established a bar date (the "CSC Bar Date") of November 15, 2002, by which time proofs of claim for all claims against CSC were to be filed.

B. Issues in the wake of the Capitol Transaction.

11. It was expected that after the closing of the Capitol Transaction, Capitol would be able to administer the ongoing business of CSC and the Affiliate Agencies without further support from the Liquidator. However, two unanticipated developments required extensive involvement of the Liquidator and embroiled the Liquidator in a complex dispute with Capitol.

12. First, the shareholders and management of the Holding Company abandoned it and the Affiliates. The management and directors resigned, leaving the companies without the ability to perform even normal corporate tasks. As such, there was no one to wind up their affairs. This proved problematic for the Liquidator because the Affiliate Agencies were in

control of bank accounts that contained premium held in trust for the Sureties. Because no person was authorized to act on behalf of the Affiliate Agencies, the premiums were frozen in the Affiliate Agencies' bank accounts.

13. The Affiliate Agencies also were in possession of cash, certificates of deposit and letters of credit (the "Collateral") that had been provided as collateral security to the Sureties. The Affiliate Agencies were the authorized agents of the Sureties for purposes of administering the Collateral and the Collateral stood in the name of the Affiliate Agencies. Because no person was authorized to act on behalf of the Affiliate Agencies, Collateral could not be released to principals and could not be liquidated for the benefit of the Sureties.

14. The Holding Company had historically filed consolidated federal tax returns for the Affiliates and CSC. Without anyone to act on behalf of the Holding Company, CSC would be unable to complete the required federal tax returns.

15. Second, Capitol continued to use the Affiliate Agencies' bank accounts and CSC's licenses in its business after the closing of the Capitol Transaction. Capitol also continued collecting premium on behalf of CSC and, after Capitol established its own bank accounts, deposited that premium in those bank accounts.

16. Prior to establishing its own bank accounts, Capitol deposited premiums for new business in accounts of the Affiliate Agencies that held premiums of Sureties for prior transactions. Capitol also deposited cash collateral into accounts of the Affiliate Agencies that held Collateral for the Sureties which had been deposited in prior transactions. Because the

Affiliate Agencies had no officers, Capitol was unable to obtain possession of the amounts deposited. In addition, the commingling of funds caused significant confusion in the Affiliate Agencies' records.

17. In connection with issuing bills for new business, Capitol also billed premiums owed to CSC. However, the bills sent on behalf of CSC indicated offsets for agent commission against premiums owed to CSC. While such offsets would be customary in ongoing insurance business, they are prohibited in liquidation cases. (Conn. Gen. Stat. § 38a-935(a)(1); Liquidation Order paragraph 23.) As a result, Capitol under-collected premium due to CSC.

18. Capitol also renewed surety bonds in the name of CSC after the close of the Capitol Transaction and while CSC was in receivership. This practice was clearly unauthorized and prohibited by the Liquidation Order.

19. Finally, when issuing Replacement Bonds, Capitol intended to obtain the benefit of any Collateral that had been provided in connection with the Old Bonds that were being replaced. However, Capitol did not obtain documentation from most principals authorizing the transfer of the Collateral from the Affiliate Agencies to Capitol or otherwise pledging the Collateral to secure the Replacement Bonds.

20. The Liquidator and Capitol conducted extensive negotiations concerning the foregoing matters. The Liquidator suggested that Capitol assume ownership and control of the Affiliates. Capitol declined.

21. As such, the Liquidator determined to take control of the Affiliates with appropriate authorization from the Court, undertake a reconciliation and accounting with respect to deposits made by Capitol, obtain court authorization to transfer the Collateral to Capitol, cause Capitol to assume liability for any business written by it in the name of CSC and resolve any liability by Capitol for actions taken by it. The Liquidator was successful in achieving these goals, without the need of litigation, as described below.

C. Resolution of Capitol Disputes.

22. In order to relieve the estate of liability under bonds issued in the name of CSC after January 31, 2002, Capitol and the Liquidator agreed that the Liquidator would enter into a reinsurance agreement with Platte River Insurance Company ("Platte River") an affiliate of Capitol. Under the reinsurance agreement, Platte River assumed the entire risk of all bonds first issued or renewed in the name of CSC after January 31, 2002. Under the agreement, the Liquidator assigned and Platte River assumed sole responsibility for the payment of all losses and loss adjustment expenses related to bonds issued by Capitol in the name of Connecticut Surety, as well as the administration and servicing of all aspects of those bonds.

23. In order to obtain control over the Affiliates with authorization from the Court, the Liquidator determined to seek an order of substantive consolidation. On April 30, 2003, the Liquidator filed a Motion for Substantive Consolidation of The Connecticut Surety Company and its Affiliates. The Court entered an Order for Substantive Consolidation on May 29, 2003 (the "Substantive Consolidation Order").

24. The Substantive Consolidation Order authorized the Liquidator to take possession of the assets of the Holding Company and Affiliates, to pool their assets and liabilities with those of CSC as a consolidated estate (the "Consolidated Estate"), and to administer the Consolidated Estate's assets and liabilities under the general supervision of the Court. The Substantive Consolidation Order also established a bar date (the "Affiliate Bar Date") of August 29, 2003, by which time proofs of claim for all claims against the Affiliates were to be filed.

25. After substantive consolidation was complete, Capitol and the Liquidator entered into extensive negotiations to resolve matters pertaining to the premiums, the Collateral, and other issues that arose following the close of the Capitol Transaction.

26. To that end, the Liquidator's staff conducted an audit of the premium trust accounts held by the Affiliate Agencies and Capitol in order to determine the amount of premium owned by each of Capitol and CSC. Capitol conducted its own audit of the accounts using PriceWaterhouseCoopers LLP. The Liquidator and Capitol also sought to reconcile ownership of the Collateral and determine what items of Collateral pertained to Replacement Bonds.

27. In order to enable the Liquidator to transfer Collateral related to Replacement Bonds, the Liquidator filed a Motion to Transfer Collateral with the Court on September 3, 2003. In the Motion, the Liquidator asserted that an interest in the Collateral securing the Replacement Bonds had been equitably assigned to Capitol. The Liquidator also asserted that the bond principals, the Sureties and Capitol all had intended that the Collateral would secure the

obligations of the bond principals under the Replacement Bonds to reimburse Capitol with respect to losses under the Replacement Bonds.

28. Pursuant to an order of the Court, the Liquidator sent notice of the Motion to all identifiable parties in interest, including bond principals, collateral owners, producers, the Sureties, CSC's reinsurers, state insurance commissioners, the Internal Revenue Service and the banks at which the Affiliate Agencies held Collateral. On October 20, 2003, after a hearing, the Court entered an order (the "Collateral Transfer Order") (1) determining that an interest in the Collateral had been equitably assigned to Capitol to secure the obligations of the principals under the Replacement Bonds to reimburse Capitol with respect to losses under the Replacement Bonds; and (2) authorizing the Liquidator to transfer possession of the Collateral to Capitol and to enter into an agreement with Capitol providing for the assumption by Capitol of CSIA's obligations to administer the Collateral for the benefit of the Sureties.

29. In accordance with the Collateral Transfer Order, the Liquidator and Capitol entered into two separate collateral administration and assignment agreements - the first with Star and the second with Redland and Acceptance - effective as of November 14, 2003 (together, the "Collateral Administration and Assignment Agreements"). Under the Collateral Administration and Assignment Agreements, Star, Acceptance and Redland authorized Capitol to assume the Affiliate Agencies' obligations to administer the Collateral for the benefit of Star, Acceptance and Redland, and authorized the Liquidator to transfer possession of the Collateral provided for the benefit of Star, Acceptance and Redland to Capitol. In addition, Capitol assumed the Affiliate Agencies' rights, duties, responsibilities and obligations necessary to

administer the Collateral including, without limitation, the return of Collateral to collateral owners.

30. Pursuant to the Collateral Administration and Assignment Agreements, on November 25, 2003, the Liquidator transferred to Capitol via wire transfer \$1,280,488.82 in cash Collateral provided for the benefit of Star, \$1,033,169.44 in cash Collateral provided for the benefit of Acceptance and Redland, and \$1,675,277.19 in cash Collateral provided to secure the Replacement Bonds. The Liquidator also delivered to Capitol possession of all letters of credit, certificates of deposit and other Collateral posted for the benefit of Star, Acceptance and Redlands.

31. The Liquidator and Capitol undertook to settle a wide range of matters outstanding between the parties, including the commingling of CSC and Capitol premiums. After months of negotiation, Capitol (and its affiliates) and the Liquidator entered into the Mutual Release Agreement dated as of November 14, 2003 pursuant to which the parties settled all pending disputes.

D. Administration of the Consolidated Estate.

Personnel and facilities.

32. Following the close of the Capitol Transaction, the Liquidator operated the estate from the Hartford, Connecticut premises (the "Hartford Office") where CSC (and then Capitol) historically operated. By the terms of the Capitol Transaction, Capitol must continue to provide the Liquidator and her staff with office space in the Hartford Office, or in any Capitol office

located within 25 miles thereof until the earlier of December 31, 2004, or the date on which CSC is no longer operating under the Liquidation Order. On April 16, 2004, Capitol relocated its local operations to 115 Glastonbury Boulevard, Glastonbury, Connecticut, approximately 5 miles from the Hartford Office. The Liquidator's staff maintains office space at the Glastonbury location.

33. Substantially all employees of CSC and the Affiliates were terminated as of the closing of the Capitol Transaction, and the remaining employees were terminated during the Rehabilitation. As such, the Liquidator retained, and continues to retain, consultants and professionals to assist in the Liquidation as needed. In addition, the law firm of Bingham McCutchen LLP continues to provide legal services to the Liquidator and the estate.

34. The Liquidator has entered into a claims management agreement with Forcon International Nevada, Ltd. and Forcon International - N.E., LLC (collectively, "Forcon") under which Forcon manages commercial and contract bond claims arising out of or relating to bonds issued by CSC, and provides recovery services relating to those bonds. To date, Forcon has been assigned approximately 265 proofs of claim for losses under bonds and has made recommendations to the Liquidator with respect to 230 of those proofs of claim.

35. The Liquidator has retained The Warren Group as a tax consultant to the Liquidator. The Warren Group specializes in tax and accounting matters for insurance companies in receivership.

Reinsurance.

36. CSC maintained reinsurance on its outstanding bond exposure. Prior to June 1, 2000, CSC had only excess of loss reinsurance. Commencing June 1, 2000, CSC entered into a quota share reinsurance agreement under which it was reinsured for one hundred percent of all losses on bonds written and renewed thereafter.

37. The Liquidator has notified the reinsurers of all proofs of claim filed in the liquidation which may give rise to claims covered by their reinsurance, and will notify them in connection with motions to the Court for allowance of claims.

38. At present, the Liquidator is in the process of producing reports of premiums and claims for the quota share reinsurers. Due to extremely poor record keeping by CSC and the Affiliates, the Liquidator has had to reconstruct significant portions of CSC's books and records. In addition, because the quota share agreement covers Star and Acceptance as well as CSC, the Liquidator must obtain information from them in order to submit a claim for sliding scale ceding commissions.

39. In addition to the reconstruction of the records of CSC, the Liquidator has undertaken the reconstruction of the records of the Affiliates. This reconstruction will be necessary in order to file appropriate tax returns. It is expected that this project will take several months to complete.

Proofs of claim.

40. On or about May 24, 2002, the Liquidator sent notice of the CSC Bar Date and the CSC claims process, along with a proof of claim form, to all persons or entities known or reasonably expected to have claims against, or an interest in, CSC. In addition, notice of the CSC Bar Date and the CSC claims process appeared in The Hartford Courant on May 24, 2002, and on the Department's website. Proof of claim forms also were available through the Department's website.

41. On or about June 3, 2003, the Liquidator sent notice of the Affiliate Bar Date, along with a proof of claim form, to all persons or entities known or reasonably expected to have claims against, or an interest in, the Affiliates. In addition, notice of the Affiliate Bar Date appeared in The Hartford Courant on June 13, 2003, and on the Department's website. Proof of claim forms also were available through the Department's website.

42. As of May 3, 2004, approximately 1210 proofs of claim (the "Proofs of Claim") were filed with the Liquidator. The Proofs of Claim are comprised of various classes of claims, as defined by Conn. Gen. Stat. § 38a-944 as follows:

42. Claims for loss under a CSC bond (the "Bond Loss Claims"). Approximately 364 Bond Loss Claims have been filed with the Liquidator. 342 Bond Loss Claims were filed in the aggregate stated amount of \$6,024,659.64. 22 Bond Loss Claims were filed in an unstated amount. The aggregate bond penalty on Bond Loss Claims filed in an unstated amount is approximately \$402,700.00. To date, the Liquidator has determined to recommend to the

Liquidation Court to allow 139 Bond Loss Claims in the aggregate amount of \$857,313.05. Of these, 53 Bond Loss Claims totaling \$164,438.56 are potentially covered under quota share reinsurance. The Liquidator has also determined to recommend to the Liquidation Court to deny 148 Bond Loss Claims filed in the aggregate stated amount of \$2,069,004.61. The Liquidator has received 29 objections to determinations to recommend or deny Bond Loss Claims. The aggregate amount of these disputed claims is \$264,280.47, which represents the lesser of the bond penalty or the amount of the claim as filed. The Liquidator has established reserves on disputed claims in that amount. \$78,350.00 of the amount reserved for disputed claims is potentially covered under quota share reinsurance. One Bond Loss Claim filed in the stated amount of \$5,123.61 has been withdrawn. 60 Bond Loss Claims reserved in the amount of \$2,226,725.12, which represents (in the aggregate) the lesser of the bond penalty or the amount of the claim as filed, remain unresolved. Of those, 18 Bond Loss Claims are potentially covered under quota share reinsurance. These claims are reserved in the amount of \$1,173,445.90, which represents (in the aggregate) the lesser of the bond penalty or the amount of the claim as filed. 16 Bond Loss Claims have been, or will be, delivered to a state guaranty fund. Those claims are reserved at \$258,843.55, which represents (in the aggregate) the lesser of the bond penalty or the amount of the claim as filed. Allowed Bond Loss Claims will be class 3 claims. Total reserves of Bond Loss Claims are \$3,607,162.19.

43. Claims for unearned premium (the "Unearned Premium Claims"). Approximately 743 Unearned Premium Claims were filed with the Liquidator. 464 Unearned Premium Claims were filed in the aggregate stated amount of \$295,422.72. 280 Unearned Premium Claims were

filed in an unstated amount. To date, the Liquidator has determined to recommend to the Liquidation Court to deny 73 Unearned Premium Claims filed in the aggregate stated amount of \$115,292.47. The Liquidator has received three objections with respect to those recommendations. The Liquidator has determined that 74 Unearned Premium Claims are Capitol's obligation under the Platte River Reinsurance Agreement. Based on the Liquidator's calculations, approximately \$14,157.75 of unearned premium is due on those claims. Within the next few weeks the Liquidator will deliver approximately 59 Unearned Premium Claims, filed in the aggregate stated amount of \$7,194.17, to a state guaranty fund. After a review of the remaining Unearned Premium Claims, the Liquidator has set reserves for Unearned Premium Claims at approximately \$135,000.00. Allowed Unearned Premium Claims are class 3 claims.

44. Guaranty association claims. Approximately 11 proofs of claim were filed by various guaranty associations with the Liquidator. All such claims were filed in an unstated amount. Claims of guaranty associations for payment of covered claims or covered obligations of a surety are class 3 claims.

45. General creditor claims (the "General Creditor Claims"). Approximately 59 General Creditor Claims were filed with the Liquidator. Of those, 52 General Creditor Claims were filed in the aggregate stated amount of \$33,888,327.47. One claim was filed in the amount of \$28,555,000. Because of the highly contested nature of this claim, the Liquidator has not established a reserve for it. This claim arises out of allegations that CSC and the Affiliates participated in a scheme to defraud a motion picture distributor. An additional 7 General Creditor Claims were filed in an unstated amount. To date, the Liquidator has determined to

recommend to the Liquidation Court to deny 6 General Creditor Claims filed in the aggregate stated amount of \$138,405.15 on the basis that they were exact duplicates of other General Creditor Claims. A review of the General Creditor Claims indicates that certain claims include claims filed with respect to certain subordinated surplus notes issued by CSC (as discussed below in paragraph 47). Accordingly, reserves on General Creditor Claims currently are estimated at \$10,287,126.55. General Creditor Claims have also been reduced to the extent that a creditor has filed multiple proofs of claim that include the same components. The Liquidator does not anticipate doing detailed review of General Creditor Claims until it is clear that all class 3 claims can be paid in full. Allowed General Creditor Claims will be class 6 claims.

46. Claims of state and local governments. 13 claims were filed by state and local governments for premium, corporate and other taxes. Of those, 12 were filed in the aggregate stated amount of \$29,599.24. One claim was filed in an unstated amount. To date, the Liquidator has determined to recommend to the Liquidation Court to deny three such claims, which were filed in the aggregate stated amount of \$6,140.00. Reserves on state and local government claims currently are estimated at \$23,459.24.

47. Subordinated surplus notes (the "Notes"). Three proofs of claim filed with the Liquidator included claims with respect to Notes issued by CSC. The Notes underlying those claims are in the aggregate face amount of \$4,211,667.00. Accrued interest on the Notes through the date of the Liquidation Order totals \$542,309.29. Reserves on the Notes currently are estimated at \$4,753,976.29. The Notes are class 8 claims.

48. Reinsurance recoverables are approximately \$1,416,234.46, and are based on current reserves for claims likely to be covered under certain reinsurance agreements. Estimated reinsurance recoverables may change significantly as reserves further develop and as the Liquidator obtains more definitive information concerning the precise dates of loss with respect to certain bond claims.

Lloyd's Litigation.

49. On September 20, 2002, Star commenced a legal action entitled Star Insurance Company v. Connecticut Surety Insurance Agency, Inc. Case No. 02-043934-CK, in the Circuit Court for the County of Oakland, State of Michigan seeking damages for CSIA's alleged failure to cancel certain bonds issued on behalf of Star by CSIA. At the time of the alleged breach of duty, Certain Underwriters at Lloyd's, London ("Lloyd's") were CSIA's errors and omissions insurer.

50. Because no one was authorized to act on behalf of CSIA with respect to the Star Action, the court entered a default judgment against CSIA for an amount in excess of \$1 million. Soon thereafter, Star commenced a garnishment action against CSIA's E&O policy in satisfaction of the Default Judgment. At that time, which was prior to the entry of the Consolidation Order, CSIA's other assets were also at risk of being garnished in satisfaction of the default judgment.

51. On May 7, 2003 and May 16, 2003, Lloyd's commenced two legal actions both entitled Certain Underwriters at Lloyd's, London v. Connecticut Surety Insurance Agency, Inc. in

the Connecticut Superior Court seeking a declaration of CSIA's rights under the Lloyd's policy (the "Declaratory Judgment Actions"). In the Declaratory Judgment Actions Lloyd's asserted that the Claim was outside of the scope of the Lloyd's policy.

52. The Liquidator maintained that both the garnishment proceeding and the Declaratory Judgment Actions were stayed or otherwise could not be maintained. The Liquidator negotiated separate agreements with Lloyd's and Star which permitted Lloyd's and Star to continue the garnishment proceedings and Declaratory Judgment Actions against each other and limited the recourse of each against the estate.

Worldwide Litigation.

5.3. Both CSC and Star wrote surety bonds on behalf of Worldwide Film, which was an insurance broker specializing in film completion bonds. In that capacity, Worldwide Film would identify film projects where a film completion bond was required to secure financing of the film. Pursuant to an agreement between CSC and Worldwide, Worldwide was required to provide security to CSC for losses that might be incurred on CSC bonds issued at Worldwide's request. At the time of the commencement of CSC's liquidation proceedings, CSC continued to hold security even though all projects secured by CSC bonds had been completed and losses with respect thereto had been paid.

54. Worldwide Film had a similar arrangement with Star, however Star did not have security from Worldwide. Star suffered losses under various bonds issued on behalf of Worldwide, and Worldwide had an obligation to reimburse Star for those losses.

55. Star filed a civil action in the Superior Court, Los Angeles County, in the State of California, against Worldwide Film in which Star alleged that Worldwide Film (a) had breached its covenant of good faith and fair dealing with Star and (b) had breached its implied-in-fact contract with Star. On July 1, 2003, Star obtained a judgment (the "Worldwide Film Judgment") against Worldwide Film in the amount of \$318,516.96, including costs. Star was unable to execute the Worldwide Film Judgment in California.

56. On November 7, 2003, Star filed a Motion for Relief from Stay with the Court seeking authorization to execute on the funds that Worldwide had provided to CSC as collateral. The Liquidator consented to the relief requested, and the Court entered an order granting the relief. In early 2004, the Liquidator received an execution on the Worldwide Film Judgment with respect to the funds provided by Worldwide Film and on March 2, 2004, the Liquidator paid to Star \$248,387.26, the balance of funds held.

E. Financial statements.

57. The attached financial statements were compiled by the Liquidator's staff on the basis of the bank records, proofs of claim and records of CSC and the Affiliates. Due to deficiencies in the records of CSC and the Affiliates, the financial statements represent only the Liquidator's best estimate of certain liabilities of the estate.

Assets

58. Short-term investments, which total \$3,465,423.31, include funds held at FleetBoston Financial Corporation and in the Short Term Investment Fund managed by the Treasurer of the State of Connecticut.

59. Reinsurance recoverables are approximately \$1,416,234,46, and are based on current reserves for claims likely to be covered under certain reinsurance agreements. Estimated reinsurance recoverables may change significantly as reserves further develop and as the Liquidator obtains more definitive information concerning the precise dates of loss with respect to certain bond claims.

60. Securities on deposit held as either bonds or money market funds are deposits held by various states. CSC made these deposits as a condition to operating in those states. These deposits are available to pay Class 3 claims. However, there are disputes between the Liquidator and certain of the states as to whether the funds held by a state must be used to first pay in full the claims of the residents of that state.

61. Funds held for others total approximately \$351,017.95. It consists primarily of funds held by the Liquidator as collateral for bond obligations.

Liabilities.

62. Class 2 administrative expenses of the Guaranty Funds currently are estimated at \$50,000.00. This amount will change as the three Guaranty Funds that have taken or will take

over the handling and payment of claims by policyholders in their states provide the Liquidator with additional information regarding their administrative expenses.

63. Class 3 consists of Bond Loss Claims, Unearned Premium Claims and Guaranty Fund claims (other than class 2 claims) which total approximately \$3,749,356. Of that, \$3,607,162 represents reserves on timely filed Bond Loss Claims, \$142,194 represents reserves on Unearned Premium Claims.

64. Class 6 general creditor claims and reinsurer claims are estimated to be 10,287,126.55 This amount is the Liquidator's best estimate of the class 6 claims based on the claims filed with the Liquidator and the Liquidator's review of the accounting and reinsurance records of CSC.

65. Class 7 state and local government claims are \$23,459.24. This amount is the Liquidator's best estimate of the class 7 claims based on the claims filed with the Liquidator and the Liquidator's review of the accounting and tax records of CSC.

66. Class 8 claims based on subordinated surplus notes issued by CSC are estimated to be \$4,753,976.20. This amount is the Liquidator's best estimate of the class 8 claims filed with the Liquidator and the Liquidator's calculation of interest accrued on those notes through May 17, 2002.

67. Amounts due insurers and reinsurers represents premium that the Liquidator may be required to remit to third party insurers and reinsurers. Funds held for others includes collateral pledged by third parties for various bonds.

Statement Of Receipts And Disbursements.

68. Loss adjustment expenses represent fees paid to third party administrators for management of the Bond Loss Claims. The majority of the loss adjustment expenses are one-time payments for the management of the Bond Loss Claims throughout the life of the claims, and therefore will benefit the estate throughout the course of these proceedings.

69. During the reporting period, the estate paid \$225,566.93 in fees to Robert Half Associates for accounting services and \$425,522.67 to Bingham McCutchen in legal fees.

CONCLUSION

During the second year of this liquidation proceeding, the Liquidator has made substantial progress in winding up the affairs of CSC. In order to accomplish this, the Liquidator was required to obtain control of CSC's affiliates and resolve substantial disputes with the purchaser of CSC's ongoing business. These tasks have delayed the Liquidator's progress toward an early distribution in the case. At present, most of the policyholder claims have been adjusted, and there is a substantial possibility that all policyholder claims will be paid in full. There remains substantial accounting work to be done due to the deficiencies in CSC's records.

Respectfully submitted this 17th day of May 2004.

A handwritten signature in cursive script, appearing to read "F Cogswell".

Susan F. Cogswell, Insurance Commissioner of the State of Connecticut, as Liquidator of The Connecticut Surety Company, Connecticut Surety Corporation, Connecticut Surety Insurance Agency, Inc., Funds Management, Inc., Connecticut Surety Insurance Agency of Arizona, Inc., Bonds II Surety Group, Inc. and Connecticut Surety Insurance Agency of Nevada, Inc.

THE CONNECTICUT SURETY COMPANY IN LIQUIDATION
BALANCE SHEET

Date Placed In Rehabilitation: February 6, 2002

Date Placed In Liquidation: May 17, 2002

As of 02/06/02

As of 3/31/03

As of 5/28/03

ASSETS				
Cash		615,503.86	86,283.70	156,926.36
Short-Term Investments		91,152.99	987,741.44	875,762.62
Total Cash & Short Term Investments		706,656.85	1,074,025.14	1,032,688.98
Bonds		0.00	0.00	0.00
Advances to Guaranty Associations		0.00	0.00	0.00
Recoverable from Reinsurers		1,280,599.10	1,280,599.10	1,280,599.10
Salvage and Subrogation Recoverables		45,000.00	53,000.00	53,000.00
Premiums/Agents Balances in Course of Collection		1,023.40	207,681.43	207,681.43
Receivable from Affiliates		0.00	0.00	0.00
Accrued Investment Income		94,375.97	15,255.27	0.00
Other Assets:				
Fees Receivable from Capitol Indemnity		0.00	46,432.64	46,432.64
Funds Held by Reinsurers		0.00	0.00	0.00
Furniture & Office Equipment		0.00	0.00	0.00
Data Processing Equipment		0.00	0.00	0.00
Total Unrestricted Assets		2,127,655.32	2,676,993.58	2,620,402.15
Restricted Assets:				
Securities on Deposit Held as Bonds		3,080,125.51	1,785,115.00	1,776,099.50
Securities on Deposit Held as Cash or MM Fs		847,229.33	737,364.79	737,364.79
Funds Held for Others		934,805.60	953,190.83	953,234.20
Total Restricted Assets		4,862,160.44	3,475,670.62	3,466,698.49
Total Assets		6,989,815.76	6,152,664.20	6,087,100.64
LIABILITIES				
Claims				
Secured Claims:				
Class 1 Claims:	Administrative Expenses (C.G.S. Section 38a-944(a)(1))	0.00	0.00	0.00
Class 2 Claims:	Administrative Expenses of Guaranty Associations (C.G.S. Section 38a-944(a)(2))	0.00	50,000.00	50,000.00
Class 3 Claims:	Policy Holder Claims, Third-Party Loss Claims, Unearned Premium Claims, & Guaranty Assoc. Claims other than those in class 2 (C.G.S. Section 38a-944(a)(3))	3,361,431.05	3,361,431.05	3,361,431.05
Class 4 Claims:	Federal Government Claims not eligible for inclusion in Class 3 (C.G.S. Section 38a-944(a)(4))	0.00	0.00	0.00
Class 5 Claims:	Employee Compensation Claims (C.G.S. Section 38a-944(a)(5))	0.00	0.00	0.00
Class 6 Claims:	General Creditor Claims, Reinsurance Claims, & Non-Policy Claims (C.G.S. Section 38a-944(a)(6))	5,328,841.91	5,328,841.91	5,328,841.91
Class 7 Claims:	State or Local Government Claims not eligible for inclusion in Class 4 (C.G.S. Section 38a-944(a)(7))	20,089.69	20,089.69	20,089.69
Class 8 Claims:	Claims Based on Surplus or Contribution Notes, or Similar Obligations, Premium Refunds on Assessable Policies, & Interest on Claims of Classes 1 through 7 (C.G.S. Section 38a-944(a)(8))	4,651,165.46	4,753,976.29	4,753,976.29
Class 9 Claims:	Claims of Shareholders & Other Owners in their Capacity as Shareholders or Owners (C.G.S. Section 38a-944(a)(9))	0.00	0.00	0.00
Total Claims Received		13,361,528.11	13,514,338.94	13,514,338.94
Other Liabilities Not Included Above:				
Amounts Due to Reinsurers & Insurers		1,023.40	207,681.43	207,681.43
Funds Held for Others		934,805.60	953,190.83	953,234.20
Total Other Liabilities		935,829.00	1,160,872.26	1,160,915.63
Total Liabilities		14,297,357.11	14,675,211.20	14,675,254.57
Excess (Deficiency) of Assets Over Liabilities		(7,307,541.35)	(8,522,547.00)	(8,588,153.93)
Total Liabilities and Equity		6,989,815.76	6,152,664.20	6,087,100.64

Disclaimer The information contained in this report is prepared by the receiver from information available to or known by the receiver as of the date of the report. The receiver makes no warranty as to the accuracy of the information or of the opinions or evaluations contained in this report and expressly disclaims any liability arising from the statements of fact, evaluation or opinion contained in the report.

THE CONNECTICUT SURETY **COMPANY et al.**, IN LIQUIDATION
BALANCE SHEET

CSC - Date Placed In Rehabilitation: February 6, 2002

CSC - Date Placed In Liquidation: May 17, 2002

Consolidated Group - Date Placed In Liquidation: May 29, 2003

	CSC As of 5/28/03	Consolidated As of 5/29/03	Consolidated As of 3/31/04
ASSETS			
Cash	156,926.36	2,086,989.93	992,263.97
<u>Short-Term Investments</u>	<u>875,762.62</u>	<u>1,569,486.07</u>	<u>2,473,159.34</u>
Total Cash & Short Term Investments	1,032,688.98	3,656,476.00	3,465,423.31
Bonds	0.00	0.00	0.00
Advances to Guaranty Associations	0.00	0.00	0.00
Recoverable from Reinsurers	1,280,599.10	1,280,599.10	1,416,234.46
Salvage and Subrogation Recoverables	53,000.00	53,000.00	0.00
Premiums/Agents Balances in Course of Collection	207,681.43	0.00	0.00
Receivable from Affiliates	0.00	0.00	0.00
Accrued Investment Income	0.00	0.00	0.00
<u>Other Assets:</u>			
Fees Receivable from Capitol Indemnity	18,179.00	18,179.00	18,179.00
Funds Held by Reinsurers	0.00	0.00	0.00
Furniture & Office Equipment	0.00	0.00	0.00
Data Processing Equipment	0.00	0.00	0.00
Total Unrestricted Assets	2,592,148.51	5,008,254.10	4,899,836.77
<u>Restricted Assets:</u>			
Securities on Deposit Held as Bonds	1,776,099.50	1,776,099.50	1,471,802.50
Securities on Deposit Held as Cash or MM F's	737,364.79	737,364.79	737,586.76
Funds Held for Others	953,234.20	4,096,996.08	351,017.95
Total Restricted Assets	3,466,698.49	6,610,460.37	2,560,407.21
Total Assets	6,058,847.00	11,618,714.47	7,460,243.98
LIABILITIES			
<u>Claims</u>			
Secured Claims:			
Class 1 Claims: Administrative Expenses (C.G.S. Section 38a-944(a)(1))	0.00	0.00	0.00
Class 2 Claims: Administrative Expenses of Guaranty Associations (C.G.S. Section 38a-944(a)(2))	50,000.00	50,000.00	50,000.00
Class 3 Claims: Policy Holder Claims, Third-Party Loss Claims, Unearned Premium Claims, & Guaranty Assoc. Claims other than those in class 2 (C.G.S. Section 38a-944(a)(3))	3,361,431.05	3,361,431.05	3,749,356.36
Class 4 Claims: Federal Government Claims not eligible for inclusion in Class 3 (C.G.S. Section 38a-944(a)(4))	0.00	0.00	0.00
Class 5 Claims: Employee Compensation Claims (C.G.S. Section 38a-944(a)(5))	0.00	0.00	0.00
Class 6 Claims: General Creditor Claims, Reinsurance Claims; & Non-Policy Claims (C.G.S. Section 38a-944(a)(6))	5,328,841.91	5,328,841.91	10,287,126.55
Class 7 Claims: State or Local Government Claims not eligible for inclusion in Class 4 (C.G.S. Section 38a-944(a)(7))	20,089.69	20,089.69	23,459.24
Class 8 Claims: Claims Based on Surplus or Contribution Notes, or Similar Obligations, Premium Refunds on Assessable Policies, & Interest on Claims of Classes 1 through 7 (C.G.S. Section 38a-944(a)(8))	4,753,976.29	4,753,976.29	4,753,976.29
Class 9 Claims: Claims of Shareholders & Other Owners in their Capacity as Shareholders or Owners (C.G.S. Section 38a-944(a)(9))	0.00	0.00	0.00
Total Claims Received	13,514,338.94	13,514,338.94	18,863,918.44
<u>Other Liabilities Not Included Above:</u>			
Amounts Due to Reinsurers & Insurers	207,681.43	1,521,739.35	1,523,398.49
Funds Held for Others	953,234.20	4,096,996.08	351,017.95
Total Other Liabilities	1,160,915.63	5,618,735.43	1,874,416.44
Total Liabilities	14,675,254.57	19,133,074.37	20,738,334.88
Excess (Deficiency) of Assets Over Liabilities	(8,616,407.57)	(7,514,359.90)	(13,278,090.90)
Total Liabilities and Equity	6,058,847.00	11,618,714.47	7,460,243.98

Disclaimer. The information contained in this report is prepared by the receiver from information available to or known by the receiver as of the date of the report. The receiver makes no warranty as to the accuracy of the information or of the opinions or evaluations contained in this report and expressly disclaims any liability arising from the statements of fact, evaluation or opinion contained in the report.

THE CONNECTICUT SURETY COMPANY IN LIQUIDATION
STATEMENT OF RECEIPTS AND DISBURSEMENTS
For Period of 02106102, 3131103, 5128103, 3131104

Date Placed In Rehabilitation: February 6, 2002	Period	Period	Cumulative
Date Placed In Liquidation: May 17, 2002	02/06/02 - 03/31/03	03/31/03 - 05/28/03	02/06/02 - 5/28/03

RECEIPTS

Marshaling of Estate Assets:			
Premium Receipts	1,957.50	0.00	1,957.50
Proceeds from Sales:			
Sale of Company Assets to Capitol Transamerica Corporation	185,022.93	0.00	185,022.93
Reinsurance Recoveries	32,055.60	0.00	32,055.60
Agents Balances	0.00	0.00	0.00
Collection of Affiliate Receivables	0.00	0.00	0.00
Salvage and Subrogation Recoveries	4,403.72	1,070.66	5,474.38
Recovery of Taxes Previously Paid	6,167.11	0.00	6,167.11
Expenses Reimbursements	7,412.60	43.45	7,456.05
Miscellaneous Income	12,242.41	0.00	12,242.41
Receipts Before Investment Activities	249,261.87	1,114.11	250,375.98
Interest and Dividend Receipts	218,555.38	38,302.28	256,857.66
Proceeds from Sales and Maturities of:			
Short Term Investments Deposits	1,376,892.77	0.00	1,376,892.77
Bonds - Capital Gains	33,437.50	0.00	33,437.50
Receipts from Investment Activities	1,628,885.65	38,302.28	1,667,187.93
Total Cash Receipts	1,878,147.52	39,416.39	1,917,563.91

DISBURSEMENTS AND DISTRIBUTIONS

Loss Payments	126,213.27	0.00	126,213.27
LAE Payments	113,608.51	1,176.66	114,785.17
Legal Fees	421,071.86	33,591.69	454,663.55
Consulting Fees	293,053.42	45,382.50	338,435.92
Salaries	148,723.94	0.00	148,723.94
Employee Benefits	30,285.13	0.00	30,285.13
Taxes	5,102.29	0.00	5,102.29
Office Expenses	11,202.35	601.70	11,804.05
Reinsurance Payments	360,930.96	0.00	360,930.96
Disbursements	1,510,191.73	80,752.55	1,590,944.28
Distributions:	0.00	0.00	0.00
Disbursements & Distributions Before Investment Activities	1,510,191.73	80,752.55	1,590,944.28
Investment Expenses	587.50	0.00	587.50
Disbursements for Investment Activities	587.50	0.00	587.50
Total Cash Disbursements & Distributions	1,510,779.23	80,752.55	1,591,531.78
Net Increase (Decrease) in Cash	367,368.29	(41,336.16)	326,032.13

Disclaimer The information contained in this report is prepared by the receiver from information available to or known by the receiver as of the date of the report. The receiver makes no warranty as to the accuracy of the information or of the opinions or evaluations contained in this report and expressly disclaims any liability arising from the statements of fact, evaluation or opinion contained in the report.

THE CONNECTICUT SURETY COMPANY at al., IN LIQUIDATION
STATEMENT OF RECEIPTS AND DISBURSEMENTS
For Period of 5/29/03 - 3/31/04

Date Placed In Liquidation: May 29, 2003	Period 05/29/03 - 03/31/04	Cumulative 05/29/03 - 03/31/04
RECEIPTS		
Marshaling of Estate Assets:		
Premium Receipts	3,554.80	3,554.80
Proceeds from Sales:		
Sale of Company Assets to Capitol Transamerica Corporation		0.00
Reinsurance Recoveries	0.00	0.00
Agents Balances	0.00	0.00
Collection of Affiliate Receivables	0.00	0.00
Salvage and Subrogation Recoveries	28,449.10	28,449.10
Recovery of Taxes Previously Paid	0.00	0.00
Expenses Reimbursements	255.08	255.08
Miscellaneous Income	111,654.95	111,654.95
<i>Receipts Before Investment Activities</i>	<i>143,913.93</i>	<i>143,913.93</i>
Interest and Dividend Receipts	82,993.24	82,993.24
Proceeds from Sales and Maturities of:		
Short Term Investments Deposits	0.00	0.00
Bonds	250,000.00	250,000.00
<i>Receipts from Investment Activities</i>	<i>332,993.24</i>	<i>332,993.24</i>
<i>Total Cash Receipts</i>	<i>476,907.17</i>	<i>476,907.17</i>
DISBURSEMENTS AND DISTRIBUTIONS		
Loss Payments	0.00	0.00
LAE Payments	13,092.80	13,092.80
Legal Fees	425,522.67	425,522.67
Consulting Fees	225,566.93	225,566.93
Salaries	0.00	0.00
Employee Benefits	0.00	0.00
Taxes	0.00	0.00
Office Expenses	3,777.46	3,777.46
Reinsurance Payments	0.00	0.00
Disbursements	667,959.86	667,959.86
Distributions:	0.00	0.00
<i>Disbursements & Distributions Before Investment Activities</i>	<i>667,959.86</i>	<i>667,959.86</i>
Investment Expenses	0.00	0.00
Disbursements for Investment Activities	0.00	0.00
<i>Total Cash Disbursements & Distributions</i>	<i>667,959.86</i>	<i>667,959.86</i>
Net Increase (Decrease) in Cash	(191,052.69)	(191,052.69)

Disclaimer: The information contained in this report is prepared by the receiver from information available to or known by the receiver as of the date of the report. The receiver makes no warranty as to the accuracy of the information or of the opinions or evaluations contained in this report and expressly disclaims any liability arising from the statements of fact, evaluation or opinion contained in the report.