

SUPREME COURT OF THE STATE OF NEW YORK COUNTY OF NEW YORK

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In the Matter of

Index No.: 41294/1986

the Liquidation of

MIDLAND INSURANCE COMPANY

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**REPORT ON THE STATUS OF THE
LIQUIDATION OF MIDLAND INSURANCE COMPANY
AND A PROPOSAL FOR THE DISTRIBUTION OF ASSETS TO CLASS TWO
CREDITORS PURSUANT TO INSURANCE LAW SECTION 7434**

INTRODUCTION

Jody S. Hall, Special Deputy Superintendent of Insurance and Agent of Howard Mills, Superintendent of Insurance of the State of New York, as Liquidator (the “Liquidator”) of Midland Insurance Company (“Midland”) hereby reports on the status of the Midland liquidation proceeding.

By order (the “Liquidation Order”) of the Supreme Court of the State of New York entered on April 3, 1986, Midland was adjudged to be insolvent and placed into liquidation. The Liquidation Order appointed then Superintendent of Insurance James P. Corcoran and his successors in office as Liquidator.

Pursuant to Article 74 of the New York Insurance Law and the Liquidation Order, the Liquidator was charged with the responsibility of, *inter alia*:

- 1) identifying Midland’s policyholders and creditors and notifying them to present their claims;

- 2) marshalling Midland's assets;
- 3) adjudicating the claims presented by Midland's policyholders and creditors and determining the total liabilities of Midland;
- 4) distributing Midland's assets to creditors; and
- 5) otherwise liquidating Midland's business pursuant to Article 74 of the New York Insurance Law.

The Liquidator has been engaged in these tasks since the commencement of the proceedings. This is the Liquidator's report concerning the status of the liquidation of Midland and a proposal for the initiation of asset distributions ("the Report").¹ Based upon the current status of the Liquidation proceeding, as reported herein, the Liquidator is seeking authorization from the Court to make a distribution of assets to Midland's allowed "class two" creditors as defined hereinafter in Section III (B) of the Report.

Midland was a multi-line carrier that wrote, among other things, a substantial amount of excess coverage for major "Fortune 500" companies. Over the past twenty-plus years, these policyholders have been subjected to significant environmental, asbestos and product liability claims that existed in the past and continue to develop today and will develop into the future. Midland also acted as a reinsurer of other primary and excess insurance companies.

Therefore, nineteen years after Midland's liquidation, and eighteen years after the last day established for filing proofs of claim, the Liquidator is confronted with the

¹ In February of 2001, the Liquidator made an application to the Court for approval of a "Guaranteed Dividend Arrangement" whereby National Indemnity Company (Berkshire Hathaway) would pay a distribution to Midland's creditors. However, this application was withdrawn.

defense of a multitude of claims/lawsuits regarding asbestos and carcinogenic dust exposure, defective products (e.g. silicone implants) and environmental pollution claims, among others, with significant domestic and global impact. These are “long-tail” claims, i.e. in many instances, the onset, or at least the continuation, of injury is alleged to be occurring now, many decades after the damage-producing events.

What follows is a history of Midland, a summary of the activities that the Liquidator performed in furtherance of and pursuant to the Order of Liquidation and Article 74 of the Insurance Law and the Liquidator’s proposal for a distribution of Midland’s assets.

I. HISTORY

Midland was incorporated under the laws of the State of New York on October 29, 1959 and began business as a stock casualty insurer on December 31, 1959. Its principal office was located at 160 Water Street, New York, New York 10038.

Midland was authorized under its charter to transact the kinds of insurance specified in paragraphs 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20 and 21 of Section 1113 (a) of the New York Insurance Law. In addition to the State of New York, Midland was authorized to transact business in all fifty states, including the District of Columbia, Puerto Rico, United States Virgin Islands and Canada.

Midland was a wholly owned subsidiary of Ashford Holding Corporation, (known previously as Midland Holding Corporation), a Delaware holding company formed in late 1977 and owned by Bush Universal, Inc., New York, New York, which, in turn, had been a wholly-owned subsidiary of Katy Industries Inc., Elgin, Illinois, a holding company

with interests in commercial fishing, communications, construction, manufacturing and transportation.

Commencing in 1985, the State of New York Insurance Department (the “Insurance Department”) proceeded to closely monitor Midland’s financial condition. On March 7, 1986, the Insurance Department directed Midland to eliminate its impairment and insolvency by March 21, 1986, or the Superintendent of Insurance would seek an order placing Midland into receivership. The Superintendent further directed Midland not to issue any new policies (other than those required by New York Insurance Law).

Midland failed to eliminate its impairment. Midland, by unanimous vote of its Board of Directors, voluntarily consented to the entry of a Liquidation Order pursuant to Section 7404 of the Insurance Law.

The Liquidation Order was entered on April 3, 1986.

II. FINANCIAL CONDITION OF MIDLAND AS OF THE DATE OF LIQUIDATION

On April 3, 1986, the date of liquidation, Midland’s books and records showed total assets of \$307,416,759 and total liabilities of \$354,582,041 making it insolvent in the amount of \$47,165,282.²

A. Assets

1. Cash and Invested Assets

As of April 3, 1986, Midland had cash and invested assets in the total amount of

² The balances presented in this report as of April 3, 1986, previously submitted to the Court in 2000, have been reclassified to conform with NAIC guidelines as have the accompanying financial statements.

\$9,570,973.

2. Reinsurance

The bulk of Midland's reported assets consisted of reinsurance recoverables in the amount of \$225,130,828.³ In addition, Midland had recorded receivables for a loss portfolio transfer (\$21,325,000)⁴ and the sale of a subsidiary (\$2,228,525) in the amount of \$23,553,525. The note receivable in the amount of \$2,228,525 represented the balance due to Midland from the sale of a subsidiary, the Guarantee Security Life Insurance Company. Originally, installment payments were due over a period of years, but the Liquidator and the purchaser of the former subsidiary agreed to an immediate settlement of \$2,228,525, which was collected by the Liquidator in November 1986.

Reinsurance is a company's most significant non-invested asset. Reinsurance is a method by which the insurance industry spreads the risk of losses covered by insurance policies. A company, such as Midland, that issued policies directly to policyholders, transfers or "cedes" a large part of the risks it had assumed to reinsurers. An insurance company can reinsure a particular risk or it can reinsure entire classes of risks. The reinsurers indemnify the ceding company ("cedant") upon the cedant's payment of reinsured risks. In exchange for "assuming" the risks, the reinsurers receive a portion of the premium paid to the cedant.

³ This number includes reinsurance recoverables due on unpaid losses of \$176,546,898 which solvent insurers do not report as assets.

⁴ Midland had purchased aggregate excess of loss reinsurance from New England Reinsurance Company and First State Insurance Company. The receivable amount of \$18,648,938 (net of offsets) was paid to Midland in May 1991.

Reinsurance contracts are indemnity contracts. The reinsurer is not liable to the cedant until the cedant actually pays the claim that is covered by the reinsurance contract. In liquidation, the insolvent insurer must secure court authorization prior to issuing a distribution. However, because of a contractual provision required by the insurance laws known as the “insolvency clause,” the reinsurer is liable to the cedant’s receiver or liquidator upon the allowance of a claim or some similar acknowledgement of the claim’s validity in the insolvency proceeding.

3. Other Assets

The balance of Midland’s assets upon insolvency consisted of (1) premiums in the course of collection in the amount of \$21,717,829, (2) furniture and fixtures valued at approximately \$879,935, (3) miscellaneous assets of \$2,416,620, which included taxes, licenses and fees receivable, and prepaid expenses and (4) accrued investment income of \$457,838. Additionally, Midland had statutory deposits of \$12,975,246. Midland also had equity in its subsidiary, Midland Property & Casualty Co. (“MIDPAC”), then reported at \$8,841,704. Midland also had ownership of a defunct company known as Midland Re Ins. Co. Ltd. (“Mid Re”), a Bermuda subsidiary that wrote maritime assumed reinsurance business from 1972 to 1977. The asset appeared worthless in 1986.

As of April 3, 1986, a receivable in the amount of \$1,872,261 was due from the Ashford Holding Corporation (the parent company) because of an inter-company tax sharing agreement. The amount of \$1,830,354 was paid to Midland and the remaining balance was written off.

B. Liabilities

Midland's records as of April 3, 1986 reflected a gross liability for unpaid claims and claims adjustment expenses reported to be \$283,346,883. Unearned premium liability was reported to be \$12,363,537. Total reinsurance liabilities were reported to be \$55,528,941. The balance of Midland's recorded liabilities consisted of operating expenses and miscellaneous liabilities in the amount of \$3,342,680 resulting in total liabilities reflected in Midland's records of \$354,582,041.

III. LIQUIDATION PROCEEDING

A. Presentation of Proofs of Claim

The Liquidator, in accordance with New York Insurance Law § 7432(b), was obligated to notify all persons who may have had claims against Midland at the date of liquidation, as disclosed by Midland's books and records, to present their claims in this proceeding. The Liquidation Order provides that the last day for filing timely claims in the proceeding was April 3, 1987.

The Liquidator mailed approximately thirty eight thousand five hundred (38,500) proof of claim forms to known policyholders, claimants and other creditors disclosed by Midland's books and records. The proof of claim form provided notice of Midland's liquidation and of the creditor's obligation to present all claims by the proof of claim filing deadline.

The Liquidator was unable to identify every creditor or potential creditor who appeared on Midland's books and records prior to the filing deadline. Upon becoming aware of such a creditor or potential creditor, the Liquidator mailed the creditor a proof of claim form. Provided that the proof of claim form was completed and returned within

four months from the date of the Liquidator's mailing, the proof of claim was deemed timely filed. The claims of recorded policyholders that did not receive a proof of claim form were also accepted as timely filed.

B. Classification of Claims

For companies liquidated prior to June 29, 1995, Article 74 of the New York Insurance Law provided that, with a few limited exceptions, all claims against an insurer in liquidation are general creditor claims and are entitled to share pro rata in the distribution of assets. Thus, the Midland estate was long referred to as a "parity" estate. In 1999, Insurance Law § 7434 was amended to set forth a comprehensive list of nine (9) classes of creditor claims in a specific order of priority of distribution. The statute provided that no distribution could be made to a class of creditor until each claim in the preceding class had been paid in full. This amendment applied to any proceeding under Article 74 of the Insurance Law as to which an order of rehabilitation, liquidation or conservation had been entered on or after such effective date, to wit, June 29, 1999. Accordingly, the 1999 amendments to Section 7434 did not apply to Midland.

Article 74 of the New York Insurance Law has been recently amended pursuant to New York Chapter Law 33 of the Session Laws of 2005 ("Chapter 33") to permit the Workers Compensation Security Fund to take loans against the assets of insolvent, domestic estates, which include Midland. In addition to that change, Chapter Law 33 has made the 1999 scheme for the distribution of assets retroactive so that it applied to liquidations entered prior to June 29, 1999. Thus, Chapter 33's nine classes of creditors, rather than the "parity" estate of creditors, now apply to Midland. Section 7434 sets forth the classes of creditors as follows:

(i) Class one. Claims with respect to the actual and necessary costs and expenses of administration, incurred by the liquidator, rehabilitator or conservator under this article. (Administrative Expenses)

(ii) Class two. All claims under policies including such claims of the federal or any state or local government for losses incurred, third party claims, claims for unearned premiums, and all claims of a security fund, guaranty association or the equivalent except claims arising under reinsurance contracts. (Policy Related Claims)

(iii) Class three. Claims of the federal government, except those under class two above. (Federal Government Claims)

(iv) Class four. Claims for wages owing to employees of an insurer against whom a proceeding under this article is commenced for services rendered within one year before commencement of the proceeding, not exceeding one thousand two hundred dollars to each employee, and claims for unemployment insurance contributions required by article eighteen of the labor law. Such priority shall be in lieu of any other similar priority which may be authorized by law. (Wages Claims)

(v) Class five. Claims of state and local governments, except those under class two above. (State and Local Government Claims)

(vi) Class six. Claims of general creditors including, but not limited to, claims arising under reinsurance contracts. (General Creditor Claims)

(vii) Class seven. Claims filed late or any other claims other than claims under class eight or class nine below. (Late Filed Claims)

(viii) Class eight. Claims for advanced or borrowed funds made pursuant to section one thousand three hundred seven of this chapter. (1307 Claims)

(ix) Class nine. Claims of shareholders or other owners in their capacity as shareholders. (Shareholder Claims)

Prior to the enactment of Chapter 33, when the Liquidator recommended claims for allowance and these recommendations for allowance were presented to the Court for approval, the Notices of Determination and orders allowing the claims stated that these claimants “will” or “may” “be entitled to share in the distribution of assets” of the Midland estate. However, under the current law, because there are now various classes of creditors who will be subordinated to another class of creditors (e.g. vendors will be subordinated to Policy Related Claims), the Liquidator thought it prudent to notify those creditors who will now be subordinated because of the change in the law.

Accordingly, the Liquidator recently issued, by first-class mail, a notice to all creditors with allowed claims whose claims are now subordinated to Policy Related Claims. (*See* Exhibit 1) The notice informed these approximately six hundred (600) creditors of the change in the law and the fact that, prior to the first distribution of assets, Midland is governed by this new law that utilizes the nine classes of creditors as set forth above and afforded them the right to object to that change in classification and request a hearing on such objection.

C. Proofs of Claim Filed

a. Pre-Chapter 33

Prior to classification pursuant to the new scheme of distribution established by Chapter 33, and as of August 31, 2005, twenty seven thousand one hundred sixty eight (27,168) proofs of claim were or had been accepted as timely filed in the Midland liquidation proceeding. A total of two hundred fifty seven (257) proofs of claim were filed

late. These numbers do not include proofs of claim for workers' compensation and no-fault claims.

Of the twenty seven thousand one hundred sixty eight (27,168) timely filed proofs of claim, four thousand nine hundred fifty six (4,956) were voided as duplicate filings. Five thousand six hundred fifty nine (5,659) proofs of claim were filed for "policyholder protection." A "policyholder protection" proof of claim does not seek payment of a particular, known claim. Rather, it provides the policyholder with the right to present claims covered by policies issued by Midland that are presented after the claim filing deadline. This was necessary for Midland where the insurance policies cover predominantly "long-tail" claims.

The number of *proofs of claim* that were filed does not correlate with the actual number of *claims* for dollar relief made against Midland, its policyholders or Midland policies for a number of reasons. First, policyholders who filed policyholder protection proofs of claim have been permitted to submit all claims made against them that are covered by Midland policies to the Liquidator for consideration in this proceeding.

Second, there are three New York Security Funds and fifty-six sister-state guaranty associations (hereinafter "the Funds") which "stand in the shoes" of Midland and pay claims up to various statutory monetary "caps." The Funds are described in more detail below. The Funds were required to file ("blanket") proofs of claim that are subrogated to the rights of the policyholders for whom or for which the Funds make payments. Many thousands of claims by Midland policyholders have been reported as being handled by the Funds and are reflected in regular filings by the Funds in this proceeding. However, because the Funds filed the blanket proofs of claim, the number of

proofs of claim does not reconcile with the number of actual claims made (*See also* Section III D).

Third, as a practical matter, claimants with workers' compensation claims were not required to file proofs of claim because their claims are handled by the New York Workers' Compensation Insurance Security Fund, and sister-state guaranty associations. Thousands of such claims are not reflected in the number of proofs of claims filed.

Fourth, the number of proofs of claim filed by Midland's major policyholder claimants ("MPHs")⁵ is also unrelated to the number of claims covered by their Midland policies. For some MPH policies multiple proofs of claim have been filed or deemed filed for each policy.⁶ The MPH claims can be adjudicated on a claim by claim basis, or on a policy by policy basis. However, the individual claims must be evaluated to determine the extent of Midland's liability under its policies. There may be thousands of such individual claims for each policy for many of these MPHs (e.g. asbestos claimants of an asbestos manufacturer). These individual claims of the MPHs are not reflected in the number of proofs of claim.

Fifth, the number of proofs of claim filed by creditors with reinsurance claims against Midland is based on the number of reinsurance contracts, not the number of claims covered by the contracts. The number of actual claims that require an evaluation by the Liquidator in this category is many times greater than the number of

⁵ "Major Policyholders" are Fortune 500 companies and other corporate entities.

⁶ For each MPH policy, where relevant, a proof of claim is established for environmental, products and asbestos coverage.

proofs of claim filed in this proceeding.

b. Post-Chapter 33

Applying Chapter 33, the claims filed can now be described as follows:

Class one – Administrative Expenses – On an ongoing basis, the Liquidator pays the actual and necessary costs of administering the Midland insolvency estate out of the company’s available assets.

Class two – Policy Related claims – For the purposes of this Report, this is the only class of creditor that will receive any assets from the Midland estate at this time.

The creditors in classes three through nine will not be receiving any distribution of assets at this time, and are not expected to be receiving any distribution of assets from the Midland estate at any time based on the information available to the Liquidator at this time.

D. Adjudication of Proofs of Claim

A proof of claim is “adjudicated” upon the Liquidator’s recommendation to the Court that it either be “allowed” or “disallowed.”⁷ An “allowed” claim is a claim that has been approved by the liquidation court and is allowed to share in the distribution of assets. Subject to statutory limits, claims that are approved and meet the requirements for the Funds’ coverage are paid by the Funds. A “disallowed” claim is a claim that has been rejected and will not share in any payments out of the estate’s assets. Creditors who

⁷ The Court approved a procedure for the disallowance of claims in an order entered March 10, 1994. The Court approved a procedure for the allowance of claims in an order entered January 31, 1997. In 2005, the Court approved an order regarding the allowance of reinsurance claims.

object to the Liquidator's recommendations are entitled to a hearing before the Court or a Court-appointed referee.⁸

As of August 31, 2005, twelve thousand four hundred thirty (12,430) proofs of claim have been adjudicated, of which two thousand eight hundred thirty nine (2,839) proofs of claim have been either allowed or recommended for allowance. Of these, approximately six hundred (600) proofs of claim have been reclassified as class five and class six claims Post-Chapter 33. A total of seven thousand eight hundred sixty three (7,863) proofs of claim have been either disallowed or recommended for disallowance and one hundred eighty two (182) have been withdrawn. Additionally, the Liquidator has also closed one thousand five hundred and forty six (1,546) proofs of claim for claims that have been handled by guaranty associations and are part of the guaranty associations' claims in this proceeding. A total of four thousand three hundred eighty one (4,381) proofs of claims remain open, which include two hundred fifty seven (257) late filed claims.

As set forth above, the adjudication of a proof of claim may reflect the resolution of a single claim or of a large block of claims covered by one or more policies. In order to determine the status of the claims in this proceeding, it is useful to analyze the classes of claims in the context of Chapter 33 as follows:

Class one – (Administrative Expenses) - as previously referenced.

Class two – (Policy Related Claims) As previously referenced and as analyzed here:

⁸ In an order entered February 24, 2000, the Court appointed Bruce Feffer as successor referee to hear and report on objections to the Liquidator's recommendation for disallowance.

a. Security Fund/Guaranty Association Claims

As mentioned earlier, upon an insurer's insolvency and resulting inability to pay claims, the Funds pay certain types of claims arising under policies issued by the insolvent company in their respective states. The Funds "covered claims" are payable up to specified statutory limits. Other types of claims are not covered at all. To the extent that the Funds pay covered losses and associated expenses, they are, in turn, entitled to reimbursement from the insolvent company.

The three New York Security Funds consist of the Property/Casualty Insurance Security Fund ("P/C Security Fund") and the Public Motor Vehicle Liability Security Fund, which are maintained in accordance with Article 76 of the New York Insurance Law, and the Workers' Compensation Security Fund ("W/C Security Fund"), which is maintained in accordance with Article 6A of the Workers' Compensation Law. The fifty-six sister-state guaranty associations pay claims up to various monetary limits with varying limitations on the types of claims or lines of insurance that will be covered.

The Funds have proofs of claim for reimbursement of payments they have made for losses and expenses as a result of Midland's insolvency. The allowances of the Funds' claims are updated periodically based on their payment of the underlying claims and expenses. The Funds' "blanket" proofs of claim will remain open until all claims handled by the Funds have been resolved.

As of August 31, 2005, fifty-seven claims of the Funds have been allowed in the amount of \$453,432,375. However, this amount must be offset by \$10,994,554 which consists of special deposits and salvage and subrogation recoveries retained by the Funds and treated by the Liquidator as an advance dividend. The reserves for open claims of the

Funds are \$109,433,417. The Liquidator continues to submit the claims of the Funds for paid losses and expenses to the Court for allowance as they are evaluated. The respective claims of the Funds will remain open until all underlying claims have been resolved or otherwise quantified.

b. Policyholder Claims

The Policyholder claims that are not covered by the Security Funds and guaranty associations are the great majority of the liabilities in the estate. Policyholders whose claims may be covered by the Funds may file their own claims to recover amounts in excess of the limit of the Funds. Policyholders may also file claims for losses that are not covered by the Funds.

As of August 31, 2005, 1,057 policyholder proofs of claim have been allowed in the amount of \$95,192,441. As of August 31, 2005, there are 3,772 open policyholder proofs of claims with case reserves in the amount of \$1,531,116,457.

Class three - (Federal Government Claims) – None; moreover, if there were any it is unlikely such claim would be resolved.

Class four – (Wages Claims) – None; moreover, if there were any it is unlikely such claim would be resolved.

Class five- (State and Local Government Claims) - As of August 31, 2005 there are 39 claims allowed in the amount of \$301,908. There are claims reserves in the amount of \$8,576,527. The claims that were allowed were sent the notice referred to in Section III B notifying them that they were subordinated to class two creditors. There are twelve open claims. It is unlikely that any such claim will be resolved.

Class six – (General Creditor Claims) - As stated previously it is unlikely that any such claim will be receive a distribution. Among these are:

a. Reinsurance Claims

Reinsurance claims include all claims arising under reinsurance contracts for which Midland acted as a reinsurer or as a reinsured. (Midland “assumed” reinsurance from companies such as Kemper Insurance Co. in addition to “ceding” reinsurance to Kemper.) In cases in which Midland was a reinsurer, the insurer is seeking payment for losses and expenses covered by the reinsurance contract. In cases where Midland was the reinsured, the reinsurer is seeking payment for premium due under reinsurance contracts.

As of August 31, 2005, there were seven hundred twenty (720) reinsurance proofs of claim. There are currently two hundred forty (240) open claims filed in the estate. These reinsurance claimants have reported losses of \$140,337,684 which have been categorized as class six creditors. The Liquidator has not yet fully resolved Midland’s reinsurance claims because these claims continue to develop as losses and expenses covered by the reinsurance contracts are reported. Therefore, it can be anticipated that additional liabilities will develop from Midland’s book of assumed business.

Although assumed reinsurance claims are class six claims in the priority of distribution of assets and may not be paid any assets from this estate, the claims must be closely adjudicated for several reasons. First, the claims may have potential retrocessional reinsurance collection recoveries behind them, i.e. if valid, the claims can be allowed and, if Midland reinsured them with other reinsurance companies, it could result in additional assets into the estate. Second, the claims may be eligible for offset; this is discussed in detail in Section V(A).

b. Non-reinsurance General Creditors

As of August 31, 2005, there are approximately five hundred twenty four (524) of these creditors with allowed claims in the amount of \$3,022,635. There are twenty five (25) outstanding such claimants with a case reserve of \$209,992. This is another group of creditors that were mentioned in Section III (B) of this report to whom notice was sent because they were originally sent Notices of Determination which stated that they would share in the assets of the estate. These creditors will now be subordinated to class two creditors.

Class seven – (Late Filed Claims) In the past, creditors who filed their proofs of claim past the filing date were classified as “deferred.” Under Chapter 33, they are now classified as 7th class creditors. There are two hundred fifty seven (257) late filed claims with stated amounts totaling approximately \$170 million. As stated previously it is unlikely that any such claim will receive a distribution.

Class eight – (Section 1307 Claims)

No claims applicable.

Class nine – (Shareholder Claims)

No claims applicable.

E. Cash Receipts

As of August 31, 2005, the Liquidator has cash and invested assets in the total amount of \$225,636,845. Midland’s Comparative Balance Sheet as of August 31, 2005 and April 3, 1986 and the statement of cash receipts and disbursements for the period ending from April 3, 1986 (the Liquidation date) to August 31, 2005 are annexed hereto as Exhibit 2.

1. Investment Income

As of August 31, 2005, the Liquidator earned \$101,656,029 on Midland's invested assets. Midland's assets are invested in government and political subdivision bonds and Treasury Bills.

2. Reinsurance

As of August 31, 2005, the Liquidator has recovered reinsurance in the amount of \$184,533,698.⁹

3. Premium Received

As of August 31, 2005, the Liquidator has collected premium totaling \$9,502,691.

4. Salvage and Subrogation

The Liquidator had made salvage and subrogation recoveries in the total amount of \$9,967,470.

5. Federal Tax Refund

The Liquidator recovered \$1,830,354 from Ashford Holding Corp. pursuant to a 1979 Tax Allocation Agreement.

6. Miscellaneous

The Liquidator has made miscellaneous recoveries in the total amount of \$19,895

7. MIDPAC and Mid Re

After the liquidation of Midland, Midland's New York subsidiary MIDPAC was placed into voluntary liquidation. The Liquidator has reviewed the value of its asset in MIDPAC and determined that it currently has no value. The Liquidator has also

⁹ The Liquidator is in receipt of an August 10, 2005 approval of a \$36,004,549 allowance of its ceded reinsurance claims in the AMRECO Illinois Rehabilitation. Sixty percent of this amount is expected to be paid in November 2005 and the balance is to be paid over time pursuant to the terms of the settlement.

reviewed the value of its defunct Bermuda subsidiary, Mid Re, and determined that it has no value.

F. Cash Disbursements

1. Administrative Expenses

The Liquidator has incurred administrative, legal and consulting expenses, net of reimbursements by the P/C Security Fund and W/C Security Fund, in the amount of \$88,428,589 from April 3, 1986 through August 31, 2005. The administrative expenses consist of salaries and related costs for the Liquidator's staff in the total amount of \$57,853,076; rent in the amount of \$14,739,325; and overhead expenses for such items as insurance, office equipment and supplies, postage and telephone, printing, stationery, and other miscellaneous items total \$9,984,630.

The Liquidator has paid the total amount of \$3,291,281 to counsel retained to represent him in various legal actions to collect assets, including those involving the collection of reinsurance. The Liquidator has paid the total amount of \$17,138,367 to consultants required to evaluate claims, bill reinsurance, develop and implement systems, assist in collection litigation and to provide accounting and audit reports.

As discussed further below, the Liquidator has paid \$3,015,676 in the form of a loan to the W/C Security Fund out of the assets of Midland as of August 31, 2005.

The Administrative expenses and other disbursements set forth above total \$106,022,355. However, \$14,578,090 relates to expenses that have reimbursed by the Property/Casualty Security Fund and W/C Security Fund. After offsetting these Funds' expense payments, the cash disbursements of the estate total \$91,444,265.

Although not recorded as a cash transaction or reflected in the Statement of Changes in Cash and Investments, statutory deposits, related interest income and salvage and subrogation recoveries totaling \$10,994,554 have been released to, or received by, the Funds and are recognized by the Liquidator as an advance dividend distribution. As of August 31, 2005, the remaining statutory deposits of \$7,817,812 are being administered by ancillary receivers in other states and Canada.

2. Loan Pursuant to Chapter 33

Not only did Chapter 33 change the priority scheme as it related to Midland, it also provides that upon certification by the Superintendent that further sums are required by the Workers' Compensation Security Fund to meet its obligations and accomplish the purposes of Article 6A of the Workers' Compensation Law, the Superintendent is authorized to make one or more loans to the W/C Security Fund, up to a total of \$70 million in the aggregate, from the assets of one or more of the liquidation estates in such amounts as established and specified by the Superintendent.

Section 1 of Chapter 33 further provides that any loan pursuant to Section 7433-a shall be a liability of the W/C Security Fund and shall be repaid pursuant to a plan of repayment to be prescribed by the Superintendent. Section 1 of Chapter 33 also provides that a repayment plan shall, among other things, require that any loan shall be made upon commercially reasonable terms in accordance with the Superintendent's fiduciary responsibilities and that no less than one-fourth of the payment collected pursuant to Section 108 of the Workers' Compensation Law shall be dedicated to the repayment of any loans made pursuant to that Section.

In accordance with Chapter 33, the Superintendent directed that:

1. Further sums are required by the W/C Security Fund to meet its obligations and accomplish the purposes of Article 6A of the Workers' Compensation Law.
2. The following six (6) liquidation estates which have the largest W/C Security Fund liabilities (the "Estates"), will transfer to the W/C Security Fund the money necessary to provide for the continuous payment of claims (the "Loan"):

Midland Insurance Company in Liquidation

Union Indemnity Insurance Company in Liquidation

Ideal Mutual Insurance Company in Liquidation

First Central Insurance Company in Liquidation

Transtate Insurance Company in Liquidation

Cosmopolitan Mutual Insurance Company in Liquidation

3. Loan Period
 - a. The Estates will transfer the money, over the course of a one-year period, in proportion to their W/C Security Fund liabilities as determined on the last day of the month preceding the date of the first Loan ("Adjustment Date"). The day the loan is made is the "Loan Date".
4. Loan Terms
 - a. The principal balance on the first anniversary of the Loan Date is the maximum Loan allowed and in no event shall the Loan exceed \$70 million.

5. Repayment

- a. Starting on the Loan Date, interest on each Loan shall be calculated at the rate of prime plus .5% simple interest and adjusted on each anniversary of the Adjustment Date. Prime is the rate in effect on the Adjustment Date.
- b. Interest and principal is to be paid quarterly.
- c. The W/C Security Fund may pay proportionally to the Estates, without penalty, all or a portion of the amount owed earlier than it is due.
- d. The Superintendent will dedicate at least one-fourth of payments collected, pursuant to Section 1 of Chapter 33, to repaying principal. Interest payments are to be made from the remainder of the payments.

As noted above, the Liquidator has loaned the W/C Security Fund a total of \$3,015,676 as of August 31, 2005 pursuant to the above provisions.

IV. CLAIMS DEVELOPMENT

The actual development of losses has greatly exceeded the reserves established by Midland prior to liquidation. Midland's loss development is, in part, related to the fact that Midland wrote specialty casualty business, including umbrella and excess liability and reinsurance policies, many with multiple layers of significant excess coverage for various Fortune 500 and other large corporate policyholders. In many instances, Midland participated in various layers of coverage over many different years, including years that

have given rise to the greatest activity of asbestos and environmental claims for the insurance industry.

The MPHs of Midland are the subject of much of this claims activity. The MPHs have been presenting claims to their respective insurance companies for decades, but have focused on seeking recovery from solvent insurers. Therefore, Midland has yet to adjudicate most of the direct claims arising from its MPH business.

Midland was frequently a major participant on a MPH insurance program. For many MPHs, thousands of asbestos, pollution, or other claims have been filed, and billions of dollars have been spent by insurers in settlement and defense of such claims. It is expected that the adverse development will continue into the foreseeable future. Other types of claims may also emerge as new legal and scientific theories of liability are developed.

In addition to the asbestos and pollution claims, other exposures have developed for that generation of casualty insurers of which Midland was a member. Breast implant cases, latex glove exposures, and the possibility of tobacco coverage litigation are also potential risks embedded in Midland's MPH business. To the extent that these claims develop into greater losses for the insurance industry, Midland's assumed reinsurance business would also be subject to claims, which may be important to Midland for purposes of offset in its reinsurance collection actions with ceding reinsurers.

V. PROPOSAL FOR DISTRIBUTION OF ASSETS

Until now, Midland's large insolvency and uncertain, but significant, exposure on its long tail excess business and reinsurance business have made it imprudent to establish a dividend percentage for a parity distribution of assets. However, based on the recent

legislative change an evaluation of the current assets and reserves, the Liquidator believes that it is now reasonable and prudent to begin to make distributions of Midland's assets to priority creditors.

A. Assets and Liabilities

As of August 31, 2005, Midland had total assets in the amount of \$1,182,156,933 and total liabilities in the amount of \$3,111,918,183, leaving Midland insolvent in the amount of \$1,929,761,250. (See Exhibit 2, Midland Insurance Company In Liquidation Statement of Net Assets and Statement of Net Liabilities ["Balance Sheet"].) The insolvency reported at the liquidation date of April 3, 1986 was \$47,165,282. The primary reason the insolvency has proven to be significantly larger than first reported is because the actual development of losses has been many times the estimated reserve at the date of liquidation. The August 31, 2005 Balance Sheet reflects the sum of the transactions described above.

Midland has reinsurance collection claims with certain reinsurance companies that have asserted "offset" claims with Midland based on monies Midland owes those reinsurers for premium or for reinsurance proceeds where Midland acted as a reinsurer of the company from which it is seeking to collect (i.e. the companies reinsured each other).

In *Kemper Reinsurance Co. v. Corcoran, Liquidator of Midland Insurance Co.*, 79 N.Y. 2d 253, 590 N.E. 2d 1186, 582 N.Y.S.2d 58 (1992), the Court of Appeals interpreted New York's offset statute, § 7427(a)¹⁰. In short, the *Kemper* decision held that mutual debts (or claims) between a ceding insolvent insurer such as Midland and an

¹⁰ "In all cases of mutual debts or mutual credits between the insurer and another person in connection with any action or proceeding [in rehabilitation or liquidation], such credits and debts shall be set off and the balance only shall be allowed or paid."

assuming reinsurer such as Kemper may be offset against each other as long as the debts are between the same parties acting in the same legal capacity. Because of this offset decision, Midland must carefully audit all assumed claims to ensure that the any offset claim asserted by the assuming reinsurer is legitimate so that collections from that reinsurer are optimized.

B. Potential Distribution of Assets

One of the Liquidator's duties is to distribute Midland's assets to creditors with allowed claims pursuant to the priority requirements of § 7434. The Liquidator has, as of August 31, 2005, adjudicated twelve thousand four hundred thirty (12,430) proofs of claim, of which, one thousand one hundred fourteen (1,114) class 2 claims have been allowed in the amount of five hundred forty eight million six hundred twenty four thousand eight hundred fifteen dollars (\$548,624,816). There are three thousand eight hundred and twenty nine (3,829) open class 2 creditor claims (including the claims of the Funds) for which there are case reserves in the approximate amount of \$1.6 billion.

Although Midland has been in liquidation since 1986, claims arising under direct policies issued by Midland that are covered by policyholder protection proofs of claim may continue to be reported. Based on the assets currently available, the Liquidator will consider and intends to make a distribution to creditors whose claims have been allowed in accordance with the requirements of § 7434. In order to calculate a feasible distribution percentage, the Liquidator must determine Midland's distributable assets and make a conservative estimate of Midland's outstanding liabilities. This approach is necessary to insure that there will be sufficient assets to pay all creditors within a class, including creditors whose claims have yet to be adjudicated or reported.

Midland's distributable assets consist of its cash and invested assets (\$225,636,845) less a reserve for administrative expenses (\$60,000,000). As of August 31, 2005, Midland's distributable assets totaled \$165,636,845. Additionally the Liquidator anticipates reinsurance collections in the amount of \$940,365,682 (*see* Balance Sheet). Midland's total class 2 liabilities as of that date were \$2,783,180,136.

As set forth in Section III(B), the priority of distribution of assets is prescribed by § 7434. Section 7434 provides that every claim in each class shall be paid in full or adequate funds retained for such payment before the members of the next class receive any payment.

Section 7434a(1) provides in pertinent part:

Upon the recommendation of the superintendent, and under the direction of the court, distribution payments *shall be made in a manner that will assure the proper recognition of priorities and a reasonable balance between the expeditious completion of the liquidation and the protection of unliquidated and undetermined claims.* . . . No claim by a shareholder, policyholder or other creditor shall be permitted to circumvent the priority classes through the use of equitable remedies.

(Emphasis supplied). In view of the above, the Liquidator believes that the affairs of the estate are in a condition such that a distribution on allowed claims can now be made to class two creditors.

C. Payment to Creditors

The Liquidator has accounted for the company's financial situation through August 31, 2005 and reserved for the claims of class two creditors which have yet to be adjudicated. This is necessary to ensure that there will be sufficient assets to pay all class two creditors.

D. Notice

The Liquidator proposes to give notice of the Verified Petition for Approval of this Report (the “Petition”) and Order to Show Cause to Midland policyholders and other creditors with allowed or unadjudicated claims in the form annexed as Exhibit 3 (the “Notice”) by serving a copy of the Notice by U.S. Mail. Given the significant number of such creditors, the Liquidator proposes to notify such policyholders and creditors and other interested parties by publication of the Notice in the New York Times and Mealey’s Report - Insurance, such publication to occur once in each of the two weeks following issuance of the Order to Show Cause, along with supplementary notice in certain electronic publications to state guaranty associations.

VI. CONCLUSION

The Liquidator recommends that the proceedings shall remain open until all open and subsequently reported claims are adjudicated. Notices of Determination will be sent to the creditors. Any disputes with such creditors will be resolved and all recoverable reinsurance and other assets of this estate will be collected and distributed to the creditors.

In the interim, the Liquidator, with the Court’s approval, will consider making periodic distributions of assets if and when such distributions are feasible and prudent.

Therefore, the Liquidator respectfully requests an order that:

- a. approves this Report;
- b. approves the transactions described in the Report;
- c. approves the Proposal and authorizes the Liquidator to make a distribution of assets in accord with the requirements of Section 7434 of the New York Insurance Law;

- d. approves the Notice and provisions for publishing and mailing; and
- e. provides for such other relief as is just.

Dated: New York, New York
October ____, 2005

Jody S. Hall