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UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

UNITED STATES OF AMERICA, Plaintiff, v. L. DONALD GUESS, et. al., Defendants	Case No. 04 CV 2184 LAB (AJB) PLAINTIFF'S MEMORANDUM OF POINTS AND AUTHORITIES IN REPLY TO DEFENDANTS' RESPONSES TO ORDER TO SHOW CAUSE, AND IN SUPPORT OF MOTION FOR PRELIMINARY INJUNCTION Judge: Larry A. Burns Date: December 3, 2004 Time: 1:30 p.m.

INTRODUCTION – SUMMARY OF FACTS

Since at least 1995, the defendants have been marketing a plan to doctors which, they promise, will enable doctors to accumulate savings for retirement and lifestyle expenses using tax-deductible dollars. In addition to the sizeable tax benefits, the success of defendants' marketing efforts rests on three key representations about the plan: (1) doctors who participate will be able to control how their savings are invested; (2) doctors will receive periodic updates on how their investments are performing; and (3) because of something called "Modern Portfolio Theory,"

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doctors can rest assured that their investments are secure, free of risks that accompany most investment decisions.

Thousands of doctors bought xélan products, and diverted hundreds of millions of dollars into xélan savings plans. Once a year xélan financial counselors – sales representatives – visited the doctors. The counselors showed the doctors how well their investments were performing, and told the doctors how much longer they would have to pay money into xélan until they were set for life. Xélan's representatives told the doctors not to be concerned that their investments appeared to be held through offshore insurance companies, or in a charitable foundation. All those payments for insurance and charitable contributions – according to the balance sheets that xélan gave each doctor every year – were included in the doctor's net worth, and would eventually be available to satisfy the doctor's "lifestyle costs." In the words of xélan's founder, owner and chairman, L. Donald Guess, "If your net worth does not increase every year you are with xélan, you should fire xélan." It seemed to work.

But then the government learned what xélan was doing, and began to investigate. First it was the Securities and Exchange Commission in 1999, which expressed concern that all the xélan functions were being handled under one roof. So xélan incorporated its separate divisions, and the head of xélan's offshore insurance company, Les Buck, "resigned" to move to the East Coast. And the SEC went away. But things remained pretty much the same, with xélan essentially operating as it had before – it even continued to list Buck as a "consultant" to its Office of General Counsel, and a member of its symposium faculty.

Until, that is, the IRS learned about xélan. In 2000 the IRS started asking questions about whether the tax benefits xélan was selling to its members were really permitted under the tax laws.

By mid-2001 the IRS had begun auditing a few xélan doctors. And it did not take long before the IRS learned that xélan was operating its so-called insurance programs as disguised savings plans. After all, that is exactly how Dr. Guess presented them and counselors sold them to doctors.

How did xélan respond to the IRS scrutiny? First, it hired an actuary to render an opinion on the xélan disability insurance program, one that did not assume only 4% of premiums were required for insurance – as xélan had been telling doctors. In a letter, xélan's attorney G. Thomas Roberts told the actuary precisely what he wanted the opinion to say, and what he planned to do with the opinion. But xélan did not take any chances. Instead of waiting for the actuary's professional opinion, the head of xélan's captive insurance company, Les Buck, actually drafted all the required assumptions, as well as the actuary's opinion. It is not surprising that the actuary's 2001 opinion said exactly what Roberts and Buck wanted it to say.

What they neglected to consider, however, is that the actuary's 2001 opinion said exactly the opposite of what *the same actuary* had told the BVI Insurance Commissioner in 1996,[1/] and exactly the opposite of what Guess and xélan were telling doctors to induce them to participate in xélan. While Guess was telling doctors that, according to xélan's research, they had just a 3% chance of becoming disabled in any 10-year period, Roberts and Buck were telling the actuaries that 80% of xélan doctors could claim and recover benefits under the "own occupation" feature of the xélan disability insurance plan. At the same time, xélan financial counselors were telling doctors that the

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[1/]The actuary, James Gordon, described the xélan insurance program in a June 1996 letter to the British Virgin Islands Insurance Commissioner just as it had been sold to doctors: 96% of "premiums" are available to the doctors as either benefits or savings, with 4% reserved for insurance. (Supp. Marien Decl., Ex. 8).

"own occupation" coverage basically allowed doctors to withdraw their money at any time.[2/] Indeed, Dr. Guess withdrew nearly $2 million from three different xélan supplemental insurance accounts in his own name on the same day, March 27, 2000.[3/]

Xélan continued to fight. Beginning in 2002 xélan's captive insurance company, DBIC, started spending hundreds of thousands of dollars that doctors had paid into xélan's "insurance" plans and the xélan Foundation in an effort designed to prevent the IRS from learning the identities of those doctors. DBIC funded that effort by routing the money through the trust account of xélan General Counsel David Jacquot, who spent the money to hire lawyers who would litigate against the IRS. According to Jacquot, DBIC determined that it was in the best interests of the insurance company to prevent the IRS from learning the identities of all the xélan doctors who had diverted millions of dollars of taxable income into xélan's savings and retirement accounts.

As the IRS continued to investigate, the defendants continued to act. In late January 2002, the IRS took the sworn statements of two xélan doctors in Florida in connection with an audit of their taxes. Xélan provided them with an attorney, Michael Lloyd. Three weeks later, Guess wrote to SEI – the Philadelphia-based investment firm through which the doctors' funds were invested – and asked them to immediately confirm for him the wire transfers reflecting the nearly $2 million he had liquidated in 2000 from so-called insurance accounts in his own name at DBIC.[4/]

[2/]Xélan Financial Counselor Jeffrey Taxman told an undercover agent that DBIC treated the "own occupation" feature of the disability program on the "buddy system," explaining how easy it is for xélan doctors to withdraw their money program under that feature: "All right, so under the disability it's easy then, the guy says I want to have eight grand a month for life. He can file a claim that he's, you know, mentally nervous or any number of things to satisfy the own occupation thing." (France Decl., ¶61).

[3/]Higgins Decl., Ex. 14, pp. 3-5. Either Guess – a retired dentist – had simply certified his own simultaneous eligibility for xélan's disability, medical malpractice, and long term care insurance benefits, or Guess had the power to liquidate his account on demand.

[4/]Higgins Decl., Ex. 14.

While the xélan entities were busy during 2003 litigating the IRS's right to learn the names of xélan doctors who had claimed millions of dollars in tax benefits from its programs, they were also busy trying to create new facts. In July 2003, DBIC for the first time began filing Forms 720, quarterly federal excise tax returns, reporting excise taxes due on premiums received by foreign insurance companies. Between July and September 2003, DBIC filed excise tax returns due on premiums received from 1997 through 2002. In fall 2003, xélan Investment Services, Inc. – a registered investment firm owned by Dr. Guess – decided to move all the assets it was managing for the DBIC insurance trusts from SEI to Vanguard. Xélan also hired a professional accounting firm in Maryland, Johnson Lambert & Company, to prepare the account statements for xélan doctors. And DBIC obtained more actuarial opinions so that xélan could support its position to the IRS that the xélan insurance programs were really insurance. But at the same time, Guess and xélan financial counselors continued to tell xélan doctors that the insurance programs allowed them to build retirement savings through tax-deductible payments to the insurance plans. And, as they had in the past, doctors continued to pay into those programs, on the strength of those representations.[5/]

February 10, 2004 marked a turning point for xélan. On that day United States District Judge Stewart Dalzell of Philadelphia issued an opinion holding that the IRS was entitled to obtain from SEI Private Investment Trust the records of all the funds contributed by and held for all the doctors in the xélan supplemental disability trust.[6/] The next day a story reporting that decision appeared in

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[5/]Xélan also began including a legal "disclaimer" on all its account statements, to suggest to doctors that the money that SEI was reporting in their accounts was not really there. "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." That disclaimer did not seem to convince the doctors that the money they had paid into xélan programs did not belong to them. (Request for Judicial Notice, Ex. C.1 - C.8.)

[6/]Cohen v. United States, 306 F.Supp.2d 495 (E.D. Pa. 2004) (records of all xélan insurance participants were relevant to IRS determination of whether payments were for insurance), on appeal.

the *New York Times*. According to Dr. Guess, things quickly began to deteriorate at xélan. Still, xélan and DBIC continued to try and prevent the IRS from learning the identities of its doctors, moving to stay the district court's order pending appeal. Whether part of that effort or not, soon afterwards DBIC owner Buck, and DBIC attorney Roberts refused to answer the IRS's questions about xélan and DBIC, citing the Fifth Amendment.[7/]

For the first time, xélan and DBIC considered liquidating. They began to set aside funds paid by doctors into the supplemental insurance plans and the xélan Foundation to litigate against the IRS on their own behalf and on behalf of doctors. DBIC's board of directors established a "defense fund" by transferring $20 million to a bank account at Butterfield Bank in Bermuda. And the xélan Foundation's board of directors approved a "special assessment" of 10% against all accounts, to defend IRS audits of the Foundation and xélan doctors. When two doctors objected and threatened to sue, the Foundation's board of directors rescinded the assessments against them, and only them.

On June 30, 2004, four xélan entities filed petitions under Chapter 11, seeking protection from creditors under the Bankruptcy Code.[8/] The other xélan entities and DBIC continued business as usual, even diverting some of their resources to pay for xélan's accountants and attorneys. But because xélan, Inc. and the other three bankruptcy debtors did not comply with their obligations under the bankruptcy laws – even before this Court appointed a temporary receiver – the Bankruptcy

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[7/]Supplemental Marien Decl., ¶¶ 3-5. "Parties are free to invoke the Fifth Amendment in civil cases, but the court is equally free to draw adverse inferences from their failure of proof." SEC v. Collello, 139 F.3d 674, 678 (9th Cir. 1998), citing, Baxter v. Palmigiano, 425 U.S. 308, 318, 96 S.Ct. 1551, 1557-58 (1976); United States v. Solano-Godines, 120 F.3d 957, 962 (9th Cir. 1997).

[8/]xélan, Inc., Pyramidal Funding Systems, Inc., dba xélan Insurance Services, xélan Pension Services, Inc., and xélan Financial Planning, Inc.

Court appointed a trustee to manage their affairs.[9/] And now the United States seeks to have the receivership extended until this case is resolved.

ARGUMENT

I.

THIS CASE INVOLVES FRAUD IN THE INDUCEMENT AND FRAUD IN FACT, AND THE PLAINTIFF HAS AMPLY DEMONSTRATED LIKELY SUCCESS ON ITS CLAIMS

The defendants have offered voluminous briefs and other documents — nearly five reams of paper – in an attempt to support their claim that DBIC has operated as a "legitimate" insurance company, and that xélan's insurance products are "really" insurance. They argue that, because the IRS and the courts have not ruled on the legitimacy of xélan's programs, it is improper to appoint a receiver here. The defendants' filings include many *post hoc* documents and legal arguments about the merits of their position under the tax laws.

But in that blizzard of paper the defendants have neglected one central feature of the plaintiff's case: This case involves fraud, the disconnect between what Guess and xélan tell doctors to induce them to pay millions of dollars into this scheme and what they now tell the IRS and this Court. The case involves promoters who tell doctors they can save tax-deductible funds for retirement by "buying" expensive so-called supplemental insurance to protect against unlikely risks, and by making "contributions" to a foundation that exists in large part to benefit the contributors and their children. And this case involves those same people trying to convince the Government that what they told the doctors simply isn't true – or that doctors simply should not have believed what xélan told them. At bottom, neither xélan nor DBIC have enough money on hand to pay the doctors

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[9/]The U.S. Trustee named William A. Leonard, Jr., the temporary receiver here, as the trustee for the four bankrupt debtors.

all the funds they paid into this enterprise, let alone the earnings they promised to the doctors. And that, in a nutshell, is why the Court should preliminarily appoint a permanent receiver.

II.

THE FRAUDULENT CONDUCT CONTINUES

These defendants have demonstrated a pattern of telling one thing to doctors and the exact opposite to the federal government.[10/] They have demonstrated a pattern of deception and concealment when caught, and of attempting to morph after the fact in order to conceal their frauds. And – perhaps most importantly – they have demonstrated a disturbing propensity to try and place large sums of money outside the reach of creditors and the federal government, whether by funneling $30 million through an attorney trust account, by setting up a "legal defense fund" consisting of $22 million transferred to a bank in a tax haven country like Bermuda, or by creating Cook Islands trusts to enable defendants Les Buck and Monte Mellon to place their assets outside the reach of creditors.

They have also refused to observe legal "formalities" when those formalities stand in their way. For example, when xélan Foundation decided to assess each member 10% to pay for legal defense, SEI refused to honor the Foundation's request to "dock" each account by 10%. So xélan Foundation simply "structured" a number of smaller withdrawals to circumvent SEI's restriction.

Similarly, the Foundation's "student loan program" was a "loan" program, in name only. Although the Foundation's rules supposedly required recipients of student "loans" to sign notes and make repayments, the Foundation did not establish a method to monitor and track compliance. Indeed, the receiver observed that only one child of a doctor who received a "student loan" from the

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[10/] And they continue to do so. Defendant Roberts testified under oath that he did not become a director of DBIC until June 2004. (Roberts Decl., p. 3) But on the March 22, 2002 Assumption Agreement transferring the assets from one a DBIC predecessor to another, Roberts signed for the transferor, xélan Insurance company, Ltd. (BVI), as "Director and Sec.". (Gaines Decl., Ex. B, p. 5).

Foundation actually repaid it, without interest – and that was only after the IRS had audited the doctor's tax return.[11/] As operated, the Foundation improperly allowed doctors to pay their children's college expenses with tax-deductible dollars. And that is, quite simply, fraud.

III.

A RECEIVERSHIP IS NEEDED TO PRESERVE ASSETS AND DETERMINE CLAIMS

The defendants – and the putative intervenors – have attempted to portray the plaintiff's action as seeking to seize the defendants' assets to pay the taxes yet to be assessed against the doctors who participated in xélan's programs. They are wrong. These defendants have, for the past eight years, induced doctors to pay hundreds of millions of dollars into programs, on the basis of claims that were materially false. Whether the frauds were committed on doctors, on the IRS, or on both, the fact remains that these defendants control hundreds of millions of dollars in assets that they obtained by fraud.

The Ninth Circuit has held that in cases brought under §1345 the courts have "authority to grant any ancillary relief necessary to accomplish complete justice," and that asset freezes and the appointment of receivers are an appropriate form of ancillary relief.[12/] On this record, unless the Court appoints a receiver to take control of those assets, these defendants will dissipate those assets, and use them to continue the fraud – as they have done in the past. The Bankruptcy Court has already ruled to that effect, and appointed a trustee to oversee the affairs of the four bankrupt debtors. But until this Court acts, the non-debtors are free to continue committing these frauds.

[11/]Receiver's Initial Report, pp. 13-14.

[12/]FTC v. HN Singer, Inc., 668 F.2d 1107, 1113 (9th Cir. 1992) (freezing assets to prevent dissipation); *see also,* FSLIC v. Sahni, 868 F.2d 1096, 1097 (9th Cir. 1989)(same); FTC v. American National Cellular, 810 F.2d 1511, 1512-14 (9th Cir. 1987) (appointment of receiver).

The United States asks this Court to use the authority granted under 18 U.S.C. §1345 and 26 U.S.C. §7402 (a), to preliminarily appoint a permanent receiver, to take control of and preserve these assets, to develop and implement a claims mechanism, and to make sure that these assets are available for the doctors and their creditors, including the federal revenue. Under this authority, the permanent receiver can protect the viatical contracts, authorize the payment of "normal" operating expenses, and protect the rights of doctors who may legitimately be entitled to receive payments on valid insurance claims. Without this relief, xélan insiders will continue to operate xélan for their own interests – they have demonstrated their willingness and ability to do so in the past, and unless stopped, they will continue to do so in the future.[13/]

CONCLUSION

Since 1995 these defendants have engaged in a fraud of massive proportions, either against thousands of doctors, against the United States and its taxpayers, or both. This Court can and should put an end to the fraud, here and now. For all the reasons appearing in this record, as discussed in this memo and the plaintiffs' other filings, the Court should issue a preliminary injunction, and convert the temporary receivership commenced on November 4, 2004 into a preliminary operating receivership. This is the best way to preserve hundreds of millions of dollars in assets, and protect the rights of the United States and thousands of xélan doctors.

DATED: November 30, 2004

Respectfully submitted,
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Stuart D. Gibson by fax
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[13/]In this respect, the Court should instruct and authorize the current directors of DBIC – defendants Bailey, Evans and Roberts – to take all necessary steps to transfer control over DBIC to the receiver, so that he can operate the company in accordance with Barbados law.

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UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

UNITED STATES OF AMERICA, Plaintiff, v. L. DONALD GUESS, et. al., Defendants	)	Case No. 04 CV 2184 LAB (AJB) PROOF OF SERVICE Judge: Larry A. Burns Date: December 3, 2004 Time: 1:30 p.m.

I declare that the foregoing Plaintiff's Memorandum of Points and Authorities in Reply to Defendants' Responses to Order to Show Cause, and in Support of Motion for Preliminary Injunction; Plaintiff's Summary of Undisputed or Uncontested Facts in Support of Motion for Preliminary Injunction; Plaintiff's Request for Judicial Notice of Matters in Bankruptcy Case with Exhibits B and C.1 through C.8; Supplemental Declaration of John L Marien with Exhibits 8 through 13; and Declaration of Jay Higgins with Exhibits 14 through 17, were served upon the following parties to this case this 30th day of November, 2004, by sending copies to their attorneys by electronic mail – as directed by the Court's Order dated November 24, 2004 – addressed as follows:

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