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9 XÉLAN, INC., PYRAMIDAL FUNDING SYSTEMS,
10 INC., dba XÉLAN INSURANCE SERVICES and
11 XÉLAN PENSION SERVICES, INC.

12 UNITED STATES DISTRICT COURT
13 SOUTHERN DISTRICT OF CALIFORNIA

14 UNITED STATES OF AMERICA,

15 Plaintiff,

16 v.

17 L. DONALD GUESS, LESLIE S. BUCK,
18 DAVID JACQUOT, MONTE T. MELLON,
19 G. THOMAS ROBERTS, CHRIS G.
20 EVANS, NIGEL BAILEY, DOCTORS
21 BENEFIT INSURANCE COMPANY, LTD.,
22 DOCTORS BENEFIT HOLDING
23 COMPANY, DOCTORS INSURANCE
24 SERVICES, INC., XÉLAN INVESTMENT
25 SERVICES, INC., XÉLAN ANNUITY CO.,
26 LTD., XÉLAN ADMINISTRATIVE
27 SERVICES, INC., XÉLAN FOUNDATION,
28 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 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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DEPARTMENT OF CLERK OF COURT
SOUTHERN DISTRICT OF CALIFORNIA

BY:  DEPUTY

CASE NO. 04 CV 2184 ~~W~~ (AJB)

**DEBTORS' SUMMARY OF
BANKRUPTCY CASE STATUS**

DATE: December 3, 2004
TIME: 1:30 p.m.
JUDGE: Larry A. Burns

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I.

SUMMARY OF ARGUMENT

This summary is filed on behalf debtors xélan, Inc., Pyramidal Funding Systems, Inc., dba xélan Insurance Services, xélan Pension Services, Inc., and xélan Financial Planning services, Inc., (“Debtors”) all of whom are under bankruptcy protection in the United States District for the Southern District of California. This brief is filed to advise the court of the status of the bankruptcy proceedings, certain issues pending resolution there, and Debtors' position with regard to the effect of these proceedings on those four bankruptcy cases.

The protective order sought by the IRS in its complaint covers a broad range of companies and individuals, some of which are under common ownership and control, and many of which are not. At the time of the filing of the bankruptcy cases, the Debtors were all under the ownership and control of L. Donald Guess, who is also subject to the receivership order. On November 17, 2004, the Bankruptcy Court authorized the U.S. Trustee to appoint a Chapter 11 Trustee. Upon agreement of the parties, Mr. William A. Leonard, the receiver in this matter, has been likewise appointed as the Chapter 11 trustee.

II.

FACTORS LEADING TO THE BANKRUPTCY FILING

The history and structure of the xélan companies is set forth in **Exhibit A** to this brief. In summary, the xélan companies (collectively “xélan”) were formed to provide financial planning services for doctors and dentists. Over the years, the xélan companies implemented the plans provided through the marketing and sale of insurance products, the preparation of pension plans, and later other investment services. Several of these plans, like all financial plans, included a component of tax-deductible or deferred programs to reduce the amount of taxes due during doctors' high earning income years.

As the services provided by the xélan companies evolved, so too did the structure of the xélan companies. Ultimately, during the late 1990s, in response to an audit by the Securities and Exchange Commission, xélan was required to create certain affiliate entities along structural lines that would honor the regulatory requirements of state and federal law. For example, a financial

1 planning agency cannot also sell investments or securities, therefore separate entities were
2 structured to comply with these requirements. Thus, while one company handled financial
3 planning matters and was a registered investment advisor, another company was a licensed
4 insurance agent and designated the general agent for the insurance companies who sold their
5 policies through xélan.

6 A series of events ultimately put the companies into financial distress, with some of them
7 being more impacted than others.

8 **A. Viatical Settlement Program**

9 One of the most significant stressors was the viatical program. A viatical contract is one
10 under which a terminally ill patient sells their life insurance policy death benefit to an investor.
11 The investor pays some amount to the patient (for example, \$60,000 on a \$100,000 life insurance
12 policy), and the patient receives the use of that \$60,000 during their lifetime. Once the patient
13 dies, the purchaser is entitled to receive the entire death benefit, thus receiving a return on their
14 investment. It is the obligation of the investor to pay the life insurance premiums for the
15 remainder of the patient's life.

16 A viatical promoter approached xélan through one of its officers and offered these viatical
17 contracts to xélan's customers. Unfortunately, the bonding company which stood for the
18 obligation to pay the insurance premiums on the policies turned out to be a pure fraud. The life
19 insurance policies backing the investments did exist, however, it is not at all clear that the
20 viators were terminally ill. As a result, xélan's customers have received very little of the expected
21 returns on these policies, and there is a continuing expense in keeping up the premium payments.

22 During 2001, xélan chose to attempt to make good these investments to their customers.
23 They structured a settlement program wherein the investors assigned their viatical contracts to a
24 settlement vehicle called the Viatical Liquidity LLC ("VL LLC"), and in return xélan, Inc., and
25 all of its affiliates undertook an obligation to fund a return of 130 percent of the investors' original
26 investments over a period of ten years. This resulted in an annual cash flow drain of
27 approximately \$5 million; \$4 million in quarterly payments plus \$1 million for the payment of
28 life insurance premiums under the agreements. This has taxed the xélan companies' cash flow so

1 severely that the companies could no longer continue to meet all of their collective obligations.
2 On June 1, 2004, Debtors defaulted on the required quarterly payment to VL LLC, and VL LLC
3 filed its own petition for Chapter 11 on June 18, 2004, Case No. 04-05472.

4 **B. Litigation with the Internal Revenue Service.**

5 The other significant stressors leading xélan to bankruptcy has been continuing litigation
6 with the IRS over the viability of xélan's programs. Specifically, xélan sold supplemental
7 disability insurance programs to its clients, which were policies issued by Doctors Benefit
8 Insurance Company, Ltd. The IRS audited some of xélan's clients, and has investigated whether
9 this program is eligible for favorable tax treatment under the Revenue Code. If it was not, then
10 the plan participants would have significantly understated their income, and would owe back
11 taxes. xélan has cooperated fully with the IRS in providing information on the programs.
12 However, the IRS has insisted on auditing other xélan customers and has gone to extreme
13 measures to obtain a list of other plan participants. xélan has moved to quash subpoenas to third
14 party providers (insurance companies) whose products would be registered in the name of xélan's
15 clients. This litigation and the potential for indemnity claims against xélan over these products
16 has been a significant expense.

17 More importantly, in response to litigation over the IRS' summonses, The New York
18 Times on February 14 published an article claiming that a federal district court had found xélan's
19 program to be "false and fraudulent." This was completely incorrect, and ultimately The
20 New York Times retracted the statement. However, it had the effect of severely damaging xélan's
21 ability to continue selling its programs.

22 **C. The Bankruptcy Case**

23 In response to the massive slowdown in business experienced during February 2004, a
24 large number of xélan's principal officers and employees left the company. One of them, Robert
25 Holcomb, formed his own insurance company called Greenbook Financial Services.
26 Mr. Holcomb approached xélan and offered to purchase xélan's business with regard to the
27 non-controversial products; that is, the insurance sales business and the pension plan
28

1 administration. Mr. Holcomb did not have any interest in purchasing the assets or otherwise
2 becoming involved with any of the controversial products formerly sold by xélan.

3 At the same time, the xélan companies were examining all their options with regard to
4 their pending insolvency. In the end, four of the xélan entities filed for bankruptcy protection
5 under Chapter 11. These were the companies from whom Greenbook Financial Services desired
6 to buy assets. One of the assets sought, however, included renewal insurance commissions that
7 were owned by xélan Insurance Services.

8 xélan Insurance Services, the registered insurance agent, had sold a substantial number of
9 policies. Each of these policies pays a commission upon sale of the insurance policy, and then for
10 a period of years if the insured party renews the policy, the agent receives renewal insurance
11 commissions. xélan Insurance Services split these renewal insurance commissions with the actual
12 financial counselors (or salespersons) on a 30/70 percent basis; that is, xélan Insurance Services
13 received 30 percent of each commission, and the financial counselor received 70 percent.

14 ***Renewal Insurance Commissions.***

15 At the time of the bankruptcy filing, therefore, xélan Insurance Services held the future
16 rights to these insurance commissions which Debtors estimated could be worth as much as
17 \$10 million. Xélan Insurance Services' share of that would have been approximately \$3 million,
18 reduced by the requirements that a certain percentage of these commissions be dedicated to
19 payment of the viatical repayment obligations. Further, there is a substantial danger that with the
20 dissolution of the company, the former clients who own these policies would go to other
21 insurance agencies to purchase insurance or continuing financial services. It is common under
22 those circumstances for the new agent to sell duplicative products which may have new features
23 which are more suited to the client at that time, and for the client to allow the old insurance policy
24 to lapse. This lapse results in the termination of xélan's right to renewal insurance commissions.
25 The potential for this dynamic to reduce the value of this large estate asset is substantial, and
26 Debtors did not have any reliable way of appraising the value of these insurance commissions.

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1 ***The Proposed Sale to Greenbook Financial Services.***

2 Greenbook Financial Services offered to purchase this asset, along with the ability to do
3 business with xélan's clients, for \$800,000. Debtors therefore proposed a sale of all the Debtors'
4 assets, including these renewal insurance commission rights, through the bankruptcy proceedings.
5 During the month of July 2004, the Bankruptcy Court for the Southern District of California
6 conducted three hearings over the proposed terms of this sale. Further, the sales procedure
7 included an "overbid" process, wherein the bankruptcy sale was subject to an auction. Any party
8 who was willing to come in and pay more for this asset could do so at the bankruptcy sale.

9 Debtors hired a certified public accountant to render an independent opinion of the value
10 of the renewal insurance commissions. At the last hearing on the sale motion on July 28, 2004,
11 this accountant testified that the asset could be worth as much as \$2.5 million. The bankruptcy
12 court approved the sale order, and required the Debtors to market the sale of these assets
13 nationally in order to try and encourage an overbid or auction. Debtors advertised the sale in The
14 Wall Street Journal and received substantial response. More than 30 parties called to inquire as to
15 potential for purchase of the assets; however, none made any of the required deposits or pursued
16 the due diligence process beyond one or two telephone calls. There was also an interest in
17 purchasing the revenue stream alone, without the assets of the business.

18 While all of this was going on, Greenbook Financial Services proposed to enhance its
19 offer (likely in recognition of the relatively high value estimate for the residual income stream) to
20 include the assumption of the viatical settlement claims. These claims, which are nominally as
21 high as \$32 million (subject to satisfaction from existing assets worth over \$32 million), would
22 satisfy a potentially large cash obligation of the estate. This dynamic, however, fundamentally
23 changed the potential for a sale, because it is extremely difficult to structure that obligation as part
24 of the bankruptcy sale. It is much more practical to propose such treatment of claims under a plan
25 of reorganization.

26 ***The Debtors' Proposed Plan of Reorganization.***

27 The Debtors therefore have deferred the hearing on the sale motion in order to propose an
28 alternative plan of reorganization which would have the effect of paying creditors 100 percent.

1 The specifics of the plan are set forth in the disclosure statement which is filed and which is of
2 record in the bankruptcy case referenced herein. In summary, however, the plan provides that the
3 estate would retain the renewal insurance commissions presently being paid, and, in conjunction
4 with a new insurance sales venture for long-term health care insurance by Dr. Guess, would
5 reorganize and use these assets to pay all the claims of creditors 100 percent. Debtors' financial
6 projections indicate that this plan is feasible, and, subject to assessment of pending claims against
7 the estate, will result in a 100 percent return to creditors. If this is the case, then the plan will
8 substantially outperform the straightforward sale of the assets.

9 **D. The IRS Adversary Litigation**

10 In conjunction with the plan, Debtors filed an adversary action for determination of
11 penalty liability against the IRS. Specifically, the IRS has contended that they are investigating
12 penalty liability by the Debtors under Revenue Code section 6700, *et seq.* Because this would be
13 an obligation of the bankruptcy estate, Debtors require an immediate determination of that
14 potential liability. Debtors therefore filed an adversary action seeking a determination of
15 potential liability in the bankruptcy court, which has jurisdiction to make such a determination
16 under 11 U.S.C. 505.

17 Prior to responding to the adversary complaint, the IRS instead filed the present complaint
18 for a restraining order against the Debtors and a significantly larger number of affiliated entities.

19 **III.**

20 **PENDING ISSUES**

21 There are therefore a substantial number of issues currently pending before the
22 Bankruptcy Court, including: (1) whether Debtors will continue with the proposed Plan of
23 Reorganization to repay creditors, (2) whether Greenbook will purchase some or all of the assets
24 of the bankruptcy estates, (3) whether the operating agreement should be terminated, (4) the
25 value of the renewal insurance commission rights held by Debtors' estates, and (5) the
26 requirement to pay financial Counselors their 70% commission split (which for many represents
27 their primary source of income, and which has been held pending the outcome of these
28 proceedings and additional proceedings in the Bankruptcy Court), among others.

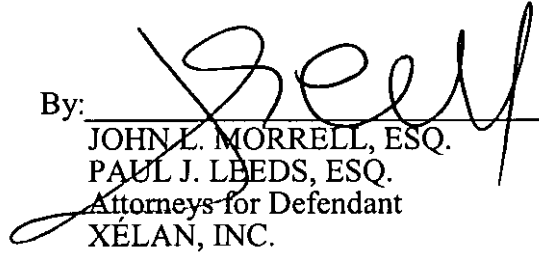
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Debtors, through their appointed counsel, await instruction from the recently-appointed Trustee on the matters pending in the Chapter 11 proceedings so described herein.

DATED: November 22, 2004

HIGGS, FLETCHER & MACK LLP

By: _____



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7
8 **UNITED STATES BANKRUPTCY COURT**
9 **SOUTHERN DISTRICT OF CALIFORNIA**
10

11 In re
12 XÉLAN, INC., a California Corporation,
13 PYRAMIDAL FUNDING SYSTEMS, INC.,
a California corporation dba XELAN
14 INSURANCE SERVICES, INC., XELAN
FINANCIAL PLANNING, INC., a
15 California Corporation,
16 XELAN PENSION SERVICES, INC., a
California corporation,

17 Debtors.
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CHAPTER 11

CASE NOS. 04-05832 through 04-05835

Jointly Administered

**DECLARATION OF JOHN M.
FARRINGTON IN SUPPORT OF
EMERGENCY MOTION FOR ORDER:**

**(1) AUTHORIZING CONTINUED USE OF
EXISTING CASH MANAGEMENT
SYSTEMS; AND**

**(3) AUTHORIZING CONTINUATION OF
INTERCOMPANY TRANSACTIONS**

DATE: *Emergency*
TIME: *Emergency*
DEPT: 2
JUDGE: Hon. Louise DeCarl Adler

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25 I, JOHN M. FARRINGTON, CPA, do hereby declare as follows:

26 1. I am a shareholder in the firm of Boros and Farrington, Certified Public
27 Accountants, APC. Boros and Farrington have been employed as accountants of xélan, Inc.,
28 Pyramidal Funding Systems, Inc., dba xélan Insurance Services, Inc., and xélan Pension Services,

1 Inc., (collectively "Debtors"), the above-referenced Debtors-in-Possession, for over five years.
2 We have not provided services to xelan Financial Planning, Inc. because it is my understanding
3 that this company has not commenced operations.

4 2. I make this declaration upon my own personal knowledge and from a review of
5 xélan's books and records kept in the ordinary course of business. If called upon as a witness, I
6 could and would testify competently to the contents of this declaration.

7 3. The Xelan group of companies has been organized along functional lines for
8 reasons of efficiency and accountability and to enhance the ability to comply with the rules of
9 various agencies that regulate the specific functions. The following summarizes these companies
10 and their functions:

11 4. The Economic Association of Health Professionals is a California non-profit
12 mutual benefit association that contracts with the xelan group of companies to provide financial
13 services and products to its members. This association derives its revenue from membership fees.

14 5. Xelan Insurance Services, Inc. is a licensed insurance agency that sells life
15 insurance, disability insurance, long-term care insurance, and annuity products to members of the
16 Economic Association of Health Professionals. This company earns commission on the sale of
17 the above products and pays out approximately 70% of this income to its financial counselors.

18 6. Xelan Investment Services, Inc. is an investment advisor registered with the
19 Securities and Exchange Commission. The company provides investment advice to members of
20 the Economic Association of Health Professionals, to the xelan Foundation, and to Doctor's
21 Benefit Insurance Company. (None of these entities have filed a petition for bankruptcy.) The
22 xelan Foundation is an Internal Revenue Code §501(c)(3) donor advised public charity and
23 Doctor's Benefit Insurance Company is an unrelated insurance company that is located in and
24 operated under the insurance laws of Barbados.

25 7. Xelan Pension Services, Inc. sets up and administers qualified pension plans for
26 members of the Economic Association of Health Professionals. Xelan Pension Services, Inc. bills
27 its pension clients directly for services provided.

1 8. Xelan Administrative Services, Inc. provides administrative services to the Xelan
2 group of companies including administration, accounting, information technology, and human
3 resources. (This entity has not filed for bankruptcy.) Xelan Administration Services, Inc. bills
4 other members of the xelan group based on services provided.

5 9. Xelan Inc. provides financial planning to members of the Economic Association of
6 Health Professionals. Xelan Financial Planning, Inc. was also formed for the purpose of "taking
7 over" this function, and Xelan Inc. would then refocus on training, seminars, and marketing
8 efforts.

9 10. Xelan Inc. incurs indirect and overhead costs that benefit the entire group. These
10 costs are allocated rationally among the group members typically at year end. These costs can be
11 grouped into the following classifications:

12 (a) Occupancy which includes rent, utilities, repairs, maintenance, and
13 telephone.

14 (b) Marketing which includes seminars, trade shows, conferences, and sales
15 materials.

16 (c) Legal and consulting costs.

17 11. As of the date of filing, not all of these allocations of costs have been made for the
18 current year. Accordingly, it appears that Xelan Inc. has incurred significant losses while other
19 group members have earned profits. However, as a group the companies have incurred a loss.

20 12. The xelan group of companies derives the majority of its revenues from insurance
21 commissions and investment advisory fees. These income streams are subject to strict rules and
22 regulations in that the companies receiving the income must be properly licensed and any person
23 receiving a related commission must also be licensed. Other revenues include pension
24 administration fees, membership fees, consulting fees and administration fees which are normally
25 deposited into the company that provides the related service. Certain members of the group
26 provide support services to these income producing companies including occupancy,
27 administration, marketing, and legal. Direct costs such as commission expense are paid out of the
28 company that receives the income. A cash management system has been utilized to pay indirect

1 and overhead costs whereby funds are transferred among the companies to pay these costs and
2 expenses as they are due. Accounting entries are made either monthly or at year end to allocate
3 these costs and expenses among the companies on a rational basis. All of the transactions are
4 recorded through intercompany accounts which are reconciled at each month end.

5 13. As discussed above, prior to the Petition Date, Debtors have provided a number of
6 services to and engaged in certain intercompany financial transactions with each other in the
7 ordinary course of their respective businesses (the "Intercompany Transactions"). Discrete
8 transfers in the appropriate intercompany books and records are made on account of these
9 transactions.

10 14. The continuation of the Intercompany Transactions should be beneficial to the
11 Debtors' estates and creditors and, thus, that corresponding transfers among the appropriate
12 intercompany books and records should be permitted post-petition. Accordingly, Debtors seek
13 authority to make the Intercompany Transactions post-petition. Given the highly centralized
14 nature of Debtors' cash management systems, Debtors frequently engage in such Intercompany
15 Transactions. Debtors' operating and cash management depend on Debtors' ability to continue to
16 engage in such Intercompany Transactions.

17 15. If the Court authorizes the Intercompany Transactions, at any given time there may
18 be balances due and owing from one Debtor to another. These balances represent extensions of
19 intercompany credit. To ensure that each individual Debtor will not, at the expense of its
20 creditors, fund the post-petition operations of another entity, Debtors will continue to maintain
21 records of such transfers, including records of all current intercompany accounts receivable and
22 payable.

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16. In order to operate the companies post bankruptcy filing, it would be very efficient and practical to continue this system of cash management and expense allocation.

I declare under penalty of perjury, under the laws of the State of California, that the foregoing is true and correct.

Executed this 20 day of July 2004 at San Diego, California.



JOHN M. FARRINGTON, CPA

PROOF OF SERVICE

I, Cindi Benfield, declare:

I am a resident of the State of California and over the age of eighteen years, and not a party to the within-entitled action; my business address is 401 West "A" Street, Suite 2600, San Diego, California 92101-7913. On November 22, 2004, I served the within documents, with all exhibits (if any):

DEBTORS' SUMMARY OF BANKRUTPCY CASE STATUS

- by transmitting via facsimile the document(s) listed above to the fax number(s) set forth below on this date before 5:00 p.m. A copy of the transmission report issued by the transmitting facsimile machine is attached hereto.
- by placing the document(s) listed above in a sealed envelope with postage thereon fully prepaid, in the United States mail at San Diego, California addressed as set forth below.
- by placing the document(s) listed above in a sealed _____ envelope and affixing a pre-paid air bill, and causing the envelope to be delivered to a _____ agent for delivery. A true and correct copy of the airbill is attached hereto.
- by personally delivering the document(s) listed above to the person(s) at the address(es) set forth below.

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I am readily familiar with the firm's practice of collection and processing correspondence for mailing. Under that practice it would be deposited with the U.S. Postal Service on that same day with postage thereon fully prepaid in the ordinary course of business. I am aware that on motion of the party served, service is presumed invalid if postal cancellation date or postage meter date is more than one day after date of deposit for mailing in affidavit.

I declare that I am employed in the office of a member of the bar of this court at whose direction the service was made.

Executed on November 22, 2004, at San Diego, California.



Cindi Benfield