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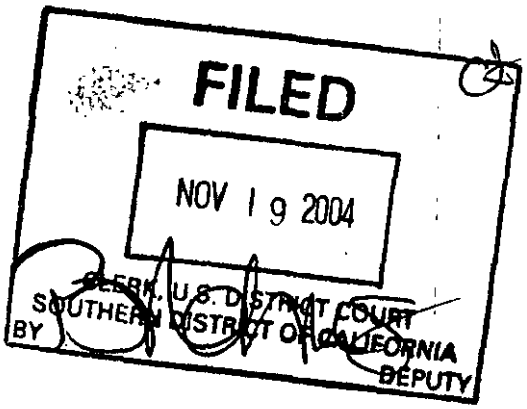

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

UNITED STATES OF AMERICA

Plaintiff,

v.

L. DONALD GUESS; LESLIE S. BUCK; DAVID JACQUOT; MONTE T. MELLON; G. THOMAS ROBERTS; CHRIS G. EVANS; NIGEL BAILEY; DOCTORS BENEFIT INSURANCE COMPANY, LTD.; DOCTORS BENEFIT HOLDING COMPANY; DOCTORS INSURANCE SERVICES, INC.; XÉLAN INVESTMENT SERVICES, INC.; XÉLAN ANNUITY CO., LTD.; XÉLAN ADMINISTRATIVE SERVICES, INC.; XÉLAN FOUNDATION, INC.; XÉLAN OF TEXAS, INC.; XÉLAN, INC.; XÉLAN, THE ECONOMIC ASSOCIATION OF HEALTH PROFESSIONALS, INC.; PYRAMIDAL FUNDING SYSTEMS, INC.; dba XÉLAN INSURANCE SERVICES; XÉLAN PENSION

CASE No. 04-CV-2184 ~~W~~(AJB).

Judge: Larry A. Burns

Date: December 3, 2004
Time: 1:30 a.m.

OPPOSITION OF DEFENDANTS XÉLAN INVESTMENT SERVICES, INC., XÉLAN ANNUITY CO., LTD., AND XÉLAN ADMINISTRATIVE SERVICES, INC. TO APPLICATION TO MOTION FOR PRELIMINARY INJUNCITON APPOINTMENT OF RECEIVER AND REPATRIATION OF FOREIGN ASSETS

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SERVICES, INC.; XÉLAN FINANCIAL PLANNING, INC.; EURO-AMERICAN TRUST COMPANY; AMS TRUST COMPANY; and JOHN DOES, UNKNOWN PERSONS WHO ARE TRUSTEES OF XÉLAN LONG TERM CARE TRUST, XÉLAN DISABILITY EQUITY TRUST, XÉLAN MALPRACTICE EQUITY TRUST and XÉLAN MEDICAL SAVINGS EQUITY TRUST,

Defendants.

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I. INTRODUCTION

Defendant xélan, Investment Services, Inc. is a registered investment advisor. It is owned by Dr. L. Donald Guess ("Guess"), and affiliated with xélan, the Economic Association of Healthcare Professionals, Inc. (the "Association"), a non-profit membership organization. It provides asset management services to Doctors Benefit Insurance Company, Ltd. ("DBIC") and the xélan Foundation ("Foundation"), as well as investment management services to xélan members and their pension plans. Defendant xélan Annuity Company, Inc. is a company owned by Guess that provided insurance products to xélan members. Defendant xélan Administrative Services is a company that provided bookkeeping and personnel services, and assisted in the sharing of expenses by the various xélan entities.

For the last several years, a DBIC insurance product, the Group Supplemental Disability Policy ("Group Policy") has been the focus of scores of Internal Revenue Service ("IRS") civil examinations. The Group Policy was designed by an independent law firm, with special expertise in the area of insurance and offshore captive insurance companies. This law firm, as well as a second law firm, provided opinions regarding the tax consequences of the programs. To date, no court has ruled on the deductibility of the disability insurance premiums made by xélan members for their participation in the Group Policy.

DBIC has filed a separate opposition, as has the founder of xélan, L. Donald Guess, and the Foundation. In this brief, we will attempt not to duplicate their arguments, but we adopt them by reference here. In this brief, the Defendants address: (1) the lack of statutory basis for the

extraordinary relief sought by the government; and (2) the government's assertion that the Group Policy operates a fraud on the xélan members who participate in that program.

II. THERE IS NO STATUTORY BASIS FOR THE REQUESTED RECEIVERSHIP.

The complaint is brought under two statutes, 18 U.S.C. § 1345 and 26 U.S.C. § 7402, which provide this Court with authority to enter injunctions in fraud cases and tax cases, respectively. Under the auspices of the fraud injunction statute (18 U.S.C. § 1345), the government seeks to freeze all of Guess's personal assets, all of the assets of several corporations of which Guess is the sole owner (including four entities which are presently involved in Chapter 11 Proceedings), as well as those of DBIC and the Foundation, on the grounds that policyholders of the insurance company and the donors to the Foundation were defrauded into paying premiums and making contributions. Then, rather than return the assets to the alleged "victims," which would be the norm in a fraud case, the government seeks to hold onto these assets under the authority of the tax injunction statute (26 U.S.C. § 7402), on the theory that the "victims" will in turn owe large amounts of federal income tax, based on their participation in the programs offered through xélan. Hence, the government seeks to freeze and hold all assets to satisfy yet undetermined tax liabilities, disregarding entirely the interests of creditors in the Chapter 11 Proceedings, policyholders of the insurance company, and the fundamental rights of Guess to utilize his assets to defend his freedom. *The statutes provide no basis for the extraordinary and completely unwarranted relief requested in* this case.

A. There Is No Basis For A Receivership Under 18 U.S.C. § 1345.

Section 1345(a)(1) of Title 18 provides that if a person is violating or about to violate certain Title 18 fraud statutes, including sections 1341 and 1343, or committing or about to commit a

federal health care offense or banking law violation, the Attorney General "may commence a civil action in any Federal court to enjoin such violation." In the case of federal health care violations or banking law violations, 18 U.S.C. § 1345(a)(2)[1] provides statutory authority for the issuance of a restraining order, including the appointment of a temporary receiver, when the government can establish:

> [the] person is *alienating or disposing of property*, or intends to dispose of property, *obtained as a result of a banking law violation* ... or a *federal health care offense*, or property which is traceable to such violation ...

The government has not alleged any type of banking law violation or federal healthcare offense. Nor has it alleged that the property over which it seeks to appoint a receiver was "obtained as a result of a banking law violation ... or a federal health care offense."

Assuming, *arguendo*, that there is evidence of ongoing violations of either 18 U.S.C. §§ 1341 or 1343 (which Defendants vigorously dispute), there is no statutory provision for the appointment of a receiver as a remedy.[2] The only way this Court could appoint a receiver would be in the exercise of its equitable powers. But, as the Supreme Court held in *DeBeers Consolidated Mines, Ltd. v. United States*, 325 U.S. 212, 65 U.S. 1130 (1945), the interim relief of an asset freeze/appointment of a receiver is only appropriate if the court has the authority to enter final

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[1] Section 1345(a)(2) was added by the Crime Control Act of 1990, Pub.L. No. 101-647, § 2521(b)(2), 104 Stat. 4789, 4865, 4925 (1990). Subtitle XXV(B), which contained the "banking law violation" amendments to 1345, was entitled "Protecting Assets from Wrongful Disposition." The legislative history indicates that the purpose of the statute was to enhance the United States' ability to prevent the wrongful disposition of assets after banking law violations had occurred. H.R.Rep. No. 101-681, 101st Cong., 2nd Sess. 74, reprinted in 1990 U.S.C.A.N. 6472, at 6584. *Also see* the Statement of Rep. Schumer, 136 Cong.Rec. H13288, H13296 (Oct. 27, 1990) ("We provide for prejudgment attachment and asset freezes. You do not want the savings and loan crooks to abscond and escape with their money. This bill will stop it.")

[2] The government has also alleged that Guess violated 18 U.S.C. § 1954. This statute is not one of the predicate statutes which gives rise to the ability to seek an injunction under 18 U.S.C. § 1954.

injunctive relief of the same character. Here, 18 U.S.C. § 1345 does not provide the district court with authority to enter such relief.

In *DeBeers*, the government brought an action to enjoin violations of the Sherman Act, specifically an alleged conspiracy to monopolize trade in gems and industrial diamonds (allegedly illegal under Sections 1 and 2 of the Sherman Act). The action was brought under Section 4 of the Sherman Act, which conferred jurisdiction upon district courts "to prevent and restrain violations of this act." The government requested and the district court had granted a restraining order, covering over $700,000 in assets. While the government argued that the restraint of assets was within the district court's inherent power in equity, the Supreme Court disagreed:

> Under the Sherman Act and the Wilson Tariff Act, the District Court has no jurisdiction in this suit to enter a money judgment. Its only power is to restrain the future continuance of actions or conduct intended to monopolize or restrain commerce. It, of course, has the power, pending final action in this respect, to restrain action or conduct violative of the statute. *A preliminary injunction is always appropriate to grant intermediate relief of the same character as that which may be granted finally. The injunction in question is not of this character. It is not an injunction in the cause, and it deals with a matter lying wholly outside the issues in the suit. It deals with property which in no circumstances can be dealt with in any final injunction that may be entered.* It is not a form of seizure of property used in offending against the statute for the property is not such as might be seized under s 6 of the Sherman Act or under s 76 of the Wilson Act, and the complaint and affidavits do not so charge. The process is, and can only be, sustained as a method for providing compliance with other process which conceivably may be issued for satisfaction of a money judgment for contempt.

325 U.S. at 220, 65 S.Ct. at 1134 (Footnotes omitted. Emphasis supplied).

The language of the 18 U.S.C. § 1345(a)(1) provides that the Attorney General may commence an action "to enjoin such violation." This language of § 1345(a)(1) does not differ materially from the language of the Sherman Act at issue in *DeBeers*, which provides the district court with authority to "prevent and restrain violations," allowing the government to request that the violation shall "be

enjoined or otherwise prohibited" and authorizing the issuance of a "temporary restraining order or prohibition as shall be deemed just."

The courts continue to apply the rule in *DeBeers* to determine if a requested restraint on assets is within the power of the district courts.[3] Indeed, the continued vitality of *DeBeers* was recently reaffirmed by the Supreme Court in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 326-327, 119 S.Ct. 1961, 1972 (1999).

In *Reebok Int'l, Ltd. v. Marnatech Entertainment, Inc.*, 970 F.2d 552 (9th Cir. 1992), the Ninth Circuit recognized that, under *DeBeers*, the power to restrain assets does not exist in every case:

> While a court generally has the power 'to preserve the status quo by equitable means [and][a] preliminary injunction is such a means,' [*Republic of Philippines v.*] *Marcos*, 862 F.2d [1355] at 1361 [(9th Cir. 1988) (*en banc*)], the equitable power to freeze assets does not exist in all cases: it exists only as 'ancillary relief necessary to accomplish complete justice.' [*FTC v. H. N.*] *Singer*, [*Inc.*], 668 F.2d [1107] at 1113 [(9th Cir 1982)]. 'Because the authority to issue a preliminary injunction rests upon the authority to give final relief, *the authority to freeze assets by a preliminary injunction must rest upon the authority to give a form of final relief to which the asset freeze is an appropriate provisional remedy*. *Id.* at 1113.

Reebok, 970 F.2d at 560 (emphasis supplied).

In the *Reebok* case, the Ninth Circuit ruled that a preliminary asset freeze was appropriate because the statute at issue (the Lanham Act) provided the trademark holder with a right to an *accounting for and return of* the infringer's fraudulently obtained profits as a form of final equitable relief. *Reebok*, 970 F.2d at 559-560.

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[3] In *Fed. Sav. & Loan Insur. Corp. v. Dixon*, 835 F.2d 554, 560 (5th Cir. 1987) and *Hoxworth v. Blinder, Robinson & Co, Inc.*, 903 F.2d 186 (3d Cir. 1990), the Courts of Appeal determined that the restraint sought exceeded, in whole or in part, the authority of the district court. However, in; *Reebok Int'l, Ltd. v. Marnatech Entertainment, Inc.*, 970 F.2d 552 (9th Cir. 1992) and *Teradyne, Inc. v. Mostek Corp.*, 797 F.2d 43 (1st Cir. 1986), the Courts distinguished the various circumstances before it from *DeBeers*, and held that that pre-judgment restraint was available because the nature of final relief in the case might include a money award or its equivalent.

In this case, the operative language of § 1345(a)(1) is nearly identical to that of Section 4 of the Sherman Act (the statute at issue in *DeBeers*). Both statutes provide the government with the authority to seek an injunction against the defendant's violation of a set of statutes. Thus, following the precepts set out in *DeBeers*, unless there is some final equitable relief authorized under the statute, an asset freeze is inappropriate. Unlike the Lanham Act provisions at issue in *Reebok*, § 1345(a)(1) does not authorize the ability to seek an accounting or a return of improperly obtained profits as a form of final equitable relief.

The only case to address the limitations imposed by *DeBeers* in the context of a preliminary injunction action under § 1345 is *United States v. Cohen*, 152 F.3d 321 (4th Cir. 1998). Following *DeBeers*; the *Cohen* court ruled that the inherent equitable power of the court did ***not*** provide a basis for an asset freeze. *Cohen*, 152 F.3d at 324. The court ruled that an asset freeze might be appropriate under 18 U.S.C. § 1345(a)(2), as the government had claimed that the defendant was disposing of property obtained as result of past banking law violations. *Cohen*, 152 F.3d at 325.[4]

[4] In the late 1980s and early 1990s, two courts ruled that the version of 18 U.S.C. § 1345 in place at the time (which did not include provisions permitting restraining orders for banking law violations or federal healthcare offenses), along with the general equitable powers of the court, provided broad authority for the issuance of restraining orders that froze assets. *United States v. Cen-Card Agency/C.C.A.C.*, 724 F. Supp. 313, 318 (D.N.J. 1989), *aff'd* in part and dismissed in part on other grounds, 961 F.2d 1569 (3d Cir. 1992); *United States v. William Savran & Assoc., Inc.*, 755 F. Supp. 1165, 1182 (E.D.N.Y. 1991). Subsequently, in *United States v. Brown*, 988 F.2d 658, 661-662 (6th Cir. 1993), the court specifically considered the statute after its amendment in 1990 (in the wake of the S&L scandals) to provide for the ability to obtain asset freezes in situations where banking law violations are alleged (18 U.S.C. § 1345(a)(2)). With respect to non-banking law violations, the *Brown* court followed *Cen-Card* and *Savran*, and ruled that the district court had the general power to grant asset freezes under the statute and pursuant to its general equitable powers. None of these cases, however, addressed the limitations imposed by *DeBeers* and its progeny.

Even if the requested asset freeze did not run afoul of *DeBeers* and *Reebok*, the injunctive relief requested in this case is unprecedented in that it does not attempt to provide restitution to those the government contends are "victims." Rather, the government seeks to delay the restitution on behalf of a potential creditor of the putative victims, i.e., the IRS. At least one court has noted the potential constitutional problems with respect to an indefinite asset freeze:

> Although the statute contemplates the possibility of injunctive relief at any stage of the proceedings, as a practical matter any preliminary injunction will almost certainly be followed in a timely fashion by a criminal proceeding. A permanent injunction freezing assets not followed by a criminal trial would be virtually impossible to justify and would undoubtedly invite serious constitutional challenge.

United States v. Fang, 937 F. Supp. 1186, 1197 n.11 (D. Md. 1996). Fundamental notions of due process are clearly violated in light of the government's efforts to freeze all of Guess's assets at the same time he is the target of a criminal investigation. Likewise, the government cannot constitutionally justify seeking a receiver on the grounds of fraud, but then retain the alleged victims' funds on behalf of a potential creditor of the victims.

B. There Is No Statutory Basis For A Receivership Under 26 U.S.C. § 7402(a).

In an ordinary fraud case, a receiver would be tasked with returning the money he/she collected to the "victims." In this case, the government requests that the funds collected by the receiver not be returned, but rather be held by the receiver for the benefit of the government, which anticipates having substantial tax claims against the "victims." As support for its request for the appointment of a receiver, the government relies upon 26 U.S.C. § 7402(a), which, in the government's view, allows the district court to grant any request that might assist the IRS in the enforcement of the Internal Revenue Laws. Memorandum of Points and Authorities ("Govt. Memo") at pgs. 11-12. While the district courts possess broad authority to take steps to compel compliance with the Internal Revenue

Laws, the request for relief made here vastly exceeds the relief available because: (1) there is no federal tax dispute before the district court that justifies the interim appointment of a receiver; (2) the IRS's legal remedies are more than adequate; and (3) the government has failed to meet the requirements of procedural due process by offering a prompt post-deprivation hearing to those xélan members whose interest in the policies were seized without notice.

1. There Is No Federal Tax Dispute Before The Court That Justifies The Appointment Of A Receiver.

Section 7402(a) of Title 26 provides the district courts with,

> jurisdiction to make and issue in civil actions, writs and orders of injunction, and of *ne exeat republica*, orders appointing receivers, and such other orders and processes, and to render such judgments and decrees as may be necessary or appropriate for the enforcement of the internal revenue laws.

While the language is broad, the propriety of the relief sought is determined on a case by case basis. *United States v. Maryans*, 803 F. Supp. 1378 (N.D. Ind. 1378) (*citing United States v. Mellon Bank, N.A.*, 521 F.2d 708, 711 (3d. Cir. 1975. The appointment of a receiver is not authorized merely because a party may ultimately be found to be indebted for taxes. *Goldfine v. United States*, 300 F.2d 260, 264 (1st Cir. 1962). Here, the situation is even further removed, because the persons who the government asserts may owe additional taxes to the IRS are not even parties to these proceedings.

While § 7402 authorizes the appointment of a receiver, such appointment is a form of provisional relief, placing assets in the control of the court, in order that the court can later determine the respective rights of the parties to these assets:

> The appointment of a receiver is ***incidental*** to the purpose of effecting other relief. *Pouliot v. West India Fruit Co.*, 283 Mass. 182, 186 N.E. 52, *Willson v. Waltham Watch Co.*, 293 F. 811 (D.Mass. 1923). 'The possession of the receiver is the possession of the court; and the ***court itself holds and administers***

> *the estate* through the receiver, as its officer, ***for the benefit of those whom the court shall ultimately adjudge to be entitled to it.***' *Porter v. Sabin*, 149 U.S. 473, 479, 13 S.Ct. 1008, 1010, 37 L.Ed. 815; *United States v. Bank of New York & Trust Co.*, 296 U.S. 463, 56 S.Ct. 343, 80 L.Ed. 331 (1936); *Wellman v. North*, 256 Mass. 496, 152 N.E. 886 (1926); *Harrison v. J.J. Warren Co.*, 183 Mass. 123, 66 N.E. 589 (1903).

Goldfine v. United States, 300 F.2d 260, 263 (1st Cir. 1962) (Emphasis supplied.).[5]

Here, the government has not requested the appointment of a receiver as preliminary or *incidental to* the court's subsequent determination of the rights of the various parties in the assets over which a receivership is sought. In fact, the government is not even requesting that this Court ultimately determine who is entitled to the assets placed under receivership. Indeed, if the IRS ultimately asserts additional tax liabilities against xélan members who participated in the Group Policy or contributed to the Foundation, and these asserted liabilities are contested, the existence and amount of these liabilities will be litigated in the United States Tax Court, the United States District Court for the district where the various xélan members reside, or the United States Court of Federal Claims. Except with respect to those xélan members who reside in the Southern District of California (who in any event may choose to litigate in the Tax Court or the Court of Federal Claims), the issue of the tax liabilities of the xélan members will ***never*** be before this Court. Even if one or more xélan members residing in the Southern District of California file refund actions in this Court, that refund action will *not* be part of the instant case. Thus, the appointment of a receiver to hold funds (which the government alleges belong to the xélan members) for the benefit of the IRS is not proper in this case because the issue of the IRS's entitlement to such funds cannot and will not be ***adjudicated*** as part of this action.

[5] In *Goldfine v. United States*, 300 F.2d 260, 262 (1st Cir. 1962), the court held that the government was not entitled to the "drastic remedy of receivership" if it were fully secured by solid liens.

> The collection of past due tax monies, as the United States concedes, is encompassed by ***specific remedial statutes*** which govern the usual procedures to collect such monies. *See, e.g.*, 26 U.S.C. §§ 6201 *et seq.* (assessments) 6321 *et seq.* (liens), 6330 *et seq* (levy), 6751 (penalties).

Molen, at *4 (Emphasis supplied). Reviewing a case where an employer simply failed to recognize its withholding obligations, arguing that wages were exempt from federal income taxes and obstructing the IRS rather than litigating any bona fide tax law contention, the *Molen* court ruled that this was an extraordinary case where the usual remedies might permit the liabilities to pyramid. *Molen*, at *4. Ultimately, the court ordered that the defendants fully comply with the tax payment and withholding requirements imposed on employers, but did not order payment of any outstanding, past due liabilities (taxes, interest, and penalties) in the preliminary injunction that it ultimately issued. *Molen*, at *4.

Other courts have concluded that the existence of other, more specific legal remedies weighs heavily against the issuance of an injunction under § 7402(a). For example, in *United States v. Mobil Corp.*, 543 F. Supp. 507 (N.D. Tex. 1981), the court denied the IRS's request for an injunction commanding the inspection of the company's records because Congress provided administrative/legal proceedings to serve precisely that purpose, i.e., 26 U.S.C. § 7602 (providing for inspection of records). Likewise, in *United States v. James*, 2004 WL 838078, at *3 (M.D. Ga. 2004), the court concluded that the statutory injunction provisions of 26 U.S.C. §§ 7407 and 7408 provided adequate legal remedies to deter the preparers of fraudulent slavery reparations claims, and ruled that additional affirmative relief sought under § 7402(a) would not be granted.

3. If Assets Are Seized In Satisfaction Of Tax Liabilities, Constitutional Due Process Requires A Prompt Post-Deprivation Hearing.

The relief requested under § 7402(a) in this case, the appointment of a receiver to collect funds for the benefit of the IRS, violates the constitutional requirement of procedural due process. When

property is taken by the government, via *ex parte* proceedings under § 7402(a) or otherwise, the government is constitutionally required to offer either a pre-deprivation hearing or a *prompt* post-deprivation hearing. *In re Carlson*, 580 F.2d 1365, 1373-1374 (10th Cir. 1978), *citing Commissioner v. Shapiro*, 424 U.S. 614, 629, 96 S.Ct. 1062, 1072 (1976). The Internal Revenue Code and the Treasury Regulations are replete with measures providing taxpayers with the opportunity to address any dispute with the IRS administratively (both with the Examination Division and the Office of Appeals) and judicially, prior to the entry of an assessment. Even in situations where the Code permits the entry of a jeopardy assessment and the immediate institution of collection action by the IRS, the affected taxpayers are afforded the right to appeal these determinations administratively and judicially on an expedited basis. *See* 26 U.S.C. §§ 6851 *et seq.*, 6861 *et seq.*, and 7429.

Here, the affected xélan members are policyholders with rights in insurance policies, who have had their interests in the policy (which include the right to disability payments in the event of disability or the return of an experience adjusted refund at the end of a policy period) "taken" by virtue of the receivership over the assets of DBIC. Other affected xélan members are donors to the Foundation, whose expectations regarding their ability to advise regarding future charitable giving have been upset. Despite this taking, no prompt post-seizure hearing is contemplated.

III. THE GOVERNMENT HAS NOT PROVEN FRAUD WITH RESPECT TO THE GROUP POLICY.

A. Representations Regarding Segregated Accounts, Risk Shifting, and Risk Distribution Were Not Fraudulent.

IRS Revenue Agent John Marien ("Marien") asserts that "the essential components of risk shifting and risk distribution required for genuine insurance are not present for the [Group Policy]." *Declaration of John Marien ("Marien Dec"), ¶ 18.* Marien explains that "risk shifting" means that

each doctor must shift to the insurance company the risk that he/she will become disabled, and "risk distribution" means that "the assets of each xélan disability insurance group member must be at risk to pay the claims of any other group member." *Marien Dec, ¶ 16(n).*

Timothy France ("France") asserts that xélan and Guess fraudulently represented to the doctors that each doctor's premiums would be invested in each doctor's separate account, and that "these payments, and any earnings realized from investing the payments, will be returned to the doctors in seven years, or when they reach age 62, whichever occurs first." *Declaration of Timothy D. France ("France Dec"),* ¶ 18. France concludes:

> However, a review of the financial records we obtained in our investigation from SEI Investment Company and Vanguard Group, as well as testimony by Buck and former xélan executive Paul Dunn made public in various IRS summons enforcement actions, shows that the funds are not held in segregated accounts belonging to the doctors, and that the monthly statements are only an approximation of what the doctors may receive in the future.

France Dec, ¶ 22.

Defendants agree with France's conclusions that the funds are held by DBIC, rather than in segregated accounts belonging to doctors. However, Defendants strongly disagree that fraudulent representations to the contrary were made by xélan and/or Guess.

A close examination of the selective documentation presented by France and Marien, in light of a more complete review of the available facts, will show that information was provided to the doctors by xélan, counselors, and DBIC explaining that: (1) SEI statements[6] are only approximations of what may be received as a benefit or refund in the future; (2) premiums are held as insurance company reserves, and the total pool of reserve funds is available to pay claims of any

[6] SEI Private Trust Company is a large institutional investment company located in Oaks, Pennsylvania.

doctor in the pool (i.e., there is risk shifting); and (3) the doctors are provided guaranteed minimum benefits, regardless of the investment performance of reserves, such that there is "risk distribution."

France submits one SEI statement, issued to Dr. Andrew Cohen ("Cohen"), for the month of January, 1998. *Defendants acknowledge this statement does not make explicit the fact that it* reflects a separate accounting to Cohen, not a "separate account" of his own, and that it was furnished to him as but an approximation of his benefits, based upon his premium payments and investment performance. However, SEI statements beginning at least as of June 2002 did make this clear, where they state, under the heading "For Your Information," the following:

> The addressee is a certificate holder in a group insurance policy. The account value represents the approximate benefits payable in the event of a claim. Actual benefits may vary due to experience of the total pool of the insureds and policy terms.

Declaration of Thomas Pettinger ("Pettinger Dec"), Exh. 4(b).

Documents produced to the IRS by counselors Rick Jaye and Michael Junck ("Jaye & Junck") from their files relating to Drs. Andrew and Margaret Cohen ("the Cohens")[7] include a document with the following explanation under the heading "Investment of Policy Reserves."

> Nearly all investments of policy reserves are managed and held at SEI Trust Company with headquarters in Oaks, Pennsylvania. These reserves currently are invested according to modern portfolio theory principles (as determined by SEI). Reserves specifically allocated to pay existing and approved claims currently are invested in fixed income and certain other cash equivalent type of investments. The Company maintains the sole right to determine the investment strategy of its reserves.
>
> The statements that you receive periodically from SEI are approximations of the total benefits which you would receive in the event that you filed (and were awarded) an 'own occupation' claim benefit. These amounts will be adjusted at the time of a claim or experience adjusted refund based upon an actuarial calculation.

[7] The Cohens have been under audit by the IRS since 2001. Rick Jaye was their counselor.

Declaration of John M. Colvin ("Colvin Dec"), Exh. 1, pg. 1.

Jaye testified to several IRS agents and lawyers for most of one day, and submitted a sworn declaration in the *Cohen* summons enforcement proceeding, where he stated as follows:

> I explained to the Cohens that I have always understood that the SEI periodic statements with respect to the Disability Program reflect only an estimate of potential disability benefits of the insured, and potential premium refund. I also explained to them that I have always understood that the SEI statements do not reflect monies owned by or in control of the insured.

Colvin Dec, Exh. 2, (Declaration of Rick Jaye ("Jaye Dec") pgs.3-4, ¶ 12) .

Dr. Thomas Pettinger ("Pettinger"), who has been a participant in the Group Policy since 1996, states that he always understood that SEI statements were approximations of his benefits, and that his premium payments were not being held in a separate account belonging to him but, instead, were part of the insurance company reserves available for payment of claims. *Declaration of Thomas Pettinger ("Pettinger Dec"), ¶¶ 12, 14.* Even the early documentation supplied to him states this. For example, Pettinger's 1996 "Investment Election Form" contains the following statement:

> I understand that the reserves supporting the insurance policies purchased by the Trust will be held in a segregated account with a Broker/Dealer and/or Trust Company and shall be invested according to the percentages specified below:
>
> | | |
> |---|---|
> | • U.S. Government Securities Fund | 35% |
> | • Core Fixed Income Fund | 35% |
> | • S&P 500 Index Fund | 30% |
> | TOTAL | 100% |

Pettinger Dec, Exh. 3.

This form reflects it was the insurance company *reserves* that were held in a segregated account, as opposed to the doctor's individual premium payment held in a personal account,

segregated from the pool. The form also reflects that, initially, the doctor could designate percentages of three categories of investments held by the insurance company whose performance would be taken into account in determining Pettinger's benefits. Notably, France and Marien neglect to disclose to the court that this investment election feature terminated entirely several years ago. The periodic statements and certificates currently issued to doctors state that "the company maintains the sole right to determine the investment strategies of its reserves." *Pettinger Dec., Exh. 6.*

Particularly significant to Marien's assertions about "risk shifting" is the following explanation in the most recent benefit statement received by Pettinger, concerning his benefits:

> There is a minimum 'own occupation' benefit equal to 110% of total premiums paid.
>
> There is a minimum 'own occupation' benefit equal to 400% of the total premiums paid.

Pettinger Dec, Exh. 5. These representations are consistent with Pettinger's understanding, throughout the time he has had coverage, that there is a guaranteed minimum benefit that will be paid to him, in the event of disability, regardless of investment performance of the reserves. That is the key to "risk shifting."

Pettinger's current Statement of Benefits also carefully explains the concept of the "experience adjusted account:"

> The Reserve Value represents the Certificate's Total Units multiplied by the current Unit Value, as of March 31, 2004. This value is your experience adjusted account balance as of the date of the statement and therefore represents an estimate of the benefits that would be received in the event of an 'own occupation' claim. The experience adjusted account balance is subject to adjustment based upon certain minimums (described below) and the claims and forfeiture experience of the total pool of insureds. Your benefits may differ; please consult your certificate.

Pettinger Dec, Exh. 5.

In addition to the January 1998 SEI statement, France submits an undated brochure in support of his allegations regarding "segregated accounts." *France Dec, Exh. 6.* Even that document, at the very least, falls far short of establishing fraudulent representations were made that doctors' premium contributions and earnings thereon would be held in their own (the doctor's) separate account for seven years, then returned to them. Perhaps the brochure could have been more artfully drafted and explicit, as were the later SEI statements and the other documents referenced above. But inartful language is not fraud.

Finally, the Government in its memorandum states as follows:

> One judge who rejected xélan's arguments noted that the representations of defendant Buck and former xélan executive Paul Dunn in one summons case, '... vary so greatly from the representations in xélan's own reports to the [doctors] that the divergence itself substantiates the IRS's own case. While some day it may turn out that xélan's assurances to this Court concerning the trust are true, the disjuncture between these representations and the documents now in the Service's possession underscores both the IRS's interest in developing complete understanding of the trust's operation and the relevancy of this inquiry to the [doctors'] audit.' [*citing Cohen v. United States*, 306 F.Supp.2d 495, 503 (E.D. Pa. 2004)].

Govt. Memo., pg. 20.

The government's reliance on *Cohen* is misplaced. As the court predicted in *Cohen*, xélan's assurances have turned out to be true. France concedes that the testimony of Buck and Dunn was true - the funds are not held in segregated accounts. *France Dec, ¶ 22.* The "divergence" the court in *Cohen* observed was based upon the limited information before it, particularly the old SEI statements. The court did not have before it the more current SEI statements, and the other documentation discussed above, which clearly explain that all funds are held in a pool as insurance company reserves.

Thus, the opinion in *Cohen* is of no precedential value for the issues before this Court. The *Cohen* proceedings were summary in nature, no discovery or evidentiary hearing was permitted, and the issue before the court was not whether anyone had been misled, but whether the identity information sought by the IRS met the broad relevancy standards of 26 U.S.C. § 7602.

B. Representations Regarding Deductibility Of Premium Payments As Ordinary And Necessary Business Expenses Were Not Fraudulent.

France concludes that premiums "could not possibly constitute 'ordinary and necessary business expenses.'" *France Dec, ¶ 21.* France's assertions are inconsistent with those of Marien, who hedges his bets on the issue of deductibility. Marien states that the "preliminary results" of his work indicate that there is no "risk shifting" or "risk distribution" required for genuine insurance and tax deductibility. While Marien adds that, even if the xélan program is ultimately determined to constitute true insurance, the doctors are not entitled to deductions for the full amount of the premium payments, he ultimately concludes "if these conclusions are correct," then the professional corporations that pay and deduct the premiums will owe substantial tax liabilities. *Marien Dec, ¶ 18.*

Since Marien, the purported IRS specialist, cannot conclude, with certainty that premiums are not deductible, the government has failed on the face of its own submission to establish fraudulent misrepresentations by xélan and/or Guess concerning deductibility. Closer examination of Marien and France's declarations provide more proof of their failure to establish a fraud case.

Marien makes a fleeting reference to "xélan attorney G. Thomas Roberts," who provided opinion letters. Tax opinion letters signed by Roberts were not those of a "xélan attorney." The opinion letters were those of the law firm of Eckert, Seamans, Chernin, and Mellott ("Eckert Seamans"), of which Roberts was a member. At the time of Pettinger's 1997 opinion letter, the

firm had offices in ten cities, including Boston and Washington, D.C. *Pettinger Dec, Exh. 7, pg. 1.* The ten-page opinion letter discusses the facts and the law, and opines that "contributions made to the trust are deductible as ordinary and necessary business expenses under [IRC Section 162]." *Pettinger Dec, Exh. 7, pg. 4.* The firm's opinion further states there is "substantial authority" for its opinions. *Pettinger, Exh. 7, pg. 9.*

The government makes no showing that Eckert Seamans knew there was no arguable basis for its opinion. The opinion's reference to "substantial authority" is particularly significant. The Treasury Regulations provide that a position taken may be taken on a tax return without being subject to even the negligence penalty (26 U.S.C. § 6662) if that position is supported by substantial authority, even where the position has a less than 50% chance of success, if litigated. 26 CFR § 1.6662-4(d)(2).

Moreover, there is no showing by the government that Guess knew Eckert Seamans' opinions were false. Good faith reliance upon counsel negates fraud. *See United States v. Defries,* 129 F.3d 1293, 1308, 327 U.S.App.D.C. 181 (D.C.Cir. 1997), *see also United States v. Anderson et. al.*, 879 F.2d 369, 377 (8th Cir. 1989). Indeed, even civil negligence penalties are not applicable in tax cases where this factor is present. 26 U.S.C. § 6662(a). The IRS concluded in Pettinger's case no negligence was involved in the claim for deductions of 100% of premiums paid. *Pettinger Dec., Exhs. 9, 10.*

France and Marien's opinions are just that - their opinions, unsupported by any federal court decision. The government seeks to put the insurance company out of business, and freeze all of the assets of the Defendants. These extraordinary measures are sought *before* the cases in which the

civil tax issues in dispute proceed to discovery, trial, and decision by the courts.[8] Equally egregious, the government seeks to deprive the defendants in this proceeding, who are also the subject of the criminal investigation, of the resources essential to defend themselves.

France alleges that, there is a "clear definition" of the terms "ordinary and necessary." *France Dec, ¶ 21*. While these precise terms do appear in 26 U.S.C. § 162, there are literally thousands of court cases deciding, in an infinite variety of fact patterns, whether the ordinary and necessary standard of the Code is met. In the landmark Supreme Court case of *Welch v. Helvering*, 290 U.S. 111, 54 S.Ct. 8 (1933), the court confirmed that payments are necessary if they were "appropriate and helpful." They need not be "essential." With respect to the determination of whether a payment is "ordinary," the court concluded:

> Many cases in the federal courts deal with phases of the problem presented in the case at bar. To attempt to harmonize them would be a futile task. They involve the appreciation of particular situations, at times with border-line conclusions."

290 U.S. at 116.

France and Marien assume, with no support submitted for doing so, that there were no legitimate business reasons for the doctors obtaining supplemental disability insurance coverage. We submit it is obvious that the disability coverage meets the "appropriate and helpful," and "ordinary," standard of the statute. Doctors are highly skilled, often high income individuals, who do in fact have a need for disability coverage, regardless of its tax consequences. France and Marien chose to ignore information that shows this.

[8] Pettinger has filed a tax claim for refund suit in the Wyoming Federal District Court. *Pettinger Dec, Exh. 11*. Adversary proceedings have been instituted in the Bankruptcy Court challenging the IRS's assertions that false tax benefits were claimed.

For example, Jaye & Junck's documents relating to the Cohens include the following explanation, under the heading "Information About Your Insurance:"

> The idea for this disability insurance program originated with xélan's doctor members in the mid 1990s who were faced with a cutback in available disability insurance coverage. For highly productive doctors, a significant percentage of their annual net practice income (50% or more) could not be insured from normal commercial sources. Moreover, "own occupation" type coverage had been curtailed even further and lifetime benefits had been eliminated in nearly all instances. The need for additional supplemental disability coverage was clearly present for many xélan doctor members.

Colvin Dec, Exh. 1, pg. 1A.

In accordance with the above, Jaye's 2003 declaration states:

> I was a financial advisor offering xélan programs to doctors prior to and at the time xélan began offering the Disability Program. It was my opinion that doctors had a significant need for disability coverage because such was becoming increasingly difficult for doctors to obtain from established companies, particularly because disability claims were increasing and the companies were capping coverage (in Florida the coverage cap was $10,000 per month for physicians and $8,500 per month for dentists) and reducing benefits. After 5 years, if a healthcare provider could do any other work but not practice his own occupation, benefits would cease or be reduced. Furthermore, the period that benefits could be received was reduced from lifetime to age 65. Hence, there was a foreseeable risk and substantial need for supplemental disability coverage, enabling the doctor to obtain disability benefits that would better correspond with his/her actual loss of income in the event of a disability. While in my observation the tax consequences of obtaining supplemental disability coverage were significant, the disability coverage was paramount.

Colvin Dec, Exh. 2, (Jaye Dec, pg. 3, ¶10).

Pettinger's testimony supports these statements. Tom Pettinger was a 32 year old doctor, right out of residency, who found himself unable to obtain from commercial insurance companies disability coverage he believed was anywhere near the amount necessary to protect his rapidly rising income from his Wyoming radiology practice. *Pettinger Dec, pg. 3.* The Group Policy provided

him with guaranteed minimum disability coverage. *Pettinger Dec, pg. 4.* It permitted him to make premium payments in amounts necessary to assure the income protection he needed.

France asserts that, because the premium relates "solely to the amount of income the doctor wishes to deduct, and not the alleged 'cost' of any actual insurance, the alleged premiums could not possibly constitute 'ordinary and necessary' business expenses." *France Dec, ¶ 21.* France ignores the fact that the amount of the premiums – that is, the cost of the insurance – directly affects the amount of the disability benefit to which the doctor became entitled. The larger the premium, the larger the guaranteed minimum benefit, and the experience adjusted benefit. France instead focused solely upon the fact that the larger the premium, the larger the deduction.

France and Marien both refer to the doctors deducting 100% of their "net practice income," in an attempt to lead this court to conclude that all doctors participating in the Group Policy pay little or no tax. Pettinger's case certainly shows that is not the case. The majority of his professional corporation's income was paid to him as compensation, and reported on his individual income tax return.

The crux of both France and Marien's conclusions that the Group Policy is nothing more than a tax deductible savings plan, like a 401K plan, is the refund feature of the plan. They fail to acknowledge that, 20 years ago, the IRS ruled that payments to a group medical malpractice liability plan were fully deductible as ordinary and necessary business expense under 26 U.S.C. § 162, despite the fact a refund of premium was available after five years of participation. Rev. Rul. 83-66, 1983-1 C.B. 43 (1983). There, doctors were members of a medical association which purchased group insurance for the doctors' benefit. The doctors could obtain a refund of premiums paid, the amount of the refund being dependent upon the experience of the covered group as a

whole. There, as here, premiums paid became part of the insurance companies' reserves, although separate records were maintained for each insured for purposes of determining their *pro rata* share of any refund. IRS revenue rulings are binding and may be relied upon as precedent by taxpayers. *Rauenhorst v. Commissioner*, 119 TC 157, 173 (2002).

The refund feature of the Group Policy explains why it could be considered an asset consisting of disability insurance protection, as well as money that may be repaid in the future depending upon a variety of factors, including claims. Accordingly, France's reliance upon an annual "Summary of Assets" prepared for Cohen showing his interest in the Group Policy under the category "Other Retirement Plans' Assets" is misplaced. This document does not establish that Cohen's disability benefit and potential refund is comparable to cash in a segregated savings account, as France argues it does. It simply shows that Cohen's interest in the Group Policy is a valuable asset. *France Dec, Exh. 4.*

Finally, without any foundation, France speculates that doctors will never report receipt of disability benefits or refunds as income. *France Dec,* ¶ 19. As testified to by Pettinger, xélan has never represented that amounts received as benefits, either pursuant to a disability claim or refund, are not includible in income. *Pettinger Dec,* ¶ 18.

C. There Was No Fraudulent Failure To Advise Doctors About 26 U.S.C. § 419.

Both France and Marien allege that there was a fraudulent omission to advise the doctors about xélan purported premium deductibility limitations of 26 U.S.C. § 419. *France Dec,* ¶ *21, Marien Dec,* ¶*16 (6).* France and Marien's conclusion that § 419's applicability is so clear that the failure of others to recognize and agree with them amounts to fraud is best refuted by the IRS' own conclusions in the *Pettinger* case. The deductibility of Pettinger's corporation's premium payments

to the Group Policy was the subject of three years of IRS examination and appeal proceedings. Pettinger's representatives fully cooperated in providing relevant information to the IRS. After Pettinger chose not to accept an IRS Appeals' settlement proposal, the IRS issued a Notice of Deficiency. The Notice's "Explanation of Adjustments" states as follows:

> The 1996 and 1997 deductions for disability trust payments are reduced $96,000.00 for 1996 and $114,240.00 for 1997 because it has not been established that any of these amounts was for ordinary and necessary business expenses, was expended for the purpose designated or that any of these amounts met the requirements of Section 162 of the Internal Revenue Code. Therefore, taxable income is increased $96,000.00 for 1996 and $114,240.00 for 1997.

Pettinger Dec, Exh. 9.

The fact that § 419 is not asserted, or even mentioned, as grounds for disallowance in the Pettinger Notice of Deficiency is particularly significant. In Tax Court litigation, the failure to identify in the Notice of Deficiency each statutory basis for disallowance of a deduction limits, and may even preclude, the IRS from raising the issue at trial. *Tax Ct. Rule 142(a).*

Neither France nor Marien show that: 1) Eckert Seamans understood that § 419 applies, so as to limit the deductions for premium payments, and fraudulently omitted disclosure of the section and its application in their tax opinion; and 2) in any event xélan entities did not rely in good faith upon the law firm's opinion.

This proceeding is not the one where all the technical arguments regarding the applicability of § 419, if any, to the Group Policy needs to be made and resolved. The issue here is fraud, and, Defendants submit, the government's argument that there is fraud with respect to the lack of discussion of the § 419 limitations in opinions addressing the Group Policy has no merit.

IV. SUMMARY AND CONCLUSION.

There is no statutory basis for the receivership in any event because the government does not allege any banking law violation or federal healthcare offenses. Under *DeBeers*, preliminary injunctive relief, which provides for the freezing of assets, is likewise not permissible under the general equitable power of the courts because the final relief available under 18 U.S.C. § 1345 does not include an asset freeze. The attempt by the government to hold funds for potential taxes that might be owed by xélan members far exceeds the statutory authority under 26 U.S.C. § 7402, and is subject to significant constitutional challenge.

In any event, the government has not proven that the Group Policy operates as a scheme to defraud. The policy is disability insurance, and xélan members are told that.

DATED this 19th day of November, 2004.

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