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**PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**

*Committee on Homeland Security and Governmental Affairs*

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*Norm Coleman, Chairman*

*Carl Levin, Ranking Minority Member*

**TAX HAVEN ABUSES:  
THE ENABLERS, THE TOOLS  
AND SECRECY**

**MINORITY & MAJORITY STAFF  
REPORT**

**PERMANENT SUBCOMMITTEE  
ON INVESTIGATIONS**



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# TAX HAVEN ABUSES: THE ENABLERS, THE TOOLS AND SECRECY

August 1, 2006

Offshore tax havens and secrecy jurisdictions today hold trillions of dollars in assets.<sup>1</sup> While these jurisdictions claim to offer clients financial privacy, limited regulation, and low or no taxes, too often these jurisdictions have instead become havens for tax evasion, financial fraud, and money laundering. A sophisticated offshore industry, composed of a cadre of international professionals including tax attorneys, accountants, bankers, brokers, corporate service providers, and trust administrators, aggressively promotes offshore jurisdictions to U.S. citizens as a means to avoid taxes and creditors in their home jurisdictions. These professionals, many of whom are located or do business in the United States, advise and assist U.S. citizens on opening offshore accounts, establishing sham trusts and shell corporations, hiding assets offshore, and making secret use of their offshore assets here at home. Experts estimate that Americans now have more than \$1 trillion in assets offshore<sup>2</sup> and illegally evade between \$40 and \$70 billion in U.S. taxes each year through the use of offshore tax schemes.<sup>3</sup>

Utilizing tax haven secrecy laws and practices that limit corporate, bank, and financial disclosures, financial professionals often use offshore tax haven jurisdictions as a “black box” to hide assets and transactions from the Internal Revenue Service (IRS), other U.S. regulators, and law enforcement. This Report is an attempt to open that black box and expose how offshore and U.S. financial professionals are helping U.S. citizens conceal and secretly utilize offshore assets, while undermining, circumventing, or violating U.S. tax, securities, and anti-money laundering laws.

Offshore abuses are not a new story. In 1983, this Subcommittee investigated some of the same problems going on today.<sup>4</sup> News accounts regularly describe U.S. persons and

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<sup>1</sup> See, e.g., “The Price of Offshore,” Tax Justice Network briefing paper (3/05)(estimating that offshore assets of high net worth individuals now total \$11.5 trillion); “International Narcotics Control Strategy Report,” U.S. Department of State Bureau for International Narcotics and Law Enforcement Affairs (3/00), at 565-66 (identifying more than 50 offshore jurisdictions with assets totaling \$4.8 trillion). The Cayman Islands alone is now the fifth largest financial center in the world.

<sup>2</sup> “The Price of Offshore,” Tax Justice Network briefing paper (3/05)(estimating that offshore assets of high net worth individuals from North America total about \$1.6 trillion).

<sup>3</sup> See, e.g., Joe Guttentag and Reuven Avi-Yonah, “Closing the International Tax Gap,” in Max B. Sawicky, ed., *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* (2006). The \$40 to \$70 billion figure is intended to describe illegal tax evasion by mostly individual U.S. taxpayers using offshore tax schemes; illegal tax evasion by corporations using offshore tax schemes such as transfer pricing and offshore tax shelters would increase the total still further. *Id.* The IRS has estimated that corporate offshore tax evasion in 2001 totaled about \$30 billion. *Id.*

<sup>4</sup> See “Crime and Secrecy: the Use of Offshore Banks and Companies,” hearing before the U.S. Senate Permanent Subcommittee on Investigations, S. Hrg. 98-151 (March 15, 16 and May 24, 1983).

businesses using offshore entities to commit tax evasion, financial fraud, and money laundering. In 2001, this Subcommittee took testimony from a U.S. owner of a Cayman Island offshore bank who estimated that 100% of his clients were engaged in tax evasion, and 95% were U.S. citizens.<sup>5</sup>

The evidence is overwhelming that inaction in combating offshore abuses has resulted in their growing more widespread and reaching new levels of sophistication. In 2000, Enron Corporation established over 441 offshore entities in the Cayman Islands.<sup>6</sup> In 2003, the IRS estimated that 500,000 U.S. taxpayers had offshore bank accounts and were accessing the funds with offshore credit cards.<sup>7</sup> A 2004 report found that U.S. multinational corporations are increasingly attributing their profits to offshore jurisdictions, allocating \$150 billion in 2002 profits to 18 offshore jurisdictions, for example, up from \$88 billion just three years earlier.<sup>8</sup> A 2005 study of high-net-worth individuals worldwide estimated that their offshore assets now total \$11.5 trillion.<sup>9</sup>

This Report examines the offshore industry behind these statistics, including the role of offshore service providers, the interactions between offshore and U.S. professionals who help to establish and manage offshore entities, and the range of sophisticated schemes being used today to enable U.S. citizens to hide and secretly utilize offshore assets.

To illustrate the issues, this Report presents six case histories showing how U.S. citizens, with the backing of an armada of professionals, hide assets, shift income offshore, or use offshore entities to circumvent U.S. laws. The first case history examines an offshore promoter located in the United States who recruited clients through the internet and helped them create offshore structures. The second case history examines an offshore promoter who developed a how-to manual for going offshore and one of his U.S. clients who used that manual to move his assets to multiple tax havens. The third case history examines a U.S. businessman who, with the guidance of a prominent offshore promoter, moved between \$400,000 and \$500,000 in untaxed business income offshore. These cases demonstrate the use of phony loans, billing schemes,

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<sup>5</sup> “Role of U.S. Correspondent Banking in International Money Laundering,” hearing before the U.S. Senate Permanent Subcommittee on Investigations, S. Hrg. 107-84, (March 1, 2 and 6, 2001), testimony of John M. Mathewson, at 12-13.

<sup>6</sup> See 2000 Form 10-K filed with the SEC by Enron, Exhibit 21; “Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations,” prepared by Joint Committee on Taxation staff (2/03), at 375.

<sup>7</sup> “Challenges Remain in Combating Abusive Tax Schemes,” report by the Government Accountability Office to U.S. Senate Finance Committee, No. GAO-04-50 (11/03) at 1.

<sup>8</sup> “Data Show Dramatic Shift of Profits to Tax Havens,” Tax Notes (9/13/04). See also “Governments and Multinational Corporations in the Race to the Bottom,” Tax Notes (2/27/06)

<sup>9</sup> “The Price of Offshore,” Tax Justice Network briefing paper (3/05).

offshore credit cards, and other methods to take funds offshore to avoid taxes and creditors, and bring them back into the United States.

The fourth case history examines actions taken by a wealthy American to hide about \$450 million in stock and cash offshore by disguising his ownership of the corporations that held those assets. The fifth case history examines a complex securities transaction, known as POINT, which was aimed at sheltering over \$2 billion in capital gains from U.S. taxes, relying in part on offshore secrecy to shield its workings from U.S. law enforcement. The sixth, and final, case history examines two U.S. citizens who moved about \$190 million in stock option compensation offshore using a complex array of 58 offshore trusts and corporations, and utilized a wide range of offshore mechanisms to exercise direction over these assets and over \$600 million in investment gains. Together, these case histories raise a wide range of U.S. tax avoidance, securities laws, and anti-money laundering concerns.

## I. EXECUTIVE SUMMARY

### A. Subcommittee Investigation

The Subcommittee began this investigation into offshore abuses over one year ago. Over that time period, the Subcommittee has consulted with numerous experts in the areas of tax, securities, trust, anti-money laundering, and international law. The Subcommittee issued 74 subpoenas and conducted more than 80 interviews with a range of parties related to the issues and case histories examined in this Report. The Subcommittee reviewed over two million pages of documents, including memoranda, trust agreements, internal financial records, correspondence, and electronic communications, as well as materials in the public domain, such as legal pleadings, court documents, and SEC filings.

### B. Overview of Case Histories

This Report sets forth several case histories to lend insight into the operation of the offshore industry, its service providers and clients, and the impact of offshore abuses on U.S. tax, securities, and anti-money laundering laws.

**EDG: An Internet-Based Offshore Promoter.** This case history examines an offshore promoter located in the United States who recruited clients through the internet and helped them create offshore structures. Equity Development Group (EDG) is a company based in Dallas, Texas; its president, Samuel Congdon, is a U.S. citizen. Over the past six years, EDG utilized the internet to provide about 900 mainly American clients, many of relatively modest wealth, with the type of offshore services previously available primarily to high-net-worth individuals. With few resources, no employees, and only nine months prior experience in the industry, Mr. Congdon was able to quickly create and promote an online offshore facilitation business that provided a one-stop-shop for persons looking to establish an offshore structure. Mr. Congdon rarely met his clients, did not work with their lawyers or accountants, and seldom inquired into their intent. EDG told prospective clients that regardless of the offshore structures established for them, the client would retain full control of their offshore funds. Mr. Congdon told the Subcommittee that, in six years of operation, he could recall only one instance in which an offshore service provider declined to comply with a client instruction, in that case refusing to supply a sworn affidavit attesting to facts for a lawsuit. By connecting his clients with offshore banks and companies that establish and manage offshore trusts and corporations, and by acting as a liaison between his clients and the offshore service providers, Mr. Congdon enabled his clients to move assets offshore, maintain control of them, obscure their ownership, and conceal their existence from family, courts, creditors, the IRS, and other government agencies.

**Turpen-Holliday: A How-To Manual.** This case history examines an offshore promoter who developed a how-to manual for going offshore and one of his U.S. clients who used that manual to move his assets to multiple tax havens. The promoter, Dr. Lawrence Turpen, of Reno, Nevada, specialized in offshore transactions, publishing a book on the subject in addition to his manual. He provided a wide range of services to his clients, facilitating their creation of offshore entities and accounts. One of his clients, Robert F. Holliday, used the how-

to manual and Dr. Turpen's other services to establish shell corporations and trusts, both in offshore tax havens and in Nevada. Dr. Turpen selected offshore service providers that supplied nominee directors and trustees for Holliday's new entities, promising Mr. Holliday that they would comply with his directions. Mr. Holliday told the Subcommittee that he was the "puppet master" who instructed the offshore personnel on how to handle his offshore assets. Mr. Holliday did not include the offshore assets and income in his tax returns, even though under U.S. tax law, if he controlled them, he was required to report them.

On Dr. Turpen's suggestion, Mr. Holliday hid his ownership of the offshore assets by owning no shares in the shell corporations. Instead, the nominee directors appointed him a "management consultant" to the corporations, with authority to make business decisions and use corporate funds. Mr. Holliday typically transferred funds offshore by paying bills for fictitious services provided by the Nevada company which, in turn, paid fictitious bills presented by the offshore company. For example, Mr. Holliday transferred about \$450,000 in untaxed income to an Isle of Man shell corporation he controlled in payment for non-existent feasibility studies. To make use of the funds placed offshore, Mr. Holliday paid his bills using a credit card issued by an offshore bank, directed the offshore companies to pay designated expenses, and instructed the Nevada companies to borrow money from his offshore entities. These efforts allowed Mr. Holliday to conceal his income from the IRS, while enjoying control and use of the money. In 2004, both Mr. Holliday and Dr. Turpen pled guilty to tax-related conspiracy charges.

**Greaves-Neal: Diverting U.S. Business Income Offshore.** This case history examines a U.S. businessman who, with the guidance of a prominent offshore promoter, moved between \$400,000 and \$500,000 in untaxed business income offshore. Kurt Greaves, a Michigan businessman, told the Subcommittee that he first contacted Terry Neal, an offshore promoter based in Oregon, after seeing an advertisement for offshore services in an in-flight magazine. Under Mr. Neal's guidance, Mr. Greaves used a variety of sham transactions to transfer untaxed business income offshore without giving up the ability to use and manage those funds. Mr. Greaves told the Subcommittee that all of the offshore service providers who managed his offshore corporations readily complied with his requests on how to handle his assets, even though he did not technically own any shares in the offshore corporations. He said that the offshore service providers even fabricated documents to support fictitious tax deductions, including a phony mortgage and insurance policy. Like Mr. Holliday, Mr. Greaves established shell corporations in Nevada as an additional layer of separation between him and his offshore assets, and arranged for fictitious bills and loans to move funds between his Nevada and offshore entities. On one occasion, Mr. Greaves tried to visit an offshore service provider he used in Nevis. He told the Subcommittee that he found the office in a small stone building on the beach near the docks. He said that when he knocked on the door, the woman who answered, whose voice he recognized from telephone conversations, refused to let him inside, discouraging personal contact. Though this offshore service provider would not allow Mr. Greaves into its office, it provided the services he needed to evade U.S. taxes. In 2004, both Mr. Greaves and Mr. Neal pled guilty to charges related to federal tax evasion.

**Anderson: Hiding Offshore Ownership.** This case history examines actions allegedly taken by a wealthy American to hide hundreds of millions of dollars in stock and cash offshore

by disguising his ownership of the corporations that controlled those assets and failing to pay taxes on those assets. Walter C. Anderson was indicted for tax evasion in 2005, and is now awaiting trial. The government has developed evidence that Mr. Anderson took advantage of secrecy laws in multiple tax haven countries to create a structure of offshore corporations and trusts. According to the indictment, through a series of assignments, sales, and transfers, Mr. Anderson placed into these offshore entities about \$450 million in cash and stock, including large interests in telecommunications firms. He allegedly disguised his ownership of these assets through a range of techniques including shell companies, bearer shares, and nominee directors and trustees. In one instance, according to the indictment, Mr. Anderson set up an offshore shell corporation in the British Virgin Islands, gave its shares to a second shell corporation he established in the same jurisdiction, and had the second corporation send the shares to a bearer-share corporation in Panama, which he controlled. The government stated that it seized a document granting Mr. Anderson's mother the exclusive option to purchase, for \$9,900, ninety-nine percent of the bearer share corporation which then held assets worth millions of dollars. According to the indictment, Mr. Anderson used these methods to evade more than \$200 million in Federal and District of Columbia income taxes.

**POINT: Offshore Securities Portfolio.** This case history examines a complex securities transaction used to shelter over \$2 billion in capital gains from U.S. taxes, relying in part on offshore secrecy to shield its workings from U.S. law enforcement. In contrast to the case histories examining offshore structures used over a period of years, this inquiry focuses on the use of offshore secrecy jurisdictions to facilitate one-time tax shelter transactions. The tax shelter was designed, promoted, and implemented by a Seattle-based securities firm, Quellos Group, LLC, (Quellos), with the assistance of lawyers, bankers, and other professionals. Quellos sold the shelter, called POINT (Personally Optimized INvestment Transaction), to six wealthy clients in six separate transactions. Together, the tax shelters were used in an effort to erase over \$2 billion in capital gains that would otherwise have been taxed, costing the U.S. Treasury lost revenue of about \$300 million.

The Subcommittee found that the POINT tax strategy was based upon billions of dollars worth of fake securities transactions that were used to generate billions of dollars in fake capital losses to offset real taxable capital gains of U.S. taxpayers so they could avoid paying taxes to the U.S. Treasury. The fake securities transactions were undertaken by two offshore shell corporations in the Isle of Man, Jackstones and Barnville, whose ownership has been kept secret. The transactions were carried out by compliant offshore administrators and trustees, since the corporations had no employees of their own. Using circular transactions and offsetting payments that cancelled each other out, these offshore corporations created a paper portfolio of over \$9 billion in U.S. high tech stocks that appeared to suffer price drops and generated the fake capital losses used in the POINT transactions. The fees charged by Quellos depended upon the amount of tax loss generated in each transaction for the taxpayer who bought the shelter; the more money the taxpayer "lost" from the transaction, the more Quellos charged for the scheme.

Six U.S. taxpayers, including Haim Saban and Robert Wood Johnson IV, purchased the tax shelter, paying fees totaling approximately \$65 million. Prominent law firms, such as Cravath, Swaine & Moore and Bryan Cave, provided written tax opinion letters affirming that it

was “more likely than not” that the Quellos plan would produce the favorable tax consequences promised, and collaborated with Quellos on its design or implementation. The factual statements used to support the legal analysis in the opinion letters inaccurately described the nature of the securities transactions generating the capital losses. The law firms accepted the representations of Quellos on these matters without inquiring behind them. Prominent U.S. and foreign financial institutions, including HSBC Bank, provided financing for the POINT transactions, without conducting adequate due diligence into the underlying transactions. Some communications involving persons who helped design, promote, and implement the tax shelter indicate that they may have deliberately hidden key aspects of the POINT transaction from the clients, lawyers, and financial institutions who participated in them.

**Wyls: 58 Offshore Trusts and Corporations.** The sixth, and final, case history comprises the most elaborate offshore operations reviewed by the Subcommittee. Over a 13-year period from 1992 to 2005, two U.S. citizens, Sam and Charles Wyly, assisted by an army of attorneys, brokers, and other professionals, transferred over 17 million stock options and warrants representing approximately \$190 million in compensation to a complex array of 58 trusts and shell corporations. The offshore trusts had either been established by the Wyls or named them as beneficiaries; the trusts owned the shell corporations that took possession of the stock options and warrants. In return, the Wyls obtained private annuity agreements from the offshore corporations. The Wyls took the position, on the advice of counsel, that because they had exchanged their stock options for annuities of equivalent value, no tax was due on their stock option compensation, until they received actual annuity payments years later. The first annuity payment was made ten years later in 2003. To date, about \$124 million in stock option compensation remains offshore and untaxed.

From 1992 through 2004, the Wyls and their representatives directed the offshore entities on exercising the stock options and warrants, and engaging in a wide range of securities trades and other transactions. The Wyls and their representatives conveyed their decisions to two individuals the Wyls had selected, called “trust protectors,” who communicated the decisions, worded as “recommendations,” to the offshore trustees, who implemented them. In addition to cashing in many of the options, the offshore entities used the cash and shares to generate substantial investment gains. The Wyls did not pay taxes on these gains, on advice from counsel, even though the U.S. tax code generally requires that income earned by a trust controlled by a U.S. person who funded or is a beneficiary of the trust be attributed to that U.S. person for tax purposes. The Wyly legal position was that the offshore trusts were independent entities. Over the 13 years examined in this Report, the offshore entities used more than \$600 million from untaxed stock sales and other investment gains to issue substantial loans to Wyly interests, finance Wyly-related business ventures, and acquire U.S. real estate, furnishings, art, and jewelry for the personal use of Wyly family members. The offshore entities placed nearly \$300 million of these offshore dollars in two hedge funds and an investment fund established by the Wyls.

The stock options exercised by the offshore entities came from three publicly traded corporations with which the Wyls were associated, Michaels Stores Inc., Sterling Software Inc., and Sterling Commerce Inc. In addition to the tax issues, a key concern is whether, by sending

millions of company stock options and warrants to offshore entities whose investments they directed, the Wylys were using offshore secrecy laws to circumvent basic U.S. principles intended to ensure fair and transparent capital markets, including disclosure requirements for directors, officers and large shareholders, trading restrictions on privately acquired shares, and prohibitions against trading on nonpublic information. For most of the 13 years examined in this Report, U.S. securities regulators and the investing public were not informed of the extent of the Wyly-related offshore stock holdings and trading activity.

The Wyly transactions also raise issues related to compliance with anti-money laundering laws. Over the years, the 58 offshore trusts and corporations opened securities accounts at three prominent U.S. financial institutions, Credit Suisse First Boston (CSFB), Lehman Brothers, and Bank of America. All three financial institutions knew that the offshore entities were associated with the Wyly family, but never required the offshore entities to identify their beneficial owners. By 2003, when Bank of America had the accounts, the law was clear that the Bank had to identify the beneficial owners. Despite being pressed for nearly a year by its clearing broker to do so, Bank of America allowed the accounts to operate without obtaining the information required by law. In addition, when for tax purposes, the Wyly-related offshore entities submitted forms representing they were independent foreign entities not subject to IRS 1099 reporting requirements for U.S. taxpayers, Bank of America accepted the forms, despite knowing the Wylys were directing the offshore entities' investments and benefitting from their account income. Had the offshore entities acknowledged that the Wylys were the beneficial owners of the offshore trusts and corporations for purposes of complying with the anti-money laundering laws, and allowed their connection to the Wylys be documented at Bank of America, it would have been harder for the Wylys to deny a connection to these entities for tax and securities purposes.

Many of the offshore mechanisms used in this case history raise serious tax, securities, or other concerns, including the stock option-annuity swaps; pass-through loans using an offshore vehicle; securities traded by offshore entities associated with corporate insiders; and the use of hedge funds and other investment vehicles to control use of funds placed offshore. Sam and Charles Wyly reaped a number of benefits from their offshore activities, including attempted deferral of taxes on their stock option compensation, nonpayment of taxes on hundreds of millions of dollars in offshore capital gains by entities they directed, a ready source of capital for their business ventures in the United States, and a ready source of funds to finance their personal interests. Among those impacted by the Wyly offshore activities are U.S. taxpayers who have to make up the lost revenue, and the investing public who were kept in the dark about the offshore stock holdings and trading activity of entities controlled by the directors of three publicly traded corporations.

### **C. Findings and Recommendations**

Based upon its investigation into offshore abuses undermining U.S. tax, securities, and anti-money laundering (AML) laws, the Subcommittee staff makes the following findings and recommendations.

## Report Findings

**1. Control of Offshore Assets.** Offshore “service providers” in tax havens use trustees, directors, and officers who comply with client directions when managing offshore trusts or shell corporations established by those clients; the offshore trusts and shell corporations do not act independently.

**2. Tax Haven Secrecy.** Corporate and financial secrecy laws and practices in offshore tax havens make it easy to conceal and obscure the economic realities underlying a great number of financial transactions with unfair results unintended under U.S. tax and securities laws.

**3. Ascertaining Control and Beneficial Ownership.** Corporate and financial secrecy laws and practices in offshore tax havens are intended to make it difficult for U.S. law enforcement, creditors, and others to learn whether a U.S. person owns or controls an allegedly independent offshore trust or corporation. They also intentionally make it difficult to identify the beneficial owners of offshore entities.

**4. Offshore Tax Haven Abuses.** U.S. persons, with the assistance of lawyers, brokers, bankers, offshore service providers, and others, are using offshore trusts and shell corporations in offshore tax havens to circumvent U.S. tax, securities, and anti-money laundering requirements.

**5. Anti-Money Laundering Abuses.** U.S. financial institutions have failed to identify the beneficial owners of offshore trusts and corporations that opened U.S. securities accounts, and have accepted W-8 forms in which offshore entities represented that they beneficially owned the account assets, even when the financial institutions knew the offshore entities were being directed by or were closely associated with U.S. taxpayers.

**6. Securities Abuses.** Corporate insiders at U.S. publicly traded corporations have used offshore entities to trade in the company’s stock, and these offshore entities have taken actions to circumvent U.S. securities safeguards and disclosure and trading requirements.

**7. Stock Option Abuses.** Because stock option compensation is taxed when exercised, and not when granted, stock options have been used in potentially abusive transactions to defer and in some cases avoid U.S. taxes.

**8. Hedge Fund Transfers.** U.S. persons who transferred assets to allegedly independent offshore entities in a tax haven have then directed those offshore entities to invest the assets in a hedge fund controlled by the same U.S. persons, thereby regaining investment control of the assets.

## **Report Recommendations**

- 1. Presumption of Control.** U.S. tax, securities, and anti-money laundering laws should include a presumption that offshore trusts and shell corporations are under the control of the U.S. persons supplying or directing the use of the offshore assets, where those trusts or shell corporations are located in a jurisdiction designated as a tax haven by the U.S. Treasury Secretary.
- 2. Disclosure of U.S. Stock Holdings.** U.S. publicly traded corporations should be required to disclose in their SEC filings company stock held by an offshore trust or shell corporation related to a company director, officer, or large shareholder, even if the offshore entity is allegedly independent. Corporate insiders should be required to make the same disclosure in their SEC filings.
- 3. Offshore Entities as Affiliates.** An offshore trust or shell corporation related to a director, officer, or large shareholder of a U.S. publicly traded corporation should be required to be treated as an affiliate of that corporation, even if the offshore entity is allegedly independent.
- 4. 1099 Reporting.** Congress and the IRS should make it clear that a U.S. financial institution that opens an account for a foreign trust or shell corporation and determines, as part of its anti-money laundering duties, that the beneficial owner of the account is a U.S. taxpayer, must file a 1099 form with respect to that beneficial owner.
- 5. Real Estate and Personal Property.** Loans that are treated as trust distributions under U.S. tax law should be expanded to include, not just cash and securities as under present law, but also loans of real estate and personal property of any kind including artwork, furnishings, and jewelry. Receipt of cash or other property from a foreign trust, other than in an exchange for fair market value, should also result in treatment of the U.S. person as a U.S. beneficiary.
- 6. Hedge Fund AML Duties.** The Treasury Secretary should finalize a proposed regulation requiring hedge funds to establish anti-money laundering (AML) programs and report suspicious transactions to U.S. law enforcement. This regulation should apply to foreign-based hedge funds that are affiliated with U.S. hedge funds and invest in the United States.
- 7. Stock Option-Annuity Swaps.** Congress and the IRS should make it clear that taxes on stock option compensation cannot be avoided or deferred by exchanging stock options for other assets of equivalent value such as private annuities.
- 8. Sanctions on Uncooperative Tax Havens.** Congress should authorize the U.S. Treasury Secretary to identify tax havens that do not cooperate with U.S. tax enforcement efforts and eliminate U.S. tax benefits for income attributed to those jurisdictions.

## II. THE OFFSHORE INDUSTRY

The business of promoting, developing, and administering offshore financial services has become a massive and complex industry. The range of services and products available offshore now parallels what is available domestically, but offshore service providers typically advertise a level of secrecy and tax avoidance that cannot be found onshore. This Report presents a number of case studies that illustrate the roles played by offshore promoters and service providers, the products and services they offer, and how they interact with U.S. persons to hide assets and shift income offshore.

Components of the offshore industry can be summarized as follows.

**Offshore Jurisdictions.** First and foremost, the offshore industry relies upon jurisdictions that promise secrecy and anonymity to persons doing business in their territories. At least 50 such jurisdictions are operating in the world today,<sup>10</sup> and the extent to which an offshore jurisdiction maintains secrecy laws and practices is typically used as a key selling point for persons considering moving their assets offshore. These jurisdictions typically provide several layers of secrecy protections to persons transacting business with their residents. U.S. law enforcement typically is not even aware that an offshore entity or account exists. Once a regulatory or law enforcement agency does become aware of the entity or account, most offshore jurisdictions require a long and cumbersome process in order to gain access to any important information, such as the identities of an offshore corporation's beneficial owners or a trust's grantors and beneficiaries. In many offshore jurisdictions it is a crime for a bank or other financial institution to divulge the names of account holders or client-specific financial transactions outside of this prolonged process. Moreover, a private party with a claim against an offshore entity, such as a plaintiff with a civil judgment, faces huge legal and logistic hurdles to find or access offshore accounts and assets.

In addition to corporate, financial, and trust secrecy, the legal regimes of offshore jurisdictions typically place restrictions on assisting international tax enforcement efforts. Most of these jurisdictions impose little or no taxes on nonresidents. Until recently, many offshore jurisdictions refused to cooperate with international law enforcement requests for information related to tax matters, because tax evasion was not considered a crime within the jurisdiction itself. In addition, offshore regulators do not have the ability to easily monitor individual transactions by the offshore service providers.

International organizations have expressed concern over the lack of information exchange on tax matters, as well as poor cooperation with international anti-money laundering

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<sup>10</sup> See, e.g., "International Narcotics Control Strategy Report," U.S. Department of State Bureau for International Narcotics and Law Enforcement Affairs (3/00), at 574-77 (identifying more than fifty offshore jurisdictions). It should also be noted that most states in the United States allow persons to create corporations without providing beneficial ownership information. See GAO Report 06-376, "Company Formations: Minimal Ownership Information is Collected and Available," 4/06, <http://www.gao.gov/new.items/d06376.pdf>.

investigations, and have taken action to pressure non-cooperative jurisdictions.<sup>11</sup> In response, in recent years, some offshore jurisdictions have improved their anti-money laundering laws and signed tax information exchange agreements with other governments. However, the heavy dependence of offshore jurisdictions on their financial sectors invites poor implementation of these reforms and weak government oversight.

**Offshore Promoters.** The transfer of funds offshore often begins with an offshore promoter. Promoters are individuals and firms who work to bring new clients offshore and facilitate the offshore movement of their assets. Promoters typically use the internet, seminars, books, mailings, and other means to advertise the benefits of taking assets offshore. They typically provide advice on the types and relative advantages of available offshore structures and connect individual clients to offshore service providers that may suit their needs. Often this advice includes recommending an offshore jurisdiction whose laws and regulatory structure best advance the client's objectives. Some promoters also act as an intermediary between their clients, the offshore governments, and local service providers.

Promoters typically earn income through fees charged to clients and referral fees paid by the offshore service providers and financial institutions to whom they refer clients. Client fees are generally either a commission based on the value of assets going offshore, an overall charge for an offshore "package" of services, or flat fees for specific services.

**Corporate Formation Agents and Trust Companies.** A key group of offshore service providers is made up of corporate formation agents and trust companies. These service providers are the individuals or firms who establish the offshore corporations and trusts that serve as the recipients of assets transferred offshore. These offshore service providers, sometimes in conjunction with a promoter, fill out the paperwork, file it with the appropriate government agencies, pay fees, and often provide trustees, nominee directors, or nominee officers for the required documentation. The client generally never needs to travel to the jurisdiction, and the client's name typically appears nowhere on the formation documents.

Most offshore corporations and trusts are shell operations that exist only on paper and function without their own employees or offices. They usually have little more than an offshore mailing address and an offshore individual empowered to sign documents on behalf of the entity. Once a trust or corporation is created, the client can open banking or brokerage accounts in its name, rather than in the client's own name. This trust or corporation can then be listed on U.S. bank transfers and other documents as the owner of the funds, even if the client is the only person with authority over the accounts. Real estate, stock, artwork, or other property can similarly be held in the name of the offshore entity.

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<sup>11</sup> See, e.g., "Towards Global Tax Co-operation ... Progress in Identifying and Eliminating Harmful Tax Practices," prepared by the Organization for Economic Cooperation and Development (6/00)(including list of 35 "uncooperative tax havens"); "Review to Identify Non-Cooperative Countries or Territories: Increasing the Worldwide Effectiveness of Anti-Money Laundering Measures," prepared by the Financial Action Task Force on Money Laundering (6/22/00).

Some clients are satisfied with a single offshore corporation or trust. Others pay for the formation of a more complex offshore structure consisting of several related corporations and trusts to disguise the client's relationship to the offshore assets they hold. For example, an offshore service provider may create one or more offshore corporations to serve as the owner of record for different client assets and offshore accounts, and it may form one or more offshore trusts to wholly own the corporations. Many corporate formation agents and trust companies will also supply trustees and nominee corporate directors and officers to give the entities the appearance of independent, functioning entities, while ensuring that the client's name is in no way attached to them. In some cases, the offshore service provider and client may sign a side letter agreement or other document attesting to the fact that the client is the beneficial owner of the offshore assets, since no other document evidences the client's ownership.<sup>12</sup>

As the offshore industry has expanded, competition among corporate formation agents and trust companies has increased. This competition has led to lower fees and quicker turn-around times in the establishment of new offshore entities. In addition, it has further weakened compliance with fiduciary duties and regulations associated with creating and managing offshore entities.

**Corporate and Trust Administrators.** In addition to forming new offshore entities, offshore service providers typically offer to manage the trusts and corporations they create, for an annual management fee. These management services include filing annual reports and paying fees to the government, authorizing corporate or trust actions, operating bank and securities accounts, keeping records, and handling correspondence. Administrators typically maintain records offshore under secrecy laws that keep them out of the reach of regulatory personnel and other onshore investigators.

As the following case histories demonstrate, offshore corporate and trust administrators typically ensure client control over the assets held by the offshore entities. Control is assured through various means. For example, administrators may appoint a nominee director of an offshore corporation in order to have the name of a natural person other than the client on the incorporation documents, but then place all of the corporate assets in an account for which the client is the sole signatory. Trust administrators also often appoint a trustee who agrees to follow all client recommendations for trust activities.

**Trust Protectors.** For the management of trusts, some service providers also supply individuals who serve as so-called "trust protectors." The role of trust protector is generally not defined in law, and these persons can provide a wide range of services. In some cases they serve to safeguard trust assets from misappropriation, while in others they effectively manage the trust

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<sup>12</sup> See, e.g., "Private Banking and Money Laundering: A Case Study of Opportunities and Vulnerabilities," S. Hrg. 106-428 hearings before the U.S. Senate Permanent Subcommittee on Investigations (11/9/99, 11/10/99), at 890 (discussing a Cayman corporation created for Raul Salinas, then brother to the president of Mexico, where his name did not appear on the incorporation documents, but was included in separate documentation maintained by Cititrust in the Cayman Islands, under secrecy laws restricting its disclosure).

assets. Some clients select a U.S. person who the client knows and trusts; others select offshore personnel outside the reach of U.S. law. Many offshore trusts are established with the intention of maintaining client control, and in such cases trust protectors can serve as conduits of the client's instructions to the trustees, with the trustees merely rubber stamping the protectors' directions. Such an arrangement permits greater client control while maintaining the appearance of trustee independence.

**Financial Institutions.** Financial institutions are also crucial players in the offshore services industry. Offshore banks and securities firms open accounts for the shell entities that hold the clients' offshore assets. These firms typically have correspondent accounts with one or more U.S. financial institutions that function as gateways into the U.S. financial system. The U.S. institutions then provide international wire transfer services, financing, and brokerage services for the offshore financial institution, often without knowing the identity of the clients whose funds are involved.<sup>13</sup> Many U.S. banks and securities firms open accounts onshore in the name of the offshore entities. These offshore entities then make use of the U.S. financial system.

**Law Firms.** Law firms are still another set of key players in today's offshore industry. Lawyers help establish offshore structures, draft financial instruments, and provide legal opinions justifying offshore transactions. In some cases, law firms take an even more active role, designing offshore structures for their clients, identifying offshore service providers, and conducting negotiations with these providers on the clients' behalf.

**Tools for Transferring Assets.** Onshore promoters and offshore service providers have devised a wide range of techniques for transferring assets offshore and then bringing funds back into the United States for the client's use. Some of these techniques are well-established. For example, offshore banks typically issue ATM or credit cards in the name of a shell corporation or trust. Clients can then use these cards in the United States to access their offshore funds, just as if the assets were in a domestic bank. Clients can also make sham loans to their offshore entities to move funds offshore or accept loans from offshore entities to bring funds back into the United States. Similarly, clients and their offshore entities can pass funds by billing each other for fictional services. Assets can also be moved in and out of offshore jurisdictions through shell intermediaries to disguise their source and destination. Recently, offshore service providers have developed new methods to transfer assets between onshore and offshore entities, including the use of annuities, mortgages, and offshore insurance companies. These techniques are explained in the case histories that follow.

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<sup>13</sup> For more information on how offshore banks use correspondent accounts at U.S. banks, see "Role of U.S. Correspondent Banking in International Money Laundering," S. Hrg. 107-84 hearing before the U.S. Senate Permanent Subcommittee on Investigations (3/1/01, 3/2/01, and 3/6/01).

## Offshore Jurisdictions Discussed in the Case Histories

This Report presents several case histories of persons who hid assets or shifted income to offshore jurisdictions, including Belize, the British Virgin Islands, the Cayman Islands, the Isle of Man, Nevis, and Panama. While these are only a few of the offshore jurisdictions where U.S. citizens have placed their assets, the case histories demonstrate how they were used by U.S. citizens to move money offshore.

Belize is a small nation on the Caribbean coast of Central America. It is home to a developing offshore financial industry, including eight offshore banks, one offshore insurance company, 23 trust companies, and 38,471 registered offshore corporations. Officials in the country have reported a recent increase in financial crimes, including bank fraud, forgery, and counterfeiting.<sup>14</sup>

The British Virgin Islands (BVI) is a group of islands in the Caribbean and an overseas territory of the United Kingdom. It has licensed 11 banks, 90 trust companies, and 90 registered agents.<sup>15</sup> The British Virgin Islands has over 500,000 registered offshore corporations,<sup>16</sup> apparently the most of any offshore jurisdiction.

The Cayman Islands is a group of islands in the Caribbean and an overseas territory of the United Kingdom. It is the world's fifth-largest financial center and has a well-developed offshore financial services industry. Firms in the Cayman Islands provide private banking, brokerage services, mutual funds, insurance, trusts, and company formation and management. It is home to over 500 banks and trust companies, 7,100 mutual and hedge funds, and 727 captive insurance companies.<sup>17</sup>

The Isle of Man is an island in the Irish Sea and a Crown Dependency of the United Kingdom. It is home to 171 offshore service providers, including banks, trust companies, and company formation agents. Together these firms managed about \$57 billion in bank deposits, \$12 billion in collective investment schemes, \$33 billion in life insurance funds, and \$11 billion in non-life insurance funds.<sup>18</sup>

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<sup>14</sup> "International Narcotics Control Strategy Report, Volume II: Money Laundering and Financial Crimes," U.S. Department of State Bureau for International Narcotics and Law Enforcement Affairs (3/06), at 92-94.

<sup>15</sup> *Id.* at 111.

<sup>16</sup> "British Virgin Islands - Overseas Territory of the United Kingdom: Assessment of the Supervision and Regulation of the Financial Sector, Volume II - Detailed Assessment of Observance of Standards and Codes," IMF Country Report No. 04/93, International Monetary Fund (4/04), at section 93.

<sup>17</sup> "International Narcotics Control Strategy Report, Volume II: Money Laundering and Financial Crimes," U.S. Department of State Bureau for International Narcotics and Law Enforcement Affairs (3/06), at 124.

<sup>18</sup> *Id.* at 217.

Panama is a nation in Central America. It is home to 34 offshore banks and approximately 350,000 offshore companies. The State Department considers Panama “particularly vulnerable to money laundering because of its proximity to major drug-producing countries, its sophisticated international banking sector, [and] its dollar-based economy.” Bearer bonds also present “a potential vulnerability that could be exploited by money launderers.”<sup>19</sup>

St. Kitts and Nevis is a federation of two islands in the Caribbean, each with the authority to organize its own financial industry. Most of the offshore financial business is concentrated in Nevis. St. Kitts and Nevis is home to one offshore bank, 50 trust and company service providers, 950 trusts, and 15,000 offshore corporations. The State Department considers the nation a “major risk for corruption and money laundering, due to a high volume of narcotics trafficking” and “an inadequately regulated economic citizenship program.”<sup>20</sup>

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<sup>19</sup> Id. at 297.

<sup>20</sup> Id. at 353.

### III. EDG CASE HISTORY: AN INTERNET-BASED OFFSHORE PROMOTER

Most U.S. citizens do not venture offshore without assistance. Over the years, a variety of companies, in the United States and abroad, have developed to promote and facilitate the establishment of offshore financial structures. These companies range in size and sophistication from single-employee, owner-operated businesses to multi-national corporations with hundreds of employees.

In the past, offshore promoters often worked with clients in person, and advertised at trade shows and in speciality publications. With the advent of the internet age, many offshore promoters established a presence online. The internet has lowered the barriers of entry into the offshore business for both promoters and clients. Promoters can reach countless potential clients through search engines and online advertising. Potential clients can access information about the offshore industry instantaneously, anonymously, and in the comfort of their own home. Promoters and their clients need never meet. In addition, online promoters are often well equipped to offer offshore solutions to people of modest wealth, not just the high-net-worth individuals sought out by traditional promoters. This case history focuses on one such internet promoter currently operating in the United States, called Equity Development Group (EDG).

**Background.** Pursuant to a formal request, Sam Congdon, EDG's founder, president, and sole employee, agreed to be interviewed by the Subcommittee, and to produce relevant documentation.<sup>21</sup> Equity Development Group is a Dallas, Texas, based company that helped set up offshore trusts, companies, and bank accounts. Nearly all of EDG's clients learned about EDG online. EDG acted as an intermediary between clients seeking to move their assets offshore, and the offshore institutions that provided the offshore structures. EDG presents a good example of the role that online promoters and facilitators play in helping U.S. citizens conceal assets offshore.<sup>22</sup>

Mr. Congdon established EDG in 1999, after receiving a BA in Economics from Hillsdale College in Michigan, an MBA from Southern Methodist University in Texas, and working for nine months in the offshore service industry, at a company called Universal Corporate Services. Mr. Congdon is EDG's sole employee. The company maintains a webpage, [www.equitydevelopers.com](http://www.equitydevelopers.com), which serves as its main interface with clients and potential clients. Mr. Congdon told the Subcommittee that EDG has had about 900 clients throughout its existence.<sup>23</sup> The great majority of those clients first contacted EDG through its website.<sup>24</sup> The EDG website states that the company also maintains an office in Nassau, Bahamas, but

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<sup>21</sup> Subcommittee interview of Mr. Congdon (6/30/06).

<sup>22</sup> EDG has clients from around the world, but most of its clients are from the United States and Canada. Subcommittee interview of Mr. Congdon (6/30/06).

<sup>23</sup> Id.

<sup>24</sup> Id.

Mr. Congdon told the Subcommittee that the Nassau office is just a mailbox, and that he, the company's President and sole employee, has never been to the Nassau office.<sup>25</sup>

**Services.** EDG endeavored to be a one-stop-shop for clients seeking to establish an offshore structure. EDG devotes much of its website to explaining the offshore structures that EDG can create for its clients. The site promotes the establishment of offshore corporations, referred to as "international business corporations" (IBCs), as well as offshore trusts, offshore bank and brokerage accounts, and offshore addresses.<sup>26</sup> It also features an online survey to match prospective clients to the right types of structures<sup>27</sup> and an order form for purchase of EDG's services.<sup>28</sup> The details of these arrangements were frequently finalized in e-mail correspondence.<sup>29</sup>

On its website, EDG advertises, "EDG can recommend offshore products and services to suit anyone's needs. . . . We can form offshore companies, trusts, open offshore bank and brokerage accounts, and establish secure offshore addresses; all in the locations that are most advantageous to a client's individual circumstances."<sup>30</sup> Clients that decide to use EDG can purchase offshore incorporation products through its website. The website contains a menu of offshore products and an e-commerce platform to allow online purchases. As of July 2006, EDG offers for purchase online two "complete offshore packages," Belize, BVI, and Nevis international business corporations, an "Offshore Asset Protection Trust," bank accounts in Antigua, Curacao, St. Lucia, and Switzerland, brokerage accounts in Panama and the Turks and Caicos, offshore mail forwarding, various trust, bank, and corporate documents, and related services including bearer share certificates, corporate seals, powers of attorney, offshore notary services, changes of corporate name, and certificates of good standing. EDG's "Offshore Package #1," which costs \$2,500, includes an offshore corporation in Belize, an offshore trust in the Bahamas, two offshore accounts, and offshore mail forwarding for a year. EDG's "Offshore Package #2" costs \$2,850 and differs from the first package in that the offshore corporation is formed in Nevis and promises a quicker set-up. Mr. Congdon told the Subcommittee that he typically set up a corporation with each trust that he established.<sup>31</sup>

EDG also sold shelf companies, which are shell corporations that have been in existence for some period of time before they are purchased. EDG's website explains, "A small

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<sup>25</sup> Id.

<sup>26</sup> EDG Website, [www.equitydevelopers.com/offshore\\_101\\_full.asp](http://www.equitydevelopers.com/offshore_101_full.asp) (viewed 10/31/05).

<sup>27</sup> EDG Website, [www.equitydevelopers.com/offshore\\_planning\\_center.asp](http://www.equitydevelopers.com/offshore_planning_center.asp) (viewed 7/5/06).

<sup>28</sup> Id. at [www.equitydevelopers.com/downloads/orderform.pdf](http://www.equitydevelopers.com/downloads/orderform.pdf).

<sup>29</sup> See, e.g., 10/10/05 email from a potential client to Mr. Congdon (EDG-EML023-28).

<sup>30</sup> EDG Website, [http://www.equitydevelopers.com/what\\_we\\_do.asp](http://www.equitydevelopers.com/what_we_do.asp), (viewed 7/7/06).

<sup>31</sup> Subcommittee interview of Mr. Congdon (6/30/06).

percentage of individuals and corporations that go offshore want to demonstrate that their offshore company has been in existence for several months or years. A Shelf Company is the perfect solution for this scenario.”<sup>32</sup> EDG’s website contains a menu of shelf companies, the oldest dating to January 1, 2001. Shelf companies are available from Belize, the British Virgin Islands, Gibraltar, and Nevis, and range in price from \$2,500 to \$6,200. In general, EDG charges more for the older shelf companies. Several of the listed shelf companies are advertised as having same day shipping available. Price of purchase includes “an original Certificate of Good Standing, government, registered agent, and nominee director fees.”<sup>33</sup>

Mr. Congdon typically included a mark-up in the price of his products, and received referral fees from some of the offshore institutions he worked with. Documents obtained by the Subcommittee indicate that EDG grossed several hundred thousand dollars in this way in 2003 and 2004.<sup>34</sup>

**Acting as an Intermediary.** Mr. Congdon served as a guide and an intermediary for clients as they established financial structures with banks, trust companies, and foreign sovereignties. Many of EDG’s transactions with clients and offshore institutions were conducted online. When a client purchased an offshore package from EDG, Mr. Congdon typically collected all of the relevant application documents from the banks and trust companies involved. Many of these documents were kept in electronic form and emailed between Mr. Congdon, the client, and the offshore institutions. For non-electronic paperwork, such as due diligence material for banks, Mr. Congdon typically collected the material from his clients and then express-mailed it to the banks. Mr. Congdon stated that EDG also kept its clients’ documents on an offshore computer server.<sup>35</sup>

Mr. Congdon also served as a liaison between his clients and the trustees and directors of their trusts and companies. Generally, Mr. Congdon chose the trustees, protectors, and directors for his clients’ companies and trusts, and served as the point of contact between them unless the client chose to serve as the sole director, which was rare. Mr. Congdon said that the majority of his clients preferred an appointed director. The trustees, protectors, and directors that Mr. Congdon chose were professionals working for offshore trust companies. Mr. Congdon estimated that one percent of his clients chose their own trust protectors.<sup>36</sup>

In the case of shell corporations established in Nevis, Mr. Congdon played a larger role, acting as owner and director during a company’s incorporation process. Mr. Congdon stated that

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<sup>32</sup> EDG Website, [www.equitydevelopers.com/learn\\_shelf\\_companies.asp](http://www.equitydevelopers.com/learn_shelf_companies.asp) (viewed 7/8/06).

<sup>33</sup> Id.; see also 1/10/05 email from Alpha Services Limited employee to Mr. Congdon (EDG-EML388-90).

<sup>34</sup> EDG Document, “New Revenue Comparison” (EDG-HD161).

<sup>35</sup> Subcommittee interview of Mr. Congdon (6/30/06).

<sup>36</sup> Id.

he performed this role for administrative purposes.<sup>37</sup> Under this system, the client's desired company was incorporated with Mr. Congdon as the sole director, and all shares of the company were issued to him.<sup>38</sup> Then, Mr. Congdon held a board meeting, at which he was the sole participant, and at the board meeting Mr. Congdon resigned as director, resolved to dissolve and destroy the stock certificates issued in his name, issued bearer shares for the company, and appointed the client, or a nominee, as the director of the company. Then Mr. Congdon shipped the bearer shares to his client.<sup>39</sup> Mr. Congdon told the Subcommittee that he never actually owned the companies that he established in this way, but rather, that he held them in trust for his clients.<sup>40</sup>

**Advertising and Promotion.** Mr. Congdon primarily used the internet to advertise and promote EDG's business of establishing offshore financial structures. Most of EDG's clients found the firm through the internet, after which Mr. Congdon corresponded with them over email. In addition, on two occasions in the first years of EDG's operations, Mr. Congdon set up a promotional booth at an industry trade show.<sup>41</sup>

The EDG website was the most important way that Mr. Congdon promoted his business to potential clients. He told the Subcommittee that he paid Google for a top position on certain searches, in order to direct greater traffic to his site.<sup>42</sup> He also hired web development professionals to improve his website, which further increased his web business. After viewing the website, prospective clients could purchase offshore products online or fill out an online form that sent an email to Mr. Congdon. Mr. Congdon typically answered inquiries promptly and often suggested an offshore structure to meet a potential client's requirements.

**Benefits of Going Offshore.** The website lists three primary benefits of taking assets offshore. First, it advertises offshore structures as "a wise and effective means of protection from ruinous lawsuits."<sup>43</sup> Correspondence between Mr. Congdon and prospective clients confirms that the ability to protect assets from liability for tort, divorce, or other legal claims motivated many of EDG's clients. In one such email, Mr. Congdon promised that "EDG's Complete Offshore Package ... will protect you from lawsuits and from relatives being able to

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<sup>37</sup> Id.

<sup>38</sup> Id. See, e.g., "Minutes of the first meeting of the Board of Directors of RSC Inc." (7/8/04) (EDG-HD025-47 at 34-35).

<sup>39</sup> Subcommittee interview of Mr. Congdon (6/30/06). See e.g. "Resolutions of the Board of Directors of RSC Inc." (7/14/04) (EDG-HD047).

<sup>40</sup> Subcommittee interview of Mr. Congdon (6/30/06).

<sup>41</sup> Id.

<sup>42</sup> Id.

<sup>43</sup> EDG Website, [www.equitydevelopers.com/why\\_go\\_offshore.asp](http://www.equitydevelopers.com/why_go_offshore.asp) (viewed 10/31/05).

take your property and funds away.”<sup>44</sup> Mr. Congdon told the Subcommittee that he instructed prospective clients seeking to escape judgments to consult counsel.<sup>45</sup> The website contains no such warning.<sup>46</sup>

Second, the website promotes offshore structures as a way to ensure “financial privacy,” keeping assets away from “credit agencies,” “asset collectors,” and potential plaintiffs. “Unless deliberate steps are taken to insure privacy,” the website explains, “sensitive and confidential information could easily get into the wrong hands. Placing bank and brokerage accounts offshore will keep them off the asset collector’s radar screen.”<sup>47</sup> Emails from Mr. Congdon also indicate that the privacy provided by offshore structures affords protection against identity theft: “So for the purposes of identity theft, offshore accounts are many times safer than US accounts. There’s really not any comparison.”<sup>48</sup>

Finally, the website advertises the “regulatory advantages” of taking assets offshore. Noting that “domestic businesses and operations are often plagued by excessive regulation,” the website explains that “[o]ffshore jurisdictions are intentionally business-friendly and have regulations that are straightforward, simple to understand and inexpensive to comply with.”<sup>49</sup> The website does not explain which regulatory requirements can be avoided by taking assets offshore.

**Tax Avoidance.** The current version of the EDG website makes no mention of tax avoidance as a benefit of taking assets offshore. However, it is clear that Mr. Congdon knew that many of his clients moved their assets offshore to avoid U.S. taxation. Moreover, several prospective clients responding to the website in 2005 expressed an interest in creating offshore structures for this purpose. Mr. Congdon’s responses to these inquiries varied. In one case, he told the prospective client that tax benefits from offshore structures were an “urban legend.”<sup>50</sup> In other emails, he recommended that the questioner seek the opinion of a tax professional.<sup>51</sup>

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<sup>44</sup> 5/12/05 email from Mr. Congdon to a potential client (EDG-EML244); see also 7/8/05 email from Mr. Congdon to a potential client (EDG-EML335) offering the client an option “to protect [his] assets from aggressive American lawyers and others;” and 5/20/05 email from Mr. Congdon to a potential client (EDG-EML246) responding to the client’s desire to protect assets from his “greedy former wife and her new husband.”

<sup>45</sup> Subcommittee interview of Mr. Congdon (6/30/06).

<sup>46</sup> EDG Website, [www.equitydevelopers.com/why\\_go\\_offshore.asp](http://www.equitydevelopers.com/why_go_offshore.asp) (viewed 10/31/05).

<sup>47</sup> Id.

<sup>48</sup> See, e.g., 4/21/05 11:04am email from Mr. Congdon to potential buyer of EDG (EDG-EML229).

<sup>49</sup> EDG Website, [www.equitydevelopers.com/why\\_go\\_offshore.asp](http://www.equitydevelopers.com/why_go_offshore.asp) (viewed 10/31/05).

<sup>50</sup> 4/19/05 email from Mr. Congdon to a potential client (EDG-EML226).

<sup>51</sup> 3/23/05 email from Mr. Congdon to a potential client (EDG-EML259).

Mr. Congdon told the Subcommittee that this was his standard response.<sup>52</sup> In response to another email from a potential client, Mr. Congdon simply ignored a question about tax issues.<sup>53</sup>

When Mr. Congdon first started his business, he used a PowerPoint presentation, obtained by the Subcommittee, at two trade shows to promote EDG. Like the current website, the PowerPoint presentation promotes increased financial privacy,<sup>54</sup> but in contrast to the website, the presentation focuses on the tax benefits of moving assets offshore. For example, two slides tout the additional money to be made offshore by avoiding the United States “20% Tax Rate.”<sup>55</sup> Another slide declares “President Clinton vetoed the tax cut bill. Who cares? Offshore investors don’t!”<sup>56</sup>

Mr. Congdon told the Subcommittee that he only delivered this presentation at two trade shows, one in New York and one in San Francisco, in 1999 and 2000, attended by 15 to 20 people of which only two or three became clients.<sup>57</sup> He stated that the presentation refers only to a specific tax-deferred investment vehicle called a Variable Universal Life Insurance policy. Though the presentation itself does not mention the Variable Universal Life Insurance policy, Mr. Congdon told the Subcommittee that he had not wanted to use such a technical term in his presentation. Mr. Congdon told the Subcommittee that he only established one such insurance policy.<sup>58</sup>

From at least February 23, 2001, until July 24, 2004, EDG also promoted the tax benefits of its offshore packages online. During that time, the EDG website included an “offshore calculator.”<sup>59</sup> The offshore calculator was an interactive application that compared the growth of an investment account onshore and offshore. A visitor to the website could enter a yearly rate of return, a capital gains tax rate, and the initial principal, and the offshore calculator would calculate, for onshore and offshore accounts over a 20 year period, the value in the accounts, the difference in the value, and the percentage difference. In an example given in older versions of the EDG website, an investment of \$100,000, with a 15% rate of return and a 20% capital gains

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<sup>52</sup> Subcommittee interview of Mr. Congdon (6/30/06).

<sup>53</sup> 8/8/05 email from Mr. Congdon to a potential client (EDG-EML347). The potential client expresses an interest in “finding ways to limit taxability, liability and protection of assets.” Mr. Congdon responds to specific questions about moving real estate and other investments into the offshore structure, and does not respond to the potential client’s desire for tax avoidance.

<sup>54</sup> PowerPoint presentation, “Offshore Investment” (EDG-PPT001-21, at 10).

<sup>55</sup> Id. at EDG-PPT008-9.

<sup>56</sup> PowerPoint presentation, “Offshore Privacy, Protection & Tax Savings” (EDG-PPT022-49 at 28).

<sup>57</sup> Subcommittee interview of Mr. Congdon (6/30/06).

<sup>58</sup> Id.

<sup>59</sup> Old versions of the EDG website can be accessed at [www.archive.org](http://www.archive.org).

tax rate after 20 years onshore would be worth \$964,629; the same investment offshore would be worth \$1,636,654. The 70% gain in value between the offshore and onshore account is solely attributable to avoidance of the capital gains tax. The offshore calculator contained the following disclaimer:

“You may be liable for taxes on foreign investments depending on your country of citizenship and/or residency. EDG strongly recommends consulting a local tax attorney or accountant to determine any tax or legal liabilities you may incur as a result of international investing. EDG also recommends consulting a local tax attorney or accountant before opening any investment accounts in any jurisdiction.”<sup>60</sup>

More recently, Mr. Congdon discussed adding a tax avoidance disclaimer to his website in a series of emails with a potential buyer of EDG. In an April 18, 2005, email to Mr. Congdon, the potential buyer wrote:

“The future for EDG is in protecting the identity of owners of assets, not tax avoidance. I think you have done a great job in maintaining some level of ‘distance’ from the underlying client’s intentions, but the laws are changing quickly, and a greater firewall is required .... I must be very careful not to be associated with any conspiracies to defraud (creditors, courts, etc.) The question is .... is there enough business with people doing it legitimately .... for asset protection from creditors, and from Internet access and identity theft? How would it hurt EDG (or possibly help?) if we placed a disclaimer right on the first page saying that if the client is interested in tax avoidance, they need to go elsewhere?”<sup>61</sup>

Mr. Congdon responded, “I think some of these things would be best discussed in person rather than email - if possible. There is definitely a market for what you are proposing - probably a higher end market than I may typically service.”<sup>62</sup> In the same exchange the potential buyer noted that identity theft protection “might not be the ultimate use of the client, but it gives a very logical and defensible ‘reason’ for it without having to discuss ‘hiding’ assets (or tax issues...)”<sup>63</sup> On April 21, 2005, the potential buyer wrote, “I think this would be a great time to roll this [identity theft protection] out hard as a new campaign. It gives EDG a great ‘reason’ for

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<sup>60</sup> Id.

<sup>61</sup> 4/18/05 email from Mr. Congdon to potential buyer of EDG (EDG-EML247-48) (emphasis removed).

<sup>62</sup> Id.

<sup>63</sup> Id. 4/21/05 11:04am email from Mr. Congdon to potential buyer of EDG (EDG-EML229).

why their customers want ‘hidden’ offshore accounts.”<sup>64</sup> Mr. Congdon responded, “i’ve never advertized vis a [vis] identity theft, but it just might work.”<sup>65</sup>

**Offshore Jurisdictions.** Mr. Congdon utilized numerous jurisdictions for establishing offshore structures for his clients, including Antigua, the Bahamas, Belize, the British Virgin Islands, Curacao, Gibraltar, Isle of Man, Panama, Nevis, St. Lucia, Switzerland, and the Turks and Caicos.<sup>66</sup> He encouraged clients to use more than one jurisdiction in an single offshore structure, in part to increase security and privacy. Mr. Congdon recommended different jurisdictions for different purposes. He typically used Belize, the British Virgin Islands, and Nevis for companies; he typically used the Bahamas and Nevis for trusts. Mr. Congdon stated that Nevis is the fastest jurisdiction to incorporate in, Belize is the cheapest, and the British Virgin Islands is preferred by Europeans due to its perceived legitimacy in Europe.

EDG helped establish bank accounts at Barrington Bank in Antigua, Bank of St. Lucia International in St. Lucia, First Curacao International Bank in Curacao, Maerki Baumann in Switzerland, and Close Private Bank in the Isle of Man; it helped establish brokerage accounts at Temple Securities in the Turks and Caicos Islands and Thales Securities in Panama.<sup>67</sup> For setting up trusts and shell corporations, EDG typically used local offshore service companies such as the Bank of Belize in Belize, Commonwealth Trust Services in the British Virgin Islands, and IFG Trust Company in Nevis. For setting up protector trusts in the Isle of Man, Mr. Congdon typically used a company called Global Holdings International.<sup>68</sup>

**Client Control.** Both on the website and in email correspondence, Mr. Congdon sought to reassure prospective clients that regardless of the structures that EDG established for them, the client would retain full control of the funds. The website promises that, “By means of an offshore trust, the founder can remove the potential liability of being the IBC’s owner without sacrificing privacy and complete control of his/her offshore corporation.”<sup>69</sup> He also told potential clients that with respect to bank or brokerage accounts opened for an offshore entity,

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<sup>64</sup> 4/21/05 email from potential buyer of EDG to Mr. Congdon (EDG-EML394-98, at 94).

<sup>65</sup> Id.

<sup>66</sup> EDG Website, [www.equitydevelopers.com/order/i01.asp](http://www.equitydevelopers.com/order/i01.asp); Subcommittee interview of Mr. Congdon (6/30/06).

<sup>67</sup> EDG Website, [www.equitydevelopers.com/order/i01.asp](http://www.equitydevelopers.com/order/i01.asp) and multiple emails.

<sup>68</sup> Subcommittee interview of Mr. Congdon (6/30/06).

<sup>69</sup> EDG website, [www.equitydevelopers.com/offshore\\_101\\_full.asp](http://www.equitydevelopers.com/offshore_101_full.asp) (viewed 10/31/05).

“you are the only signer on the account and the only one that will have access to the funds in the account,”<sup>70</sup> and “you would be in 100% control.”<sup>71</sup>

Mr. Congdon served as the point of contact between his clients and their trustees, trust protectors, and nominee directors. A client could choose to be the sole director of a shell corporation, in which case he maintained total control of the shell corporation. EDG’s clients, however, did not sacrifice control by choosing a nominee director. Mr. Congdon told the Subcommittee that he can recall only one instance in the history of his company in which a nominee director did not follow the instructions of a client. In that instance, the client had asked the nominee director to sign a sworn affidavit attesting to facts relating to a lawsuit; the director could not attest to the facts and would not commit perjury.<sup>72</sup>

In the case of trustees, Mr. Congdon stated that while a trustee has formal control of a trust, to his knowledge the trustees he chose for his clients never denied a client’s request.<sup>73</sup> For clients that did not want to rely on nominee trustees, Mr. Congdon helped establish trusts in which the client was the sole trustee.<sup>74</sup> Clients who wanted to guarantee complete control over accounts in the name of their shell corporation could instruct the nominee director to make the client the sole signatory on the shell corporation’s accounts.

**Accessing Offshore Assets.** Mr. Congdon also established convenient and confidential means for clients to repatriate the assets deposited into accounts held by the offshore entities. The EDG website describes the process used. Mr. Congdon arranged for the client to become the signatory on the offshore account. Because the account was in the name of the offshore company, “transactions carried out with the account (wire transfers, debit cards, etc.) are all in the IBC’s name, not the client’s name.” But the offshore bank then “issue[d] private Visa/Mastercard debit cards that an account holder may use to withdraw funds from an ATM or to purchase goods and services directly.”<sup>75</sup> Mr. Congdon confirmed to the Subcommittee that clients could use wire transfers, cashiers checks, and debit cards to repatriate funds in this fashion.<sup>76</sup>

Mr. Congdon regularly reassured potential clients that they would have easy and secure access to the funds. For example, he told one client, “There are a couple of ways to bring back

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<sup>70</sup> 3/17/05 email from Mr. Congdon to a potential client (EDG-EML308-09).

<sup>71</sup> 6/3/05 email from Mr. Congdon to a potential client (EDG-EML255-56).

<sup>72</sup> Subcommittee interview of Mr. Congdon (6/30/06).

<sup>73</sup> Id.

<sup>74</sup> See, e.g., 2/3/05 email from EDG to client (EDG-EML399).

<sup>75</sup> EDG website, [www.equitydevelopers.com/offshore\\_step3.asp](http://www.equitydevelopers.com/offshore_step3.asp) (viewed 10/31/05).

<sup>76</sup> Subcommittee interview of Mr. Congdon (6/30/06).

funds without anyone connecting them to you,” including “wir[ing] money back” into the country, “cashier’s check,” or “an anonymous ATM card.” He also recommended that this client avoid wiring money to himself, but rather send it directly to a vendor, “for example, if you are buy[ing] a car, have the money wired . . . [to] the car dealership.”<sup>77</sup> He told another client “funds can be pulled out of offshore banks using wire transfers, bank checks, Visa/MC debit cards and cash machine cards. ... As long as everything is done in the name of the offshore company, then it is private and no one (including Inland Revenue) can get any information about it.”<sup>78</sup>

**Lack of Due Diligence.** Mr. Congdon performed little or no due diligence on his clients. He told the Subcommittee that offshore service providers required no due diligence to set up a trust or a shell corporation. Banks required an identification, a bank reference, and a verification of address in order to establish an account. Mr. Congdon stated that he typically performed rudimentary due diligence only if the client volunteered information that raised a red flag. For instance, he chose not to work with people who volunteered that they were in the pornography or adult entertainment business,<sup>79</sup> and he chose not to do business with clients in countries he considered suspect, such as Iran and Cuba.<sup>80</sup> Mr. Congdon stated that when a potential client volunteered that he was seeking to avoid a judgement, Mr. Congdon advised the potential client to contact a lawyer. Mr. Congdon stated that when a potential client that he had referred to a lawyer returned to EDG and wished to do business, Mr. Congdon accepted the client’s word that his actions were legal. He did not independently verify the legality with an attorney.

Mr. Congdon did not express concern about the motives of potential clients. One such client emailed Mr. Congdon, “Hi Sam, [it] appears that my wife has found out about my account and IBC and now wishes to control the money that is in it. ... What are your suggestions regarding this situation?” Mr. Congdon replied, “Does she know the IBC name? If so, you might want to form a new company or just change the name of your existing one. We can also set up another account at a 2nd bank – that certainly wouldn’t hurt.”<sup>81</sup>

The following email exchange indicates that Mr. Congdon was willing to consider and advise potential clients who volunteered dubious intentions. The exchange also suggests that Mr. Congdon did not always advise potential clients who raised legal issues to contact a lawyer. On January 6, 2005, a potential client wrote:

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<sup>77</sup> 1/17/05 email from Mr. Congdon to a potential client (EDG-EML039-41).

<sup>78</sup> 1/24/05 email from Mr. Congdon to a potential client (EDG-EML053).

<sup>79</sup> Subcommittee interview of Mr. Congdon (6/30/06); 6/21/05 email from EDG to potential client (EDG-EML330-33).

<sup>80</sup> Subcommittee interview of Mr. Congdon (6/30/06).

<sup>81</sup> 1/6/05 email to EDG (EDG-EML006).

“I am interested in opening an offshore account to protect my assets from my ex-wife and uncle sam. My ex-wife recently obtained a judgement against me, without my knowledge, and the courts ‘stole’ a substantial sum from my checking account also without my knowledge. It took me over three months and a lot of stress and legal fees to reverse the judgement and get my money back.

“I am leaning towards simply opening a swiss bank account. ... What does the offshore corporation that you offer provide above the protections offered by swiss banks.”

On the same day that Mr. Congdon received the above email, he replied:

“Thank you for your email. Having an offshore account won’t really protect your assets because everything is still in your personal name. What will protect you from lawsuits and such is an offshore structure. I would [recommend] reading the following page on the EDG site:

[http://www.equitydevelopers.com/offshore\\_101.asp](http://www.equitydevelopers.com/offshore_101.asp) This will give you a good idea of why a structure (rather than just an account) is the best way to go.”

“Please let me know if you have any additional questions.”

On January 8, 2005, the potential client emailed Mr. Congdon with additional questions:

“The research I’ve done indicates that a Swiss bank account is protected because Switzerland has strict privacy laws. If lawsuits and creditors can’t find my account, they can’t attach it. How does an offshore structure provide more protection than that?”

On the same day, Mr. Congdon replied:

“Swiss accounts aren’t that secure (i don’t [recommend] them) because in order to get one you have to have an apostilled copy of a passport – what that means is that you have to tell your state govt that you are presenting a copy of your passport in Switzerland. That throws whatever privacy someone might have hoped to achieve out the window. Also, having a personal account does not protect you should you get sued and [lose]. Because it is a personal account, you will have to list it as among your assets – it doesn’t matter what Switzerland’s laws are. Having an offshore structure in place prevents this from happening. I would [recommend] reading the following page on the EDG site:

[http://www.equitydevelopers.com/offshore\\_101.asp](http://www.equitydevelopers.com/offshore_101.asp) This will give you a good idea of why a structure (rather than just an account) is the best way to go.”<sup>82</sup>

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<sup>82</sup> 1/8/05 email from EDG to potential client (EDG-EML391-9).

**Conclusion.** The accessibility, anonymity, and low cost of online communication are a natural fit for the offshore industry, which trafficks in secrecy and transactions that skirt regulatory oversight and legal requirements. With few resources, no employees, and only nine months prior experience in the industry, Samuel Congdon was able to quickly create and promote an online offshore facilitation business. EDG utilized the internet to provide hundreds of clients, many of relatively modest wealth, with the type of offshore services previously available primarily to high-net-worth individuals. Mr. Congdon rarely met his clients, did not work with their lawyers or accountants, and seldom inquired into their motives. Yet, he helped design and establish the financial structures that enabled his clients to move assets offshore, maintain control of them, obscure their ownership, and conceal their existence from family, courts, creditors, the IRS, and other government regulators. Mr. Congdon willfully remained ignorant of his clients' motives for moving money offshore, and in so doing, he operated in apparent compliance with current law while facilitating potentially illegal activity. There are hundreds of other online businesses like EDG.

#### IV. TURPEN-HOLLIDAY CASE HISTORY: A HOW-TO MANUAL

This case history examines another offshore promoter, Dr. Lawrence Turpen of Reno, Nevada, who spent many years helping U.S. persons move assets offshore. It also examines the actions of one of his clients, Robert F. Holliday, who used a how-to manual provided by Dr. Turpen to create an offshore structure he used to hide his assets. This case demonstrates the ability of U.S. persons to evade taxes by placing their money into offshore accounts. The nearly total compliance of offshore trustees with the wishes of Dr. Turpen and Mr. Holliday allowed the two men to retain full control over the funds they placed offshore. At the same time, they were able to use billing schemes, management consultant agreements, and intermediary corporations in Nevada to distance themselves from the entities and obscure the links between them.

Both men recently pleaded guilty to tax-related charges. In 2004, Dr. Turpen pleaded guilty to a charge of conspiracy to defraud the IRS in connection with his promotion and facilitation of offshore tax evasion.<sup>83</sup> He was sentenced to three years probation and six months home detention with electronic monitoring, and ordered to pay a \$10,000 fine, perform 300 hours of community service, and pay back taxes. Mr. Holliday pleaded guilty to one count of conspiracy to defraud the United States by impeding the IRS.<sup>84</sup> He was sentenced in 2005, to five years probation and 12 months home detention, plus a \$30,000 fine. Both men were interviewed by the Subcommittee.<sup>85</sup>

**Background.** In his plea agreement, Dr. Turpen stated that he became a full-time financial consultant after retiring from a career in dentistry, and in approximately 1987 he began soliciting clients who wanted to move assets offshore.<sup>86</sup> In 1990, he published a book on the subject, “How and Why Americans Go Offshore.”<sup>87</sup> He then held speaking engagements and established a website to advertise his products and services.

Dr. Turpen told the Subcommittee that his interest in the offshore industry began in 1969, after a visit to the Isle of Man. On this trip, he inquired about establishing an offshore corporation and spoke with Charles Cain, an administrator for an offshore service provider. Dr. Turpen said that he chose Mr. Cain’s firm from a telephone book, concluding that the firm would be more aggressive because it advertised in bold print. Mr. Cain told Dr. Turpen that, although Dr. Turpen would not “own” a company Cain established for him, “if you need something, ask me [as company administrator] and you can have it.” This arrangement satisfied

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<sup>83</sup> United States v. Turpen, Criminal No. CR-N-04-86-DWH(VPC) (D. Nev.), Plea Agreement (6/23/04)(hereinafter Turpen Plea Agreement).

<sup>84</sup> United States v. Holliday, Criminal No. CR-N-04-0117-DWH-VPC (D. Nev.), Plea Agreement (10/6/04).

<sup>85</sup> Subcommittee interviews of Dr. Turpen (4/6/06) and Mr. Holliday (4/4/06).

<sup>86</sup> Turpen Plea Agreement at 5.

<sup>87</sup> L. Turpen, How and Why Americans Go Offshore, (Haynes & Assoc. 1994) (hereinafter the “Turpen book”).

Dr. Turpen, and he engaged Mr. Cain to help him form his first offshore company, Intercon Associates, Ltd., to hold his offshore assets.

Throughout his interview with the Subcommittee, Dr. Turpen continually referred to Intercon Associates as “my company.” At one point, he caught himself and said “well, not *my* company. I don’t know who owned it – a couple of trusts.” He said he did not know who the trustees were or who the beneficiaries were, and that such matters were irrelevant to him. What mattered was that, as “managing consultant,” he had influence over the day-to-day activities of Intercon and could benefit from the assets without “owning” them.

Dr. Turpen told the Subcommittee that he further educated himself about the process of creating an offshore structure through his own research, in particular by studying the financial arrangements of large corporations with international subsidiaries. He identified the two greatest difficulties in transferring assets offshore to be avoiding “perceived ownership” and finding a trustworthy agent to hold the offshore assets. After studying the various tax havens and secrecy jurisdictions, Dr. Turpen selected a group of eight or nine jurisdictions and cultivated relationships with one or two trust and company administrators in each. Although he declined to identify the offshore service providers he used, he claimed that he carefully vetted them for their trustworthiness and responsiveness.

Dr. Turpen then began speaking at financial seminars as a paid speaker. He first accumulated his notes into brochures, which he would pass out on request. In 1990, he incorporated the brochures into his book, which he sold at the seminars. In his interview with the Subcommittee, Dr. Turpen insisted that his clients who moved assets offshore were predominantly motivated by a desire for privacy from competitors, protection from predatory creditors who filed frivolous lawsuits, and the potential for increased profits through making foreign investments free from stifling U.S. regulations. He claimed that tax avoidance was only a minor motivation of some clients. However, his book dwells extensively on the use of offshore structures to free U.S. professionals and small businessmen from the burdens of federal income tax.

Dr. Turpen’s presentation and book focused on protecting assets by putting them in corporations. Dr. Turpen told his audiences that he could form an offshore corporation, provide nominee officers and signatories on bank accounts, and provide any other such services the client desired.<sup>88</sup> He sold an “ultimate privacy” package for \$4,500, which included a telephone answering service, mail forwarding, and opening and maintenance of bank accounts, all to create the appearance that the corporations were actually operating where the corporate administrator was located.

**Dr. Turpen’s Principles for Going Offshore.** According to Dr. Turpen’s book, the key to a successful offshore structure was to separate the client from the paper ownership of the client’s assets, while retaining the ability to benefit from them:

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<sup>88</sup> Subcommittee interview of Mr. Holliday (4/4/06).

“It is possible to structure companies in such a way that the U.S. citizen ... is not listed as a member or stockholder. Thus, if that person has an identifiable beneficial interest it is obscure and relatively safe from discovery and claims against it. In many cases, such beneficial interest and any connection to the United States citizen or company is never put in writing or disclosed.”<sup>89</sup>

The mechanisms he advocated to “break the connecting factors” between the client and the assets included the formation of an offshore company to “own” the assets and the use of an offshore trust to hold title to the company. Under Dr. Turpen’s scheme, the client retained “complete responsibility for the source and application of funds” by signing a “management services” agreement through which the offshore company hired the client as a “management consultant.” In this role, the client could issue instructions to the administrators of the offshore entities in the form of “recommendations,” but would not sign any checks or other documents. The client would instead request that the corporate administrator sign them.

Dr. Turpen also distanced the U.S. client from the offshore entities by arranging for the client to make all payments of administrator and similar fees through Dr. Turpen’s entities, Intercon Associates, Ltd., and LAD Financial Services. Intercon and LAD contracted with the clients, collected their fees, and then paid, on behalf of the client, all fees necessary to establish the entities. Intercon and LAD also entered into an agreement with each client to receive fees through debits on the client’s offshore accounts and, after deducting a “reasonable profit,” remitting maintenance fees to the service providers. Dr. Turpen instructed the service providers to send no bills to the client in the United States. These arrangements ensured that the only apparent connection between the offshore and Nevada entities and the client would be the “management services” agreements.

Dr. Turpen recommended that his clients purchase an Isle of Man “hybrid company,” which he called the “Cadillac of offshore planning.” He explained to the Subcommittee that a hybrid company had two classes of stock: voting shares to be held by the nominal “owners” and associate shares with all rights of distribution, to be held by the client as beneficial owner. Dr. Turpen’s book described the purpose and function of this arrangement as follows:

“It is essential that any offshore structure that is designed to withstand an inquisition by any government agency that the United States citizen be totally and completely unlinked from the company. Yet the client needs the assurance of the security of the company assets.”

“The proper use of the Hybrid company as described in Appendix I, “Isle of Man: A Business and Tax Haven” is critical to this concept. In essence, we must re-create the individual as a foreigner through the use of this unique company structure. Each individual who works with us is so re-created. The key element of your involvement with the Hybrid is that you are elected as an *associate*

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<sup>89</sup> Turpen book at 40.

*member* with rights of distribution, but without the right to vote. This takes you out of the control loop but gives you the right to all the assets should the company ever be dissolved. This fact gives you the assurance of the security of any assets you may have assigned or loaned to the company.”

“You, as acting CEO [under the previously described management agreement], dealing directly with the selected registered agent, are responsible for the source and application of funds. You alone are responsible for the assets of the company. No one else is given that responsibility and no disbursements can take place without your approval as the responsible employee.”<sup>90</sup>

Dr. Turpen also recommended including a Nevada corporation in the offshore structure to assist in the transfer of assets from the client to the offshore entities, or what Dr. Turpen called “upstreaming.” He explained that Nevada corporations were useful, because corporation-to-corporation transactions were considered more “normal” and came under less scrutiny than individual-to-corporation transactions. Dr. Turpen incorporated and maintained the Nevada corporations through his domestic company, LAD Financial Services.

Examples of “upstreaming” techniques advocated by Dr. Turpen include inter-corporate billing and inter-corporate loans. In an inter-corporate billing scheme, the Nevada corporation would send a bill for fictitious services to the client’s business. The client’s business would then pay that bill and claim a tax deduction for the amount paid to the Nevada corporation. The offshore corporation would do the same with respect to the Nevada corporation, sending fictitious bills that would exactly equal the funds provided by the client. In the end, these transactions resulted in the transfer of funds from the client’s business, through the Nevada corporation, to the offshore corporation, generating tax deductions at the same time. Alternatively, under an inter-corporate loan scheme, the Nevada company would issue a sham loan to the offshore corporation, transferring the client’s funds without any intention of repayment. In both cases, Dr. Turpen advised clients that, as “managing employees” of both companies, the clients were in a position to set any price or interest rate they liked, and the transaction could be documented as independent in case of a later government inquiry.

**Holliday’s Offshore Structure.** One of the people who attended Dr. Turpen’s seminars and became a client was Robert F. Holliday. Mr. Holliday was a booking agent for musical acts in the 1970s, and after a failed business venture he began looking for another occupation. With the assistance of an acquaintance, he opened an escort service business in Atlanta in 1979, which he operated successfully until 2005. After the first year, he began to handle administrative matters such as advertising and banking. In the early 1990s he expanded the business to Charlotte, North Carolina, where he became the subject of a federal investigation. He pleaded guilty to money laundering charges in 1994, and he ultimately withdrew from the Charlotte market, continuing to do business in Atlanta.

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<sup>90</sup> Turpen book at 203.

Mr. Holliday told the Subcommittee that due to an unsuccessful attempt by the prosecutor in Charlotte to forfeit his residence under the money laundering statute, Mr. Holliday began searching for means to protect his assets should something similar happen in the future. In 1995, he received a flyer in the mail about a seminar in Raleigh, North Carolina, on methods for controlling assets without owning them using Nevada and offshore corporations. He attended the seminar, at which Dr. Lawrence Turpen was a speaker, and purchased Dr. Turpen's book.

According to Mr. Holliday, Dr. Turpen told the approximately 50 people at the Raleigh seminar that his average client paid about \$1,000 a year in income tax after following his plan. Dr. Turpen explained the use of inter-corporate billing schemes to move assets offshore and told his audience that as long as one has the documents to support it, he or she can receive tax deductions for everything. By way of example, according to Mr. Holliday, Dr. Turpen said, "When I was in dentistry, I sent \$60,000 a year to my offshore corporation for advice. The advice never was worth a damn, but at the end of the year I had \$60,000 in my offshore account." In Mr. Holliday's words, they were fictitious deductions, "but that is how you cook the books."

When Mr. Holliday asked how he could trust Dr. Turpen and the offshore service providers to follow his instructions regarding the money, Dr. Turpen cautioned him, "You don't instruct me. You make requests." Dr. Turpen also said that he carefully selected the administrators in Nevada and in the offshore jurisdictions to be professional and responsive to such requests. Mr. Holliday told the Subcommittee that he was willing to take the risk because of his concern that the government might again try to forfeit his assets. According to Mr. Holliday, Dr. Turpen told him that if all he wanted was a Nevada corporation, Dr. Turpen would help him create it. However, for an additional \$6,000, he could establish a "hybrid company" in the Isle of Man. Dr. Turpen told Mr. Holliday that he preferred the Isle of Man because of their secrecy laws and that the Isle of Man administrators "won't even acknowledge you exist."

Dr. Turpen assured Mr. Holliday that it would not be necessary for Mr. Holliday to actually go to Nevada or the offshore jurisdiction to establish or operate his offshore corporations. Mr. Holliday told the Subcommittee that throughout the relationship between the two men, Mr. Holliday never once set foot on the Isle of Man or Nevis. He interacted with persons in those jurisdictions exclusively at a distance.

**The How-To Manual.** Mr. Holliday decided to purchase a package from Dr. Turpen. The package included a hybrid company in the Isle of Man named "Landmark Planning, Ltd.," as well as a Nevada corporation, "Business Directions, Inc." Mr. Holliday gave Dr. Turpen the names for the companies and a check, and Dr. Turpen made all of the other arrangements. Two weeks later, Mr. Holliday received a document entitled "Personal and Confidential International Business Plan, prepared for Landmark Planning, Ltd." (the "Confidential Plan"). Dr. Turpen referred to the existence of such Confidential Plans at numerous points in his book, explaining that certain details of his offshore strategies could not be fully explained in a book, but were provided only to his clients in such individualized plans.

The Confidential Plan functioned as a how-to manual for going offshore. It indicated that tax avoidance, rather than asset protection, was the focus of the offshore structure: “The primary service of Intercon Associates is to operate foreign companies on behalf of our clients in a way that will enable them to effectively do business worldwide from a tax free jurisdiction.” The foundation of the Confidential Plan was to keep effective control over the offshore assets of the client notwithstanding the formality of placing paper ownership in others. The Plan stated that point one of “Our Eight Point Service Commitment” was:

“5.1. Number 1. ... Intercon Associates will undertake to create a company structure and to offer you the responsible position of “Managing Consultant.” We instruct the directors of the company to appoint you to this position of responsibility and to give you complete responsibility with regard to source and application of funds ....”

“5.3. It should be stressed that you may be the only employee of the company and the directors by tradition and custom will ratify your decisions and support your actions. You can count on this if they are assured that your actions are legal and will not cause harm to any individual connected with the company administration.”

Point Four explained how this de facto control over company assets would be concealed by avoiding any paper evidence of a connection between the client and the company:

“5.9. Number 4. We create a definite BREAK IN THE CONNECTING FACTORS between you and the company by retaining unto Intercon Associates the responsibility for paying the fees to the country of company domicile along with the annual standing charges as long as our association stays active and current. This means that you as a citizen of the United States is never in a position to write a check to the foreign government or administrator.”

“5.10. ... With the structural plan that is organized by Intercon these fees are never raised to you directly. In fact, the address used on the company documents is in no way linked to you, the company is not organized by you and your role is reduced in documented form to that of a responsible consultant ....”

“5.12. As a matter of fact, as a rule signature power on the company bank account is held by the company administrator and the directors, together with the designated bank officer. They will respond to your direction as the responsible employee and will act on your requests in a timely manner. Additionally, for your security, the board will allow you to set up control codes with the bank that gives you effective oversight of the accounts. These control codes can be explained in detail in our personal consultations. It therefore is not necessary to disclose your signature on a foreign account.”

The Confidential Plan at several points reassured Mr. Holliday that, even though he was not the “owner” of the hybrid company on paper, no one would interfere with his use of company assets:

“10.4. ... As a consultant to the company our client makes recommendations that are submitted to the board of directors or to the company administrators for action. His position of responsibility will be honored and his recommendations will be activated. But, in no case will there be a signed document to require this action ....”

“11.4. ... Aside from our concern that your activities are legal, details of your business activity would be of no concern of ours. We make no effort to inquire about what you do. We are only concerned with the structure and its ability to serve your needs ....”

“13.14. You as the CEO, dealing directly with the selected registered agent, are responsible for the source and application of funds. You alone are responsible for the assets of the company. No one else is given that responsibility and no disbursements can take place without your approval as the responsible employee ....”

“26.4. ... There is no need to be concerned about the proper allocation or the disbursement of funds. The board has given you that authority and you should realize they will ratify your decisions.”

The Confidential Plan referred to Landmark Planning, Ltd., as Mr. Holliday’s “piggy bank.”<sup>91</sup> In fact, while it offered to set up a personal account for him at the offshore bank, it noted that “most of our clients find that they do not need a personal account, because of the easy access to company funds.”<sup>92</sup>

**Moving Funds Offshore.** Once his structure was in place, Mr. Holliday began using it to move money offshore. The Confidential Plan suggested a number of ways to do so, including the method chosen by Mr. Holliday: transferring funds in payment for fictitious “services” allegedly performed by the offshore company. The Confidential Plan suggested that, as a businessman, Mr. Holliday had “every right to pay any bill you receive and the foreign company has every right to charge you whatever it wishes or has contracted with you for its services. So, in the ordinary course of business much money can be moved from one country to another. If there is a possibility of an audit on this side, it is prudent to create the proper paperwork to document the payment. To pay the bill, you simply write a check to the company.”<sup>93</sup>

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<sup>91</sup> Personal and Confidential International Business Plan prepared for Landmark Planning, Ltd., (“Confidential Plan”), sections 12.4, 13.3, 14.5.

<sup>92</sup> Confidential Plan, section 26.3.

<sup>93</sup> Confidential Plan, section 7.12.

Mr. Holliday told the Subcommittee that no real “services” were performed by the offshore company to justify the payments. Indeed, the company had no personnel to perform any such services. He gave an example of one such fabricated fee-for-service transaction, designed to create paperwork supporting a payment of \$45,000 to Landmark Planning. In that instance Mr. Holliday bought a book on the premium-rate telephone business, used for adult chat lines, psychics, and other similar services. He used the book to prepare a several page “report” on the business, and sent the draft report through Dr. Turpen to the administrator of the Isle of Man company to type up on Landmark Planning letterhead. The report was then sent back to Mr. Holliday in exchange for the \$45,000. The report from Landmark Planning was then given to the tax return preparer to support a tax deduction for \$45,000. As a result, Mr. Holliday was able to move \$45,000 of untaxed income to his Isle of Man “piggy bank,” Landmark Planning.

Mr. Holliday created paperwork for many similar fictitious transactions. He told the Subcommittee that he paid Landmark Planning for “real estate investment advice.” Among the documents made available to the Subcommittee by Mr. Holliday were research agreements and management agreements under which Landmark Planning undertook to provide services for two business feasibility studies totaling \$450,000, for real estate management services for \$200,000, for an extension of the real estate management agreement for another \$200,000, and for the premium-rate telephone business report for \$45,000. According to Mr. Holliday, all these agreements, and others, were fabricated to justify the transfer of untaxed funds to the Isle of Man.

**Accessing the Offshore Funds.** Once the money was offshore, the Confidential Plan offered several ways of accessing it.<sup>94</sup> The means included obtaining loans from the offshore company, using a credit card drawing on the offshore account, obtaining payments from the offshore company for services (a method with the disadvantage of being taxable), and Dr. Turpen’s “personal favorite,” using the offshore company to pay the client’s bills.

Mr. Holliday accessed most of his offshore funds by “borrowing” the funds back from Landmark Planning. Each time he obtained funds, Dr. Turpen’s office would document the transaction by preparing a promissory note. Typically the note would be signed on behalf of a Nevada corporation as the borrower, because Dr. Turpen said it was best to keep the transactions between corporations, distancing the client from the assets. Thus, when Mr. Holliday wanted to use Landmark Planning funds to purchase a real estate investment in the United States, he would create a Nevada corporation to purchase the real estate, and that corporation would “borrow” the funds from Landmark Planning. The funds would typically be wired from the Isle of Man account to the Nevada corporation that was going to buy the property. Dr. Turpen created a

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<sup>94</sup> The Confidential Plan actually addressed the subject of spending the offshore money even before it explained how to get the funds out of the country. These suggestions begin with the observation, in section 7.1: “One of the first questions we are asked is ‘if this company is set up, how do we get money back so we can spend it?’”

number of Nevada corporations for Mr. Holliday for this purpose.<sup>95</sup> If a property was later sold, the funds could be returned to Landmark Planning in repayment of the “loan” and could later be used on another transaction. Mr. Holliday told the Subcommittee that eventually the transactions became so complex that he had no idea how much was paid back to Landmark Planning, but he believed some amount was returned to the offshore entity in this way.

Dr. Turpen also secured a credit card account at Global Bank of Commerce Limited in Antigua in the name of Landmark Planning, Ltd. The bank issued a card to Mr. Holliday with his own name on it. Mr. Holliday used the card many times between 1995 and October 2002. The billing statements from this card were faxed to the Isle of Man for payment from a Landmark Planning account at Royal Bank of Canada (later moved to Royal Bank of Scotland). Mr. Holliday said that the offshore service providers always secured his approval before paying these charges. As it was explained to Mr. Holliday, this arrangement ensured that his Social Security number was nowhere involved, and his use of the card would be absolutely secret. Unfortunately for Mr. Holliday, the IRS developed a way to access the records from computers in the United States. He told the Subcommittee that he believed the IRS discovered his offshore activity through the IRS Offshore Credit Card Project and then began an audit of his returns.

Mr. Holliday made available to the Subcommittee copies of the credit card records obtained by the IRS, showing that he spent the following amounts through the Global Bank of Commerce card:

1999	\$ 51,816
2000	\$ 30,657
2001	\$ 91,513
2002	\$ 70,740

Mr. Holliday also had access to a U.S. brokerage account at Merrill Lynch, which the Isle of Man administrators opened in the name of Landmark Planning, Ltd. He had complete control over the investments in this account but felt that his access was somewhat inconvenient, in that he had to send trading instructions to Isle of Man administrators who then sent them to the U.S. broker. At some point, Dr. Turpen called Mr. Holliday and offered to establish another offshore account for him, saying “if you want a back-up, I can get you a Nevis package.” Mr. Holliday agreed, and Dr. Turpen created a company in Nevis named “Select Investments.” Mr. Holliday told the Subcommittee he believed the company may have been held by a trust, because he remembered being called a “trust protector” in that arrangement. The Nevis company opened an E-trade brokerage account in the “Select Investments” name and gave Holliday the password, so that he could directly trade on the account. He also received a credit card from Leadenhall Bank & Trust Co. in the Bahamas as part of the Nevis package. This card worked in the same way as the card from Global Bank of Commerce.

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<sup>95</sup> According to Mr. Holliday, Nevada was always the jurisdiction of choice for such corporations, because they allowed bearer shares (which do not disclose the name of the owner), had no state income tax, and would not share information with the IRS.

Mr. Holliday told the Subcommittee that at some point after he started using Landmark Planning, Ltd., he went to another offshore seminar in Nevada offered by Laughlin International, to determine whether Dr. Turpen was being “straight” with him. Mr. Holliday characterized the seminar as “not in any real agreement” with what Dr. Turpen taught. At the event he met with two of the presenters, both lawyers from San Diego, and showed them Dr. Turpen’s plan. They said that his arrangements with Dr. Turpen were illegal and offered to show him a better way. They said “we do it right in the Cook Islands” and offered to establish a structure for him for a \$50,000 fee. However, Mr. Holliday told the Subcommittee that he had no interest in spending that much money, and he decided to stick with Dr. Turpen, as everything was “working so far.”

**Controlling the Offshore Assets.** Mr. Holliday told the Subcommittee that he did not select the persons who established and administered his corporations, but relied on Dr. Turpen to choose the offshore service providers. Dr. Turpen explained that clients could feel comfortable entrusting their assets to the offshore service providers selected by him, because he only recommended trustworthy administrators. He also suggested that, if a trust administrator were ever to act in a dishonest manner, that administrator would be forced out of business by the regulators and other administrators.

When asked specifically about the willingness of offshore trust and corporate administrators to do what the client wanted with trust and corporate assets, Dr. Turpen cited only two instances where such administrators had declined to follow instructions: one in which the client wanted to do something illegal (such as purchase cocaine) and one in which a “duress clause” in a trust instrument directed the trustee not to follow instructions given under duress. He insisted that the trust and corporate administrators he used maintained their independence in controlling the trusts and corporations of his clients, but was unable to cite a single instance in his more than 30 years of experience when the client’s legal instructions, not given under duress, were not followed.

Mr. Holliday could only remember one instance when the corporate administrator in the Isle of Man declined to carry out a requested transaction. In that instance he wanted to conduct a British pound transaction through a bank account that was only authorized to deal in U.S. dollars. His impression was that they were careful not to violate their own laws, but that their job was to otherwise approve his “requests.” According to Mr. Holliday, “I was the puppet master.”

Mr. Holliday did not know any of the people who served as officers and directors of his companies, all of whom were selected by Dr. Turpen. He did, however, have dealings with some of them over the telephone and by fax, when he would pass along his “requests” for their approval. He understood that, under Dr. Turpen’s plan, he had been designated “management consultant” for the hybrid company, giving them justification to act on his “advice.” Initially he dealt with an administrator in Ireland named John Fitzgerald, of Fitzgerald and Associates. However, in 1999, he became disenchanted with Mr. Fitzgerald’s company as administrator, due to two \$30,000 errors involving misplaced funds. In both instances, Mr. Fitzgerald found the funds and restored them to Landmark Planning, but Mr. Holliday concluded that Landmark Planning was not getting the attention it deserved.

The Confidential Plan made provision for just this situation:

“11.3. Sometimes it may be in your best interest to move the administration of the affairs of “Landmark Planning Ltd” to another administrator. Since we meet with these individual companies on a regular basis, we are in a better position to see that need and to act in your behalf. This is never done without your knowledge or consent. It is most often done because of a client’s dissatisfaction with the present administration or the costs involved. Because of our extensive network of affiliated agents we are always able to find an agent or administrator that will interact in a positive way with the client.”

Mr. Holliday wrote Dr. Turpen a letter addressed to Corporate Office Services in Nevada, requesting Mr. Fitzgerald’s removal,<sup>96</sup> and Dr. Turpen immediately wrote to Mr. Fitzgerald<sup>97</sup> and to Reg Newton of Meridian Management in the Isle of Man<sup>98</sup> directing the transfer of the administrator duties to Meridian. There is no indication in any of these letters that any person other than Mr. Holliday was consulted about this decision regarding administration of the hybrid company that was allegedly owned by someone else.

According to Mr. Holliday, apart from the incident with Mr. Fitzgerald, the administrators were responsive to every “request” for action from him. He told the Subcommittee that the Isle of Man administrators preferred to have a letter or fax in the file to document his requests, while Fitzgerald and Associates in Ireland preferred to act on telephone requests, telling him at one point “the less in writing the better.” He said that no trustee or administrator ever hesitated to give back funds he had placed in Landmark Planning, and the administrators would often wire funds as he directed even before receiving the signed promissory note. The administrators also exercised no authority over the brokerage accounts once they were established, leaving it to him to conduct all trades. They encouraged Mr. Holliday not to trade on margin, but did not prevent him from doing so. He said that the credit card accounts were also completely at his disposal. The bills were sent to the corporate administrators, but they would not pay the bills without consulting him first.

**Keeping Records of Offshore Activity.** The Confidential Plan contained several cautions about maintaining secrecy with respect to company documents:

“26.1. As soon as you receive them, “Landmark Planning Ltd” documents can be made available at our office in London. If it is your desire we can see that a second set be sent to your address in the United States. Once again, we suggest that you take special care of these, since disclosure of them would be evidence

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<sup>96</sup> 2/22/99 letter from Mr. Holliday to Dr. Turpen.

<sup>97</sup> 2/22/99 letter from Dr. Turpen to Mr. Fitzgerald.

<sup>98</sup> 2/23/99 letter from Dr. Turpen to Meridian Management.

that you know more about the company than you would want to disclose if asked by anyone intent on invading your privacy. Remember from a practical standpoint you are a consultant with specific responsibilities. You own no stock and are not a director. Our service has made it possible for you to be completely un-linked to the company.”

“26.2. The document you are now reading contains a lot of substantial information. Guard it carefully. This is not for public consumption and it would not serve your interests well to “pass it around”. It is our suggestion that after you review this document as well as any formal documentation that is sent along with the company organization, and that you then return all of it to our office in London where it can be safely stored in your behalf ....”

“27.2. In addition, we will be happy to instruct the London office to store any records that you feel are sensitive and would rather not keep in the states. Clearly, any client should recognize that his best defense is that he is an employee or a consultant with the company and has no knowledge of all the company details. So keeping any records in the states should be done with care ....”

“29.1. Each of our registered agents has agreed to send a computer generated quarterly statement of company account activity directly to your address, at the same time that he pays Intercon the “Landmark Planning Ltd” quarterly fees. Any records that are sent to London will be forwarded to you by our staff there and will not be entered into our computers. (One less place for the inquiring mind to look for the data). You need to tell the administrator where you want the records sent. You should read these records and destroy them. It would not serve your best interests for them to be found in your possession.”

Ironically, Dr. Turpen did not follow his own advice. In approximately 2003, Mr. Holliday received a call from Dr. Turpen instructing him to open a Hushmail (encrypted email) account and to contact Dr. Turpen through that account. When Mr. Holliday did so, Dr. Turpen informed him that the IRS had executed a search warrant for his offices in Nevada and taken all of his records, including the hard drives from his computers. Mr. Holliday asked if this material contained any records with his name on them, and Dr. Turpen replied that there were numerous such documents. Mr. Holliday told the Subcommittee that he responded to the effect of, “You idiot! That is exactly what you told me never to do.”

Mr. Holliday told the Subcommittee that, during the years he operated under Dr. Turpen’s plan, Dr. Turpen referred him to an accountant to have returns prepared for the Nevada corporations. Mr. Holliday supplied the accountant with all the false documents that had been prepared to document the “business” purpose of the transfers of funds to Landmark Planning in the Isle of Man. The accountant based the returns on those false documents, and the resulting false returns ultimately led to Mr. Holliday’s conspiracy conviction.

**Conclusion.** Dr. Turpen and Mr. Holliday took advantage of some of the most problematic features of the current offshore industry. They used the secrecy laws of offshore jurisdictions to conceal ownership of the offshore entities they established, allowing them to avoid payment of taxes for years. At the same time, they were able to maintain total control through a group of compliant offshore service providers. The two men were only apprehended because of the carelessness of Dr. Turpen in keeping records onshore. If the records had been themselves secreted offshore, the two men might still be cheating the federal taxpayer today.

## V. GREAVES-NEAL CASE HISTORY: DIVERTING U.S. BUSINESS INCOME OFFSHORE

This case study examines the offshore activities of Kurt Greaves, a Michigan businessman, who worked with Terry Neal, a prominent offshore promoter based in Oregon. Mr. Neal designed and implemented an offshore structure into which Mr. Greaves placed between \$400,000 and \$500,000 in untaxed business income. With the help of Mr. Neal, Mr. Greaves established corporations in Canada, Nevis, and Nevada, to which he transferred this business income and other assets using a sham mortgage, fictitious service contracts, and a phony insurance policy. While Mr. Neal assured Mr. Greaves that all of the arrangements were legal, after a few years Mr. Greaves learned that they were not, and he began cooperating with federal authorities.

On April 13, 2004, both Mr. Neal and Mr. Greaves pleaded guilty to federal tax evasion charges. Mr. Greaves pleaded guilty to one count of filing a fraudulent tax return<sup>99</sup> and was sentenced to two years of probation and a \$30,000 fine.<sup>100</sup> Mr. Neal pleaded guilty to conspiracy to defraud the United States by impeding the IRS.<sup>101</sup> He was sentenced to five years in prison followed by three years probation and a \$50,000 fine.<sup>102</sup> The information in this case history is based on a Subcommittee interview of Mr. Greaves, documents he provided, and legal pleadings in the cases of United States v. Kurt P. Greaves<sup>103</sup> and United States v. Terry L. Neal, et al.<sup>104</sup>

**Background.** Kurt Greaves is the owner and president of Mr. Roof, the largest residential roofing company in Michigan. Mr. Greaves told the Subcommittee that in the winter of 1998, while flying home from a vacation in the Carribean, he saw an advertisement by Terry Neal, a prominent offshore promoter, about the benefits of moving money offshore. Mr. Greaves showed the advertisement to his father, the founder of Mr. Roof, and asked him to contact Mr. Neal.<sup>105</sup>

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<sup>99</sup> Press Release, Department of Justice, “Two Businessmen Plead Guilty to Tax Fraud in Offshore Credit Card Scheme,” 4/13/04.

<sup>100</sup> United States v. Greaves, Criminal No. 2:04-cr-80274-AJT-RSW-ALL (E.D. Mich. 2004), Criminal Docket.

<sup>101</sup> Press Release, Department of Justice, “Two Promoters of Offshore Tax Fraud Scheme Plead Guilty in Oregon,” 4/13/04.

<sup>102</sup> United States v. Neal, Criminal No. CR 03-35-HA (D. Oregon 2003), Criminal Docket.

<sup>103</sup> Criminal No. 2:04-cr-80274-AJT-RSW-ALL (E.D. Mich. 2004).

<sup>104</sup> Criminal No. CR 03-35-HA (D. Oregon 2003).

<sup>105</sup> Subcommittee interview of Kurt Greaves (4/14/06).

Mr. Neal was the operator of three companies involved with promoting, creating, and managing offshore tax shelters. Offshore Corporate Services, Inc. (OCS) operated out of Portland, Oregon and Carson City, Nevada.<sup>106</sup> It established foreign and domestic corporations for Mr. Neal's clients, appointed nominee directors, and opened bank and brokerage accounts.<sup>107</sup> OCS was later renamed Laughlin International, Inc.<sup>108</sup> The second company, Nevis American Trust Company (NATCO) was based in Nevis and created offshore corporations for Mr. Neal's clients.<sup>109</sup> NATCO also provided nominee directors and established bank and securities accounts for these offshore corporations.<sup>110</sup> The third company, Offshore Consulting Services, Inc., assisted Mr. Neal's clients in developing their offshore plans. Both Offshore Corporate Services, Inc. and Offshore Consulting Services, Inc. operated out of the same Portland, Oregon office and used the same acronym, OCS.

**Sales Pitch in Portland.** Mr. Neal invited Mr. Greaves and his father to visit his office in Portland, Oregon in late 1998 or early 1999. Mr. Greaves and his father traveled to Portland, and Mr. Neal's colleague, Aaron Young, picked them up at the Portland airport. He drove them to Pumpkin Ridge Country Club for lunch, where they were joined by Mr. Neal and his son-in-law Lee Morgan. According to Mr. Greaves, Mr. Neal led the discussions, Mr. Young acted as his "sidekick," and Mr. Morgan held himself out to be their lawyer. The discussion at lunch focused on the general benefits and procedure of moving assets offshore. Mr. Neal assured Mr. Greaves that his business practices were completely legitimate.<sup>111</sup>

After lunch the party drove to Mr. Neal's home and continued their meeting. Mr. Greaves told the Subcommittee that he led Mr. Neal to believe that he was very wealthy, and used his perceived wealth to leverage Mr. Neal into describing the offshore business in great detail. Mr. Neal explained that his companies, OCS and NATCO, could help Mr. Greaves establish offshore corporations to hold his assets, while ensuring that he would not be listed as an owner of the corporations. Mr. Neal assured him that this arrangement was perfectly legal. Mr. Neal also said that his company had hundreds of customers and millions of dollars under management and mentioned that several celebrities were his clients.

Mr. Greaves stated that their discussion of offshore strategies at first focused on asset protection, but as the discussion progressed, tax benefits were raised. By end of day, they were discussing specific structures, and Mr. Neal wanted to know everything about the Greaves

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<sup>106</sup> United States v. Neal, Criminal No. CR 03-35-HA (D. Oregon 2003), Superseding Indictment at 2.

<sup>107</sup> Id.

<sup>108</sup> Id.

<sup>109</sup> Id.

<sup>110</sup> Id.

<sup>111</sup> Subcommittee interview of Mr. Greaves (4/14/06).

family finances so they could design an appropriate plan. Mr. Greaves had the impression that Mr. Neal would design the offshore plan, and that Mr. Young would help implement it.

Mr. Greaves and his father left Portland that evening, having spent, in his estimation, seven or eight hours in meetings with Mr. Neal and his team. They agreed to follow up over the telephone. Mr. Greaves told the Subcommittee that he felt the benefits of moving his assets offshore sounded “too good to be true.”<sup>112</sup>

**Offshore Strategy.** On July 14, 1999, after further telephone contacts, Mr. Greaves sent a \$20,000 fee to Mr. Neal by check payable to “OCS, INC.”<sup>113</sup> In return, Mr. Neal’s company sent a written offshore strategy to Mr. Greaves with recommendations on establishing offshore entities. Mr. Greaves considered consulting a lawyer or an accountant before investing in the strategy, but he said that Mr. Neal told him that most lawyers and accountants would not be familiar with the type of offshore strategy they had devised. Mr. Greaves told the Subcommittee that Mr. Neal assured him, “There’s nothing you can’t ask us, we’re one-hundred percent legit.”<sup>114</sup>

To carry out the strategy, Mr. Greaves formed five or six corporations with Offshore Corporate Services.<sup>115</sup> The corporations were formed in Canada, Nevis, and in Nevada, and were owned on paper by Nevis American Trust Co. Mr. Greaves said that one corporation held his mortgage, one corporation held his credit card, and one corporation was used to facilitate an insurance premium scheme; one corporation, named Midwest Consultants, was used to pay for services in the United States. There were one or two additional corporations, the purpose of which Mr. Greaves could not recall. Mr. Greaves paid Mr. Neal’s company approximately \$2,000 in fees to establish each corporation.

Mr. Neal instructed Mr. Greaves to open bank accounts for his corporations at Mr. Neal’s private bank, Exchange Bank and Trust, a shell operation administered in Nevis by NATCO.<sup>116</sup> When Mr. Greaves later tried to withdraw money from his account at Mr. Neal’s private bank, he learned that it functioned primarily as a correspondent bank account at a Canadian bank. Mr. Neal’s shell bank pooled all of its depositors’ money in one account at the Canadian bank under the name of Exchange Bank and Trust. Mr. Greaves told the Subcommittee that on one occasion Mr. Greaves noticed a \$17,000 discrepancy, to his detriment, between his records and the records of Mr. Neal’s shell bank.

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<sup>112</sup> Id.

<sup>113</sup> Check dated 7/14/99 (FR031771). It is not clear whether Mr. Neal processed this check through Offshore Corporate Services, Inc., or Offshore Consulting Services, Inc.

<sup>114</sup> Subcommittee interview of Mr. Greaves (4/14/06).

<sup>115</sup> 7/14/99 letter from Mr. Neal to Mr. Greaves (FR031784).

<sup>116</sup> Exchange Bank and Trust, Inc. document (FR031787-92).

**Client Control.** While NATCO appeared to own the companies that Mr. Neal helped Mr. Greaves establish, Mr. Greaves actually controlled the companies. He explained that NATCO appointed Mr. Greaves to a position of “Business Consultant” in the companies, and when he wanted any action taken by his companies, he called Mr. Neal’s office in Portland. The Portland office then forwarded his instructions to one of Mr. Neal’s employees in St. Kitts. According to Mr. Greaves, his instructions were followed on every occasion. Though corporate decisions were ostensibly made by nominee officers and directors, Mr. Greaves stated, “if I wanted to do something, it would happen.”<sup>117</sup>

**Moving Assets Offshore.** Mr. Neal developed several schemes to help Mr. Greaves move his assets offshore. In one scheme that combined asset protection and tax benefits, Mr. Greaves took out a mortgage on his home through an ostensibly independent Canadian corporation that he in fact controlled. No money was actually borrowed, but the mortgage encumbered Mr. Greaves’s property and thereby rendered it immune from asset seizure. Each tax-deductible interest payment to the company on the “mortgage” moved money into foreign bank accounts that Mr. Greaves controlled.<sup>118</sup>

Mr. Greaves described another scheme that used a Nevada corporation called Midwest Consultants. Mr. Greaves paid about \$150,000 to the company for “consulting services,” which he listed as a tax deduction. Then Midwest Consultants sent the money to a company in Nevis controlled by Mr. Greaves, and Midwest Consultants deducted the expense as well. Mr. Greaves routinely moved money in this way, sending it offshore through a U.S. company he controlled for phony business expenses such as consulting or accounting services.

A third scheme devised by Mr. Neal and utilized by Mr. Greaves involved a phony insurance company. Mr. Greaves wired \$230,000 to a company controlled by Mr. Neal called Sovereign Life & Casualty Limited for “Business Casualty and Fidelity Insurance,” which purported to insure against a variety of business losses.<sup>119</sup> The policy was phony, and Sovereign Life & Casualty Limited did not provide any actual insurance coverage. A Nevis company controlled by Mr. Greaves, called McLaren Investment, Inc., entered into an indemnity agreement with Sovereign Life & Casualty Limited and assumed all of its liabilities under the policy.<sup>120</sup> The money that Mr. Greaves wired to the phony insurance company then went into an offshore account that he controlled.

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<sup>117</sup> Subcommittee interview of Mr. Greaves (4/14/06).

<sup>118</sup> *Id.* See also 9/5/02 letter from Benjamin Knaupp of Benjamin D. Knaupp, P.C., Business, Tax, and International Legal Advisors to Mr. Greaves (FR031877) and 9/13/02 letter from Marcus O’Sullivan of Amicus Neighborhood Law Centre in Victoria, British Columbia to Mr. Greaves (FR031878).

<sup>119</sup> Sovereign Life & Casualty, Ltd. Approval Memorandum (FR031781-82); Sovereign Life & Casualty, Ltd. insurance policy (FR031860-67).

<sup>120</sup> Sovereign Life & Casualty document, “Indemnity Agreement” (FR031858-59).

**Offshore Secrecy.** Mr. Morgan advised Mr. Greaves to authorize the movement of his corporate files offshore in order to provide additional asset protection. On September 6, 2000, Mr. Morgan wrote to Mr. Greaves and his wife and explained the purpose of moving corporate files offshore:

“We have completed our corporate consulting services from within the United States and recommend that you instruct us to move your file to St. Kitts & Nevis where our work product and mutual correspondence will be secure in accordance with the Privacy and Confidentiality Act of St. Kitts & Nevis.

“Under U.S. law, a litigant can subpoena files from our U.S. office and we could be required to provide copies of the contents of such files. Enclosed is an Acknowledgment and Indemnification Agreement wherein you relieve us from responsibility to maintain such files in the U.S. and instruct us to move documents, legal work product, letters, memos, records, research, etc. to a safe haven beyond the grasp of predators.”<sup>121</sup>

**Moving Money Back.** Mr. Greaves primarily repatriated his money through credit cards and loans. Several Greaves family members received an “Infinity Global Axxess” Mastercard issued by Leadenhall Bank & Trust Company Limited in the Bahamas.<sup>122</sup> In addition to the card-holder’s name, each card also listed the name of Nevis American Trust Co. The credit cards were secured and required the card holder to deposit in escrow an amount equal to a little less than one-and-a-half times the card’s credit limit. Mr. Greaves deposited the minimum escrow, \$33,000, in order to receive a \$25,000 credit limit.<sup>123</sup> The escrow account was not used to pay charges on the credit account; it was just held by the bank to protect itself in case any charges went unpaid. Mr. Greaves paid his credit card balance by electronically transferring the funds from his companies’ offshore accounts at Mr. Neal’s bank in Nevis. Account records show that Mr. Greaves paid a significant number of ordinary living expenses in this way.<sup>124</sup>

**Offshore Jurisdictions.** According to Mr. Greaves, Mr. Neal preferred to utilize Nevis as an offshore jurisdiction because of the sophistication of its banking services, its lack of regulation, and its strong secrecy laws. Mr. Neal told Mr. Greaves that “the IRS has no pull there.”<sup>125</sup> Mr. Neal also told Mr. Greaves that there were advantages to the geography of St. Kitts and Nevis. The two islands in the nation of St. Kitts and Nevis are separated by a small

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<sup>121</sup> See 9/6/00 letter from Lee E. Morgan to Kurt Greaves and Grace-Anne Greaves (FR031815).

<sup>122</sup> Subcommittee interview of Mr. Greaves (4/14/06). See also photocopies of the credit cards in question (FR031884-95).

<sup>123</sup> See Global Axxess Mastercard Schedule of Fees (FR031893).

<sup>124</sup> Leadenhall Bank & Trust account statements from 2000 and 2002 (FR031896-901).

<sup>125</sup> Subcommittee interview of Mr. Greaves (4/14/06).

channel. The islands are so close together that walkie-talkies can be used to communicate between them. According to Mr. Greaves, Mr. Neal's bank had operations on both islands, with his main office on Nevis near the island's main docks. In the event of an official raid on the bank, Mr. Greaves was told that the bank's files could be quickly moved to St. Kitts by boat.

In 2002, Mr. Neal began to move his operations to Grenada in response to the Patriot Act. Mr. Greaves' father received a letter that explained this move:

"Now, the so-called 'Patriot Act' is interrupting offshore banking activities. A sample paragraph from a letter from SKNA bank (the largest commercial bank in the West Indies) points out this problem: 'We advise that as a result of the stringent requirements imposed by our USA correspondent banks and other banking partners, and in particular the requirements of the USA Patriot Act passed by the United States Government, our Bank has been forced to discontinue providing banking services to offshore companies.'"<sup>126</sup>

Mr. Greaves believes that his accounts were transferred to Granada at about this time. Mr. Greaves was also told that Mr. Neal decided to move his operation to Grenada because he had a strong relationship with the nation's Prime Minister. Mr. Greaves told the Subcommittee that he was assured his assets would be "untouchable" in Grenada.<sup>127</sup>

**Suspicious.** Mr. Greaves told the Subcommittee that, despite assurances from Mr. Neal, he had his suspicions about the legitimacy of the offshore system he had established. His suspicions were heightened when he received documents from Mr. Neal that were stamped with the phrase "Read and Destroy." While on a cruise to the Carribean, Mr. Greaves decided to visit NATCO's office in Nevis. The cruise docked in St. Kitts. Mr. Greaves hired a small boat to take him across the small channel to Nevis. In Nevis he hired a cab to find the office. Mr. Greaves said that he quickly found a 30-by-40 foot stone building with a small sign reading "Nevis American Trust." The building was easy to find, as it was right on the beach and close to the docks where he landed. He knocked on the door, and a women answered and stepped out to talk with him. He recognized her voice from his regular telephone calls to the company. He introduced himself, stated that he was a client, and asked to see the office. She would not let him in, and stated that meetings were by appointment only.

**Cooperating.** Mr. Greaves cooperated with the Criminal Division of the IRS and with the Office of the United States Attorney in their investigations of Mr. Neal's operation. He told the Subcommittee that he withdrew his money from his offshore structures so that Mr. Neal could not steal it once he found out that Mr. Greaves was cooperating. Mr. Greaves stated that Mr. Neal was reluctant to allow Mr. Greaves to withdraw a large amount of money all at once, but Mr. Greaves was able to prevail upon him to do so by saying that the money was needed

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<sup>126</sup> Letter to Herbert Greaves, undated, (FR031883).

<sup>127</sup> Subcommittee interview of Mr. Greaves (4/14/06).

immediately for a business deal, and that he would soon reinvest even more money offshore. For a while Mr. Neal didn't realize that Mr. Greaves was cooperating with federal authorities, and he continued contacting Mr. Greaves and sending him documents. Mr. Greaves said that he and his father had about \$60,000 combined at NATCO when Mr. Neal realized that they were cooperating with authorities; they were unable to withdraw that money.<sup>128</sup>

**Conclusion.** Under the guidance of Terry Neal, a prominent offshore promoter, Kurt Greaves used a variety of sham transactions to move between \$400,000 and \$500,000 of untaxed business income offshore without giving up the ability to access and manage those funds. Mr. Greaves's experience demonstrates that offshore service providers can enable a client to retain complete control over assets that are ostensibly owned by independent entities. Mr. Greaves' providers even fabricated documents to support fictitious tax deductions, rendering suspect the legitimacy of documents produced by offshore providers based in tax havens. Mr. Neal's operation promoted, and Mr. Greaves relied on, the fiction that, for legal and tax purposes, there can be a distinction between ownership and control. This case history is also notable for Mr. Greaves' use of Nevada corporations as an additional layer of separation between him and his offshore assets. Many offshore promoters take advantage of Nevada's policy of collecting very little information on the people behind the businesses that incorporate in the state.

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<sup>128</sup> Id.

## VI. ANDERSON CASE HISTORY: HIDING OFFSHORE OWNERSHIP

This case history focuses on Walter C. Anderson, a U.S. citizen who allegedly placed more than \$450 million offshore, devising several ways to hide his ownership of these assets.<sup>129</sup> In 2005, he was indicted for evading more than \$200 million in federal and District of Columbia income taxes, and he is now awaiting trial.<sup>130</sup> The indictment alleges that Mr. Anderson founded and owned several corporations, particularly in the telecommunications industry. It claims that through the use of offshore structures, he disguised his ownership of these companies, and profited from their growth and sales while avoiding oversight of tax agencies and securities regulators.

**Background.** Born in the 1950s and raised in the Washington, D.C. area, Mr. Anderson earned hundreds of millions of dollars during the 1990s in the telecommunications industry through a complex series of company mergers and sales. He founded three telecom companies, Mid Atlantic Telecom, Telco Communications Group Inc., and Esprit Telecom, and sold each, obtaining cash and valuable shares which he then allegedly hid offshore.

In 1984, Mr. Anderson formed a regional long-distance carrier in Washington, D.C., called Mid Atlantic Telecom (MAT), and became its principal shareholder and president.<sup>131</sup> Documents filed with the SEC reveal that by 1993, MAT was losing money and was in danger of going out of business.<sup>132</sup> In 1992, Mr. Anderson entered into negotiations to sell MAT to a publicly traded corporation, Rochester Telephone Corporation (RTC).<sup>133</sup> Mr. Anderson was allegedly due to earn about \$7 million upon completion of the merger.<sup>134</sup>

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<sup>129</sup> The information in this section is taken primarily from the federal indictment of Mr. Anderson and related legal pleadings. United States v. Anderson, Criminal No. 05-66 (USDC DC), indictment (2/23/05), superceding indictment (9/30/05)(hereinafter “Anderson Indictment”). Mr. Anderson declined the Subcommittee’s request for an interview. Subsequent to this report and the Subcommittee’s hearing, on 9/8/06, Mr. Anderson pled guilty to tax evasion.

<sup>130</sup> Anderson Indictment at para. 18.

<sup>131</sup> United States v. Anderson, Criminal No. 05-66 (USDC DC), Affidavit in Support of Government’s motion to Order Walter C. Anderson to Comply with Grand Jury Subpoenas or Show Cause Why He Should Not Be Held in Contempt at para. 3 (10/28/04)(hereinafter “Government Affidavit”). This affidavit was sworn by Matthew J. Kutz, an IRS special agent assigned to the investigation of Mr. Anderson.

<sup>132</sup> 5/3/93 Independent Auditors’ report of MAT, included with Form S-4 filed with the SEC by Rochester Telephone Corporation (“The Company’s recurring losses from operations, working capital deficit, net stockholders’ deficiency and obligations under existing borrowing arrangements raise substantial doubt about the entity’s ability to continue as a going concern.”). See also “\$200,000,000: Telecom Tycoon Used International Financial Labyrinth,” The Washington Post (4/18/05)(hereinafter “Telecom Tycoon”).

<sup>133</sup> 8/25/93 Amendment No. 2 to Form S-4 filed with the SEC by RTC.

<sup>134</sup> Government Affidavit at para. 3.

**Anderson Offshore Structure.** Prior to the completion of the merger, Mr. Anderson allegedly took steps to prevent his earnings from the merger from being seized as payment for back taxes.<sup>135</sup> According to the indictment, in early September 1992, Mr. Anderson hired an offshore services provider known as Arias, Fabrega & Fabrega Trust Company to establish a company in the British Virgin Islands (BVI) which he named Gold & Appel (G&A). The incorporation papers apparently authorized the issuance of one thousand G&A shares.<sup>136</sup> The indictment alleges, however, that Mr. Anderson directed the issuance of only ten shares, all of which were given to Icomnet S.A., another offshore company that Mr. Anderson had previously formed in the British Virgin Islands. Mr. Anderson then allegedly granted himself an exclusive option to purchase the remaining 990 shares of G&A.<sup>137</sup>

The indictment further alleges that later that same month, September 1992, Mr. Anderson, using the alias Mark Roth, hired another offshore services provider, The Company Store, to form a bearer share company in Panama called Iceberg Transport, S.A. (Iceberg).<sup>138</sup> According to the indictment, Mr. Anderson had the shares delivered to him, making him the sole owner of Iceberg.<sup>139</sup> The indictment alleges that Mr. Anderson then caused Icomnet to transfer its ten G&A shares to the new company, Iceberg. There is apparently no evidence that Mr. Anderson ever exercised or transferred his option to purchase the remaining G&A shares. The end result was that Iceberg, the bearer share corporation, became the sole owner of the issued shares of G&A, while the unissued shares were under the exclusive control of Mr. Anderson.

The indictment alleges that Mr. Anderson claimed under oath in court proceedings that he did not know the identity of the beneficial owners of G&A.<sup>140</sup> In addition, although Mr. Anderson owned Iceberg which, in turn, owned G&A, he disclaimed ownership of G&A in a filing with the SEC.<sup>141</sup> The indictment alleges that he further hid his ownership of G&A by

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<sup>135</sup> According to the indictment and related pleadings, during this period, Mr. Anderson had repeated contacts with the IRS. Mr. Anderson then filed delinquent tax returns for the years 1987-1993, but did not pay the taxes he allegedly owed. See Anderson Indictment at para. 31.

<sup>136</sup> Id. at para. 12.

<sup>137</sup> Id.

<sup>138</sup> Id. at para. 13. Unlike the typical U.S. corporation, there is no central registry of the owners of a bearer-share company; the person in actual possession of the bearer-shares is deemed the owner of the company.

<sup>139</sup> Id.

<sup>140</sup> Government Affidavit at para. 5

<sup>141</sup> See 1/21/97 Schedule 13D filed with the SEC by Walter Anderson as G&A's "attorney-in-fact" ("Mr. Anderson disclaims beneficial ownership of the Common Share held by Gold & Appel.").

using aliases and private mail boxes to exercise control of the company's officers and directors, business records, and bank and brokerage accounts.<sup>142</sup>

**Transferring Assets Offshore.** After forming G&A, Mr. Anderson began allegedly transferring his assets to the offshore company. In December 1991,<sup>143</sup> he granted G&A an option to buy almost his entire ownership stake in MAT for three cents a share.<sup>144</sup> The next year, just before RTC purchased MAT, G&A exercised its option, took possession of a substantial number of MAT shares, and when the sale went through, took possession of the sale proceeds.<sup>145</sup>

A letter prepared by MAT's tax counsel, Swidler & Berlin, indicates that MAT shareholders did not treat the merger with RTC as a taxable event, instead classifying the merger as a reorganization.<sup>146</sup> Swidler & Berlin expressed the opinion that because G&A had acquired its shares of MAT prior to the beginning of merger negotiations and not in anticipation of the merger, G&A should be treated as a "historical shareholder."<sup>147</sup> Yet subsequent SEC filings by RTC indicate that Mr. Anderson had been authorized to investigate "strategic alternatives for the financial recapitalization of the company" in July 1991.<sup>148</sup> This authorization was provided five months before the agreement granting G&A the option to purchase Mr. Anderson's MAT shares.<sup>149</sup>

Mr. Anderson continued to add to G&A's assets by transferring additional ownership interests in various companies to G&A, according to the indictment. For example, in 1994, Mr. Anderson sold about 5.8 million shares in Telco Communications Group Inc., a company he had founded, back to the company for \$25,000. He then directed Telco to sell about 6.5 million

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<sup>142</sup> Anderson Indictment at para. 15.

<sup>143</sup> This date, December 1991, was cited in a 6/23/93 letter from Swidler & Berlin, Chartered, which was included with 7/13/93 Amendment No. 1 to Form S-4 filed with the SEC by Rochester Telephone Corporation. The Anderson Indictment, however, states that G&A was not formed until September 1992.

<sup>144</sup> 6/23/93 letter from Swidler & Berlin, Chartered, included with 7/13/93 Amendment No. 1 to Form S-4 filed with the SEC by Rochester Telephone Corporation. At the time of the merger Mr. Anderson was listed as beneficial owner of 734,680 shares of MAT, with G&A legally owning 684,680 of those shares, though Mr. Anderson retained control of those shares through a power of attorney agreement. 5/3/93 Form S-4 filed with the SEC by Rochester Telephone Corporation.

<sup>145</sup> See "Telecom Tycoon."

<sup>146</sup> Section 1.368-1(b) of the Treasury Regulations requires that there be a "continuity of interest" for the stockholders, meaning that at least half of the consideration given for the merger must be given to target stockholders who owned stock in the target company prior to the merger, not including any stockholders who may have acquired their stock in anticipation of or in reliance upon the merger. See 6/23/93 Swidler & Berlin letter.

<sup>147</sup> 6/23/93 Swidler & Berlin letter.

<sup>148</sup> 8/25/93 Amendment No. 3 to Form S-4 filed with the SEC by Rochester Telephone Corporation.

<sup>149</sup> 6/23/93 Swidler & Berlin letter.

shares to Iceberg for \$50,000. Upon receipt of the shares, Iceberg transferred them to G&A.<sup>150</sup> Two years later, in August 1996, Telco went public, dramatically increasing the value of its shares. As a result of the public offering, the Telco stock held by G&A was worth about \$90.5 million.<sup>151</sup> The next year, in 1997, Telco was merged with another publicly traded corporation, Excel Communications, forming a new company. As a result of that merger, G&A received \$97 million in stock in the new company and \$92 million in cash.<sup>152</sup>

Mr. Anderson also transferred to G&A about 20 million shares of a European-based company that he had founded, known as Esprit Telecom. In 1997, Esprit went public, increasing the value of the shares held by G&A to more than \$26.5 million.<sup>153</sup> Two years later, in 1999, Esprit was sold to another public company, Global Telesystems, Inc. (GTS). After the merger, G&A apparently held GTS stock worth over \$250 million.<sup>154</sup>

The indictment alleges that Mr. Anderson held 100 percent of the stock of Iceberg through bearer-shares, and that G&A was a wholly-owned subsidiary of Iceberg. According to the indictment, all of Iceberg's income was attributable to Mr. Anderson as the company's sole owner.<sup>155</sup> In addition, the indictment alleges that the stock held by G&A and Iceberg had appreciated in value between 1995 and 1999, with a net value of about \$450 million, none of which had been reported on Mr. Anderson's tax returns.<sup>156</sup> Further, after learning of IRS liens against property held in his name, Mr. Anderson allegedly took the step of purchasing real property with G&A funds in the names of corporate or trust entities created and controlled by him.<sup>157</sup>

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<sup>150</sup> See 6/13/96 Form S-1 filed with the SEC by Telco (stating that, on 7/20/94, Telco purchased about 5.8 million shares from "a founding shareholder" for \$25,000; that shareholder then directed Telco to sell about 6.5 million shares to Iceberg for \$50,000; and on 4/30/96, Iceberg transferred these shares to G&A).

<sup>151</sup> See 9/20/96 Form 10-Q filed with the SEC by Telco (showing its shares sold for \$14 per share in the initial public offering).

<sup>152</sup> See 9/11/97 Form S-4 filed with the SEC by New Res, Inc.

<sup>153</sup> On 3/30/98, Mr. Anderson filed a disclosure form with the SEC indicating that G&A was the beneficial owner of more than 20 million shares of Esprit Telecom or about 16 percent of the total company. The form also stated that Mr. Anderson might be deemed to be the beneficial owner of those shares, but he disclaimed such ownership. The form indicated further that another 2 million shares were held by the Foundation for the International Non-Governmental Development of Space, an organization of which Mr. Anderson was the President and Director. See Schedule 13D, filed 3/30/98 by G&A and Mr. Anderson.

<sup>154</sup> At the time of the merger, G&A beneficially owned nearly 33 million shares, which were exchanged for GTS stock worth \$7.96 a share. Schedule 14D1, filed 2/2/99 by Global Telesystems.

<sup>155</sup> Anderson Indictment at para. 24.

<sup>156</sup> Id. at para. 17-18.

<sup>157</sup> Id. at para. 31.

In March 2002, the law enforcement agents obtained a search warrant and searched Mr. Anderson's Washington, D.C. office. During that search, the government states that it found and seized all of the Iceberg bearer shares, which allegedly had been mailed at the time of Iceberg's formation to a mailbox in the Netherlands controlled by Mr. Anderson.<sup>158</sup> The government states that it also seized a document granting Mr. Anderson's mother the exclusive option to purchase 99 percent of Iceberg, a company worth hundreds of millions of dollars, for \$9,900. Mr. Anderson's mother told investigators that she had been unaware of her rights to purchase Iceberg.<sup>159</sup>

**Disguising Ownership.** After the search of his office, Mr. Anderson took further action to disguise his ownership of Iceberg and protect the assets under his control, according to the IRS investigator's affidavit. Mr. Anderson allegedly directed G&A's nominee director in the British Virgin Islands to limit her disclosures about the company's ownership. According to the IRS affidavit, he then changed the structure of Iceberg by establishing two wholly-owned subsidiaries, Space Inc. in the British Virgin Islands, and Comverge Ltd. in the Bahamas. Mr. Anderson then allegedly requested the companies in which G&A owned shares to reissue those shares in the names of the two new subsidiaries. Then he caused Iceberg to issue a new share certificate representing 100 percent of its equity and give it to a newly formed offshore trust, called Smaller World Trust. Mr. Anderson allegedly also named Iceberg the trustee of Smaller World Trust, making Iceberg the trustee of the entity which owns Iceberg.<sup>160</sup>

The affidavit further alleges that Mr. Anderson took action to create a Cayman Islands entity with the name Smaller Island Trust, and contacted a Panamanian offshore services provider, Sovereign Management Services, to form the Smaller World Foundation.<sup>161</sup> It is unclear whether or not Mr. Anderson transferred any assets to these new entities. Mr. Anderson also shipped millions of dollars in artwork to Switzerland.<sup>162</sup> The end result was a far-flung offshore structure with entities in the British Virgin Islands, Cayman Islands, Panama, and Switzerland.

In November 2003, government investigators executed a second round of search warrants for Mr. Anderson's residence, storage facility, and new office. In Mr. Anderson's office, the agents state that they found a trust document for the Smaller World Trust with the names of the settlor and the date of settlement redacted. Mr. Anderson was identified as the trust's "initial protector" and "protector" and was named as "the party most familiar with the true and actual

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<sup>158</sup> *Id.* at para. 13.

<sup>159</sup> Government Affidavit at para. 13.

<sup>160</sup> *Id.* at para. 16.

<sup>161</sup> *Id.* at para. 20.

<sup>162</sup> *Id.* at para. 15.

intentions and Purposes of the Trust.” The protector was given the right to current information for all trust matters.<sup>163</sup>

In February 2005, a federal grand jury issued a twelve-count indictment charging Mr. Anderson with engaging in a tax evasion scheme that concealed more than \$450 million in taxable income.<sup>164</sup> He was arrested and pleaded not guilty. In part, Mr. Anderson claimed to be a mere employee of G&A. The court has upheld the government’s motion to detain Mr. Anderson pending trial, noting his “unique ability to flee the jurisdiction and evade detection by the United States government by virtue of his substantial assets abroad, his connections overseas, and his use of aliases and false identities.” The court stated that Mr. Anderson’s false identities included, “Mark Roth, William Prospero, Robert Zzylich, Robert Zzylick, R. Langer, Ragnor Danksjold, and Dr. Paul Anderson.” It also noted that the books seized from Mr. Anderson’s home and office included: “I.D. by Mail,” “Reborn Overseas: Identity Building in Europe, Australia and New Zealand,” “Methods of Disguise,” “Poof! How to Disappear and Create a New Identity,” “Who Are You? The Encyclopedia of Personal Identification,” “Bulletproof Privacy, How to Live Hidden, Happy, and Free,” “Complete Guide to Financial Privacy,” “Complete Guide to Offshore Money Havens,” “Reaching Offshore Assets (It Won’t Be Easy),” and “Capturing Cargo Adrift – Reaching Offshore Assets.”<sup>165</sup> These books alone illustrate the breadth of the offshore industry today.

**Conclusion.** The government has developed evidence that Walter Anderson took advantage of secrecy laws in multiple tax haven countries to create a structure of offshore corporations and trusts. Through a series of assignments, sales, and transfers, Mr. Anderson allegedly placed into these offshore entities more than \$450 million in cash and stock, including large interests in telecommunications firms. Mr. Anderson is accused of disguising his ownership of these assets through a range of techniques including shell companies, bearer shares, nominee directors and trustees, and the issuance of options to a person with no knowledge that she possessed them. The government claims that this structure allowed Mr. Anderson to evade more than \$200 million in taxes.

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<sup>163</sup> Id. at para. 18-19.

<sup>164</sup> Anderson Indictment at para. 18.

<sup>165</sup> United States v. Anderson, Criminal No. 05-66 (USDC DC), Opinion and Order (3/16/05).

## VII. POINT CASE HISTORY: OFFSHORE SECURITIES PORTFOLIO

In addition to the offshore asset protection and tax structures discussed above, which were normally designed for use over an extended period of time, the Subcommittee investigated the use of offshore secrecy jurisdictions to facilitate the development, sale, and execution of one-time tax shelter transactions. This aspect of the investigation focused on a small number of transactions designed and sold by Seattle-based Quellos Group, LLC, (Quellos) to several high net worth individuals to defer and to some extent eliminate tax on other transactions that produced income.

As will be explained in detail below, the Subcommittee's investigation found that:

- The U.S. tax shelter promoter, Quellos, concocted a tax shelter that was based upon the fabrication of billions of dollars worth of fake securities transactions that were used to generate billions of dollars in fake capital losses and offset real taxable capital gains of U.S. taxpayers so they could avoid paying taxes to the U.S. Treasury.
- The POINT transaction was carried out under offshore secrecy laws with the assistance of compliant trust and corporate management companies in the Isle of Man and the Cayman Islands which allowed the true nature of the securities transactions and the entities that conducted them to remain hidden.
- The POINT strategy was promoted to individuals as a tax avoidance product, but with the possibility of realizing some income to cover a part of the fees.
- The part of the scheme included to provide the appearance of a profit objective needed to support the claimed tax benefits was intended to be eliminated long before any possible profit could be realized.
- The fees charged by Quellos for designing and implementing the scheme depended on the amount of tax loss generated in each transaction; the more money the transaction "lost," the larger fees Quellos collected.
- Prominent law firms collaborated with Quellos on the development of a legal rationale to support the legitimacy of the tax losses generated by the POINT transactions.
- Prominent U.S. and foreign financial institutions provided financing, planning, and technical assistance for the execution of the transactions knowing they were designed to avoid taxes and without conducting adequate due diligence into the underlying transactions.

Quellos advertises itself as a “global financial boutique that is focused on providing leading edge investment management services to institutional and private clients worldwide.”<sup>166</sup> The firm employs professionals with asset management, investment banking, and “big four” audit experience.<sup>167</sup> Quellos has offices in Seattle, New York, and London.<sup>168</sup> Founded in 1994 by CEO Jeffrey Greenstein, Bryan White, and two others, Quellos operated under the name Quadra Capital management until 2000. In the mid to late 1990s, Quellos helped accounting firm KPMG LLP design, develop, market, and implement tax shelter products for sale to U.S. clients.<sup>169</sup> In 1999, Quellos developed a new tax shelter strategy, based on helping clients with large anticipated capital gains acquire securities with built-in losses to offset the gains and defer, or even avoid altogether, paying income tax on those gains. Over the next two years, Quellos promoted this strategy, known as POINT (Personally Optimized INvestment Transaction), to six wealthy clients in six separate transactions resulting in the elimination of over \$2 billion in gains at a cost to the Treasury of approximately \$300 million.<sup>170</sup>

In the sections that follow, this Report will describe the genesis of the POINT strategy, the entities involved, the transactions as described in the documentation, and the transactions as they actually occurred.

### **Development of the POINT Strategy**

The Quellos employees centrally involved in the development and promotion of the POINT strategy were founder and CEO Jeffrey Greenstein, Private Client Group Director Chuck Wilk, Larry Scheinfeld, also of the Private Client Group, and Brian Hanson and Chris Hirata, of the Custom Strategies Group. Mr. Greenstein, who has been with Quellos since 1997, specialized in developing financial services tailored to individual clients. Mr. Greenstein’s expertise is in securities investments, including derivatives and hedging transactions. Mr. Wilk, a tax lawyer, came to Quellos in May 1999 from PriceWaterhouseCoopers, where he had been in charge of their Wealth Transfer Solutions practice in the Southwest Region. He was hired by Quellos primarily to provide estate planning services for wealthy clients. Mr. Scheinfeld is a former KPMG employee who heads up Quellos’ New York office. Mr. Hanson and Mr. Hirata provided administrative and accounting assistance and worked out much of the transactional details and documentation for the strategy planned by Mr. Greenstein and Mr. Wilk as applied to the needs of individual clients.

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<sup>166</sup> Quellos website, [www.quellos.com/Section.aspx?Link=About](http://www.quellos.com/Section.aspx?Link=About) (viewed 7/13/06).

<sup>167</sup> Id. at [www.quellos.com/Section.aspx?Link=InvestmentManagement](http://www.quellos.com/Section.aspx?Link=InvestmentManagement) (viewed 7/13/06).

<sup>168</sup> Id. at [www.quellos.com/ContactUs.aspx](http://www.quellos.com/ContactUs.aspx) (viewed 7/13/06).

<sup>169</sup> See Report of the Permanent Subcommittee on Investigations, “The Role of Professional Firms in the U.S. Tax Shelter Industry,” S. Rept No. 109-54, 4/13/05, p.11.

<sup>170</sup> The \$300 million estimate is based on applying the 15 percent capital gain tax rate to the total amount of loss generated by the POINT transactions.

The idea behind POINT was to combine two products already in wide use into a new strategy that would be proprietary to Quellos. One was a product, already marketed by Quellos, in which a taxpayer would acquire a partnership that held stock with a large unrealized capital loss and use that loss to offset other gains of the taxpayer. Mr. Greenstein said he had heard the transaction referred to as a “mixing bowl” because the partnership is used to mix loss assets with existing gain assets to wipe out the gain.<sup>171</sup> These plans are also often referred to as “loss importation” strategies, because they involve identifying loss assets, “importing” them into partnership structures, where they can be mixed with the client’s gain assets to cancel out the gains. There have been many variations of this shelter promoted over the years, and the principal weakness in all of them is the absence of a non-tax business reason for the transaction. The Internal Revenue Service has consistently challenged various forms of this transaction based essentially on the same issue: the lack of a profit motive to support the claimed tax losses.<sup>172</sup> As Mr. Greenstein told Subcommittee staff, the question about this transaction is “why would anyone buy these?”<sup>173</sup>

In June 1999, Quellos was promoting such a strategy, called “Gain Deferral Trade.”<sup>174</sup> This product involved a three-step transaction designed to completely offset the client’s anticipated gain on the sale of securities (or other property).<sup>175</sup> Quellos issued a memorandum

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<sup>171</sup> Subcommittee interview of Mr. Greenstein (6/28/06).

<sup>172</sup> See, e.g., IRS National Office Field Service Advice Memorandum on Basis Shift (302/318 Loss Importation)(FSA 200202057), 2001 FSA LEXIS 197 (10/11/01).

<sup>173</sup> Subcommittee interview of Mr. Greenstein (6/28/06).

<sup>174</sup> 6/21/99 Memorandum entitled “Quadra Custom Strategies, LLC, Gain Deferral Trade” (PSI-QUEL27244-48).

<sup>175</sup> The steps, as described in a Quellos memorandum, were as follows:

Step One – Quellos and a third party investment fund with loss stock would create a Limited Liability Company (LLC) taxable as a partnership and the fund would contribute stock with the amount of loss needed by the Quellos client to the LLC in exchange for a 99 percent share in the LLC. Because the stock was contributed, rather than sold to the LLC, the LLC’s tax basis in the stock would be the same high basis that the hedge fund had (the amount originally paid for the stock before it declined in value).

Step Two – The Quellos client would buy the investment fund’s interest in the LLC with borrowed money equal to the current value of the stock, and for an additional fee the fund would give the LLC a two month “put” or right to sell the loss stock back to the fund at that day’s price. The client would also contribute his gain stock to the LLC. At the end of step two, the client would hold a 99 percent interest in an LLC holding both the gain and loss stock, and his basis in the LLC would be his original basis in the gain stock contributed, plus the amount of cash paid to the hedge fund. (The LLC would still have the high basis in the stock it owned carried over from its original owner.)

Step Three – All of the stock would be sold, and the losses and gains would cancel each other out, so that no tax would be due on the sale. (The Quellos memorandum does not state who the stock

describing this strategy as “designed to allow an investor to liquidate low basis stock [gain stock] on a tax deferred basis.” Nowhere in the memorandum is there any mention of any aspect of the transaction that would make a profit for the Quellos customer on the transaction itself.<sup>176</sup>

The second product was a sophisticated securities derivative product being sold to investors in Europe by large financial institutions like UBS, which had a version of this product called BLOC. Jeffrey Greenstein and Chuck Wilk of Quellos learned about BLOC in the summer of 1999, when they traveled to London to meet with representatives of UBS to discuss their investment relationship.<sup>177</sup> One part of the BLOC product involved the issuance of long dated warrants<sup>178</sup> backed by U.S. securities. The warrants were sold to investors for a premium, and the funds from the warrant premium were then used to hedge against a decline in the price of the stock or to generate interest income. UBS would also package the securities that backed the warrant with the premium investments and sell shares of the package to other investors, generating additional income. By breaking the ownership of the package into smaller shares for resale, UBS would generate a further premium for itself.<sup>179</sup>

Quellos decided to combine the concept of the tax loss partnership from the first product with the long dated warrant from the BLOC transaction to form a new product called POINT. By including the warrant feature, POINT would have an apparent source of income that could supply a profit objective that was missing from products like the “Gain Deferral Trade.” The plan was to create a portfolio of stocks that were expected to decline in value, wait until the market moved down, and select particular loss stocks from the portfolio to place in partnerships that could be sold to taxpayers who wanted to use the losses to offset against their gain on other assets to reduce their taxes. Each partnership would sell a long dated warrant on its loss stock in

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would be sold to, but the existence of the put suggests that the stock could be sold back to the hedge fund at the original price unless the market price went up before the time of sale. (PSI-QUEL27246)) The client would have enough basis in his interest in the LLC to make a tax free withdrawal of enough cash to pay off the bank loan needed to buy the LLC interest, and he could continue to invest the sales proceeds tax free for as long as the investments were made through the LLC. (PSI-QUEL27244-48).

<sup>176</sup> Id.

<sup>177</sup> Subcommittee interview of Mr. Wilk (6/26/06).

<sup>178</sup> A warrant is a certificate entitling the holder to buy, at a future date, a specific amount of securities at a specific price, usually above the current market price at the time of issuance. A warrant is like a call option, but with a much longer time span – anywhere from a few years to forever. A long dated warrant is one with a longer, rather than shorter exercise term. In the case that the price of the security rises to above that of the warrant's exercise price, then the investor can buy the security at the warrant's exercise price and resell it for a profit. Otherwise, the warrant will simply expire or remain unused. Warrants are listed on options exchanges and trade independently of the security with which they were issued.

<sup>179</sup> Subcommittee interview of Mr. Wilk (6/26/06); Brochure, UBS BLOC, Higher returns when markets are moving sideways, June 2005; Memorandum on Point Strategy (PSI-QUEL22599-600); 8/11/99 email from Mr. Wilk to Mr. Greenstein and attached Memorandum on Point Strategy (PSI-QUEL22589-91).

exchange for a fee called a “premium.” The warrant was portrayed as providing an attractive opportunity to make a profit (which would support the tax aspects of the transaction).<sup>180</sup> Because it generated this premium income, the warrant was a critical element in promoting the appearance that the POINT strategy had a profit-making objective. However, as will be discussed in detail below, the Quellos documents establish that there was never any real intent to earn a profit from the warrants, because the plan was to recall the warrants and forfeit the premium as soon as they were issued.<sup>181</sup>

Because of the importance of the tax attributes to the transaction, Quellos sought the assistance of prominent tax counsel to help design the structure, as well as to issue tax opinions to potential investors. According to Chuck Wilk, the POINT design team consisted primarily of himself and Jeffrey Greenstein from Quellos; Lewis Steinberg and Aktssa Wolpin from the law firm Cravath, Swaine & Moore; and Chris Donegan, John Staddon, and Rajab Puri from UBS.<sup>182</sup>

Email records provided to the Subcommittee by Quellos confirm that obtaining a favorable tax opinion from prominent tax counsel was critical to going forward with the POINT transactions. Quellos was looking for a firm that would take an aggressive approach in support of the POINT strategy. In an email to Mr. Greenstein and Mr. Wilk dated July 19, 1999, Mr. Scheinfeld expressed his frustration at the delay in lining up tax counsel:

“I hope we are making the right decision by waiting for Cravath/Skadden [Cravath, Swaine & Moore LLP and Skadden, Arps, Slate, Meagher & Flom LLP]. I’m having second thoughts on waiting. I believe we should make a decision on either Mike or KPMG and move forward with them. Start to finish is still a long process for either of these firms, regardless of whether we have an opinion or not. I feel like we have lost the momentum of our June meeting with KPMG. We cannot compete with them as far as finding clients. It seems to me that all the Big 5 firms are selling all kinds of strategies.”<sup>183</sup>

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<sup>180</sup> See, e.g., summary of transaction provided to Mr. Johnson (PSI-RWJ000271-72); 8/5/99 email from Mr. Greenstein to Mr. Wilk (“attached are some initial thoughts.”) and attached draft outline (“The premium received from selling the option/warrant is used to pay the owner an attractive yield substantially above comparable securities.”)(PSI-QUEL22581-82).

<sup>181</sup> See, e.g., 8/5/99 email from Mr. Greenstein to Mr. Wilk and attached outline (PSI-QUEL22581-82)(stating that the first step after closing on the transaction is “Taxpayer liquidates asset(s) and redeems warrants (under the call option)”); 8/11/99 email from Mr. Wilk to Mr. Greenstein and attached draft outline (PSI-QUEL22589-91)(describing the plan for a POINT transaction: “Subsequent to the closing on the ownership units, [Quellos] evaluates the economic benefit of leaving the covered warrants out in the market and decides to exercise the imbedded call option and redeem the warrants.”).

<sup>182</sup> Subcommittee interview of Mr. Wilk (6/26/06).

<sup>183</sup> 7/19/99 email from Mr. Scheinfeld to Mr. Greenstein (PSI-QUEL22597).

Two weeks later, Mr. Greenstein sent Mr. Wilk an email suggesting that the considerations in hiring a firm were not only who had the best credentials, but who would be most “aggressive”:

“Had drinks last night with friends from Mayer Brown & Platt/ Akin Gump, Strauss & Howard/ Millbank, Tweed, Hadley & McCoy/ Battle Fowler. Battle Fowler does a lot of real estate and some very aggressive basis savings transactions. My friend thinks they would have clients with high basis low FMV [fair market value] assets (the bad assets) and clients who would like our trade because they have low basis high FMV real estate. He also thinks they would be willing to opine. My friend also told me that Shearman and Sterling had been very aggressive on 704(c)<sup>184</sup> transactions prior to the re-write of that section and would probably still retain an aggressive stance.

“Spoke with Chris . . . about Mayer Brown & Pratt. He will check but believes UBS would take their opinion and told me that there had been an occasion when MBP opined for the Bank when Cravath would not.”<sup>185</sup>

During the Fall of 1999, Quellos was working with Andy Kenoe of Skadden Arps Slate Meagher & Flom (Skadden Arps) on preliminary planning for the POINT transaction, and was negotiating with Skadden Arps over the provision of an opinion on at least the BLOC (warrant) portion of the structure. Chuck Wilk emailed Chris Donegan at UBS regarding the need to get BLOC materials to Skadden Arps:

“Andy left me a voicemail stating that it was not that they had any substantive issues but merely that he was having a hard time coordinating the schedules of the ‘opinion’ committee members. . . . He did state that they would prefer being retained by the client and delivering the opinion to the client.

[Redacted by Quellos.]

“POINT – the reason Jeff is hesitant to assist in locating the ‘loss’ assets is because Skadden told us to limit if not eliminate our involvement in the original formation of the BLOC piece and to become involved at the point in time that we introduce the U.S. investor to the trade. This is merely an ‘optics’ issue and not a substantive tax issue. I believe that it would be o.k. for us to introduce UBS to a hedge fund that we knew had assets (‘loss’ assets) and at that point UBS and the fund without further [Quellos] involvement could form the BLOC piece.”<sup>186</sup>

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<sup>184</sup> An Internal Revenue Code provision relating to the allocation of gain and loss on partnership property. 26 U.S.C. § 704(c).

<sup>185</sup> 8/4/99 email from Mr. Greenstein to Mr. Wilk (PSI-QUEL22583).

<sup>186</sup> 9/23/99 email from Mr. Wilk to Mr. Donegan (PSI-QUEL22586-87).

As late as September 29, 1999, Quellos was still dealing with Skadden Arps, but UBS was expressing concerns that the “optics” the one partner was “playing around” with should not be permitted to make the trade “too cumbersome to execute.”<sup>187</sup>

By December, Quellos was working with Cravath, Swaine & Moore (Cravath) on drafting an opinion.<sup>188</sup> On December 17, 1999, Quellos informed a prospective POINT investor that it was nearing completion of a draft opinion:

“I had a meeting this week with Lew Steinberg of Cravath Swaine & Moore to finalize the draft of the opinion and to review the economics of the trade. All is moving forward and Lew is attempting to have a draft opinion for our review in the next two weeks (holidays permitting). Jeff Greenstein is reviewing the current economic model and after receiving his comments we should be able to deliver, after the holidays, an economic model. We believe that after reviewing the merits of this trade you will conclude, as we have, that this trade both economically and structurally [sic] (thanks to Cravath's input) is more robust than the other trades in the marketplace.”<sup>189</sup>

Thereafter, Quellos consulted with Mr. Steinberg of Cravath on the design of the first three transactions and the crafting of legal opinions for three potential clients.

In early 2000, John Staddon, Chris Donegan, and Rajan Puri moved from UBS to European American Investment Group (Euram). Euram is a financial services provider with offices in six cities, including New York, London, and Vienna.<sup>190</sup> It was founded in 1999 by professionals from UBS, Deutsche Bank, and McKinsey.<sup>191</sup> Euram employs 90 full-time staff working in areas including securities brokerage, investment advising, and wealth management.<sup>192</sup> Mr. Staddon became the Global Head of Structured Products for Euram subsidiary Euram Advisors in London, and Mr. Puri became the Managing Director and Chief Financial Officer of the Structured Products Group.<sup>193</sup>

Quellos continued to develop the POINT Strategy in concert with Mr. Staddon, Mr. Donegan, and Mr. Puri after their move to Euram.

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<sup>187</sup> 9/29/99 email from Mr. Wilk to Mr. Donegan (PSI-QUEL22585).

<sup>188</sup> 12/1/99 email from Mr. Wilk to Mr. Greenstein (PSI-QUEL11572).

<sup>189</sup> 12/17/99 email from Mr. Wilk (PSI-QUEL13317).

<sup>190</sup> Euram website, at [www.eurambank.com/simple.asp?id=98](http://www.eurambank.com/simple.asp?id=98) (viewed 6/20/06).

<sup>191</sup> Id.

<sup>192</sup> Id.

<sup>193</sup> Id.

## **Basic Structure of the POINT Transaction**

The structure of the POINT transaction designed by Quellos with the assistance of Cravath and Euram basically followed the pattern of the “Gain Deferral Trade” described above, with a long dated call warrant added on to provide an apparent profit objective that was required to support the transaction for tax purposes. However, the evidence developed by the Subcommittee shows that the profit objective was not real because the parties never intended to actually sell the warrant into the marketplace.

Each transaction was expected to take place in a series of steps, many of which would occur simultaneously. A key player was a shell corporation established in the Isle of Man, called Barnville, which participated in all six POINT transactions. Another key player was Jackstones, a second Isle of Man corporation that, like Barnville, appears to have had no employees and virtually no assets of its own. Both companies are administered by Isle of Man offshore service providers, Triskelion Trust Company in the case of Barnville and Trident Trust Company (later Sanne Corporate Services) for Jackstones, which accepted directions from Euram on corporate actions. The plan was for Barnville to acquire a large portfolio of loss stock and contribute a portion of the stock to a “Trading Company” in exchange for about 99 percent of the ownership of the Trading Company.<sup>194</sup> The remaining one percent of the Trading Company would be owned by another Euram entity, so that the Trading Company could be considered a “partnership” for U.S. tax purposes. Because the transfer of the portfolio to the Trading Company was a non-taxable contribution to capital, rather than a taxable sale, the Trading Company would take the portfolio at the same high tax basis Barnville had in the shares, under 26 U.S.C. §§ 721(a) and 723.

An “Acquisition Company” formed by or on behalf of the Quellos client would purchase Barnville’s share of the Trading Company for cash equal to the present, low value of the loss stock portfolio, and the one percent share of the Euram entity would be bought by another client entity or perhaps Quellos. In the mean time, the stock portfolio would supposedly be used by the Trading Company to support the issuance of a long dated warrant for a premium that would be reinvested as the principal source of economic profit on the transaction. (Appreciation of the portfolio after the purchase would be another potential source of profit, but a hedging transaction called a collar was planned to limit the potential for loss if the stock declined in value, and the collar would also limit the amount the client could profit if the stock rose.)

The investor would at some point contribute the previously owned stock with a capital gain (gain stock) to the Acquisition Company, which would in turn contribute it to the Trading Company. Once the gain and loss stock were both in the Trading Company, the stock could be sold, and the loss on the stock acquired from Barnville would offset the gain on the investor’s

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<sup>194</sup> Because Barnville had “loaned” all shares in the “portfolio” to another Isle of Man entity, Jackstones, for “cash collateral” as will be discussed in detail below, all Barnville could actually contribute to the Trading Company was the right to call in the loaned shares, subject to Jackstone’s right to a return of its “cash collateral.” These rights had to be readjusted or “unwound” in various ways as variations of the transaction played out.

stock. As long as the stock proceeds were kept in the Trading Company, the theory was that the investor could avoid indefinitely all taxes on the profits on his original stock.

### **Creation of the Barnville Portfolio**

In order for the POINT transaction to work, Quellos had to have access to a large quantity of loss stock. Quellos told HSBC Bank, which financed some of the trades, that the loss stock was being acquired with the assistance of Euram from European investors who were holding stock that had declined in value but who could not use the losses:

“Among other business lines, EURAM Advisors, using among other vehicles Barnville and Jackstones, creates and arranges transactions with institutional and high net worth clients. Some existing clients cannot use loss for tax deductions. They warehouse these losses until a buyer is located who can take advantage of the situation. In this way, the clients can recoup some of the losses.”<sup>195</sup>

Contrary to what Quellos told HSBC, the loss stock was not being acquired from European investors. Jeffrey Greenstein was selecting “high flying tech stocks” that he believed were overvalued and likely to decline in value and then passing those selections to Euram.<sup>196</sup> Euram’s job was to create a paper portfolio of securities from which smaller subsets or “baskets” of securities that had gone down in value could be later selected for sale to U.S. investors who needed the tax losses. Since the goal was to create losses, and since the portfolio only existed on paper, the more the stock went down, the better for Quellos and Euram.

The paper portfolio was “created” by having two Isle of Man companies with no apparent assets exchange contracts with each other. Under these contracts, Jackstones, which owned no stock, would “sell” stock to Barnville in exchange for cash that Barnville did not have, and Barnville would “loan” the stock, which it had not received, back to Jackstones in exchange for the payment of cash collateral, which Jackstones did not have. Because these transactions were undertaken simultaneously, the two obligations to pay each other equal amounts of cash and stock would be offset. No stock ever changed hands, and no money ever changed hands. The entire transaction was a fiction.

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<sup>195</sup> HSBC summary of Quellos transaction (HUI0000885-87, at 886); Subcommittee deposition of Mary Pan (7/25/06) at p. 69.

<sup>196</sup> Subcommittee interview of Mr. Greenstein (6/28/06).

In explaining the POINT transaction to investors,<sup>197</sup> to the lawyers writing the tax opinions,<sup>198</sup> and to HSBC,<sup>199</sup> Quellos represented that Barnville was contributing a portfolio of stock to each of the entities that would be acquired by the POINT investors. In fact, Barnville had no actual stock to contribute to the entities. Mr. Wilk of Quellos told the Subcommittee that what Barnville owned was a “right” to stock that it had acquired from Jackstones.<sup>200</sup> The stock “rights” were created in five batches, or “tranches,” in the following amounts on the dates indicated:

<u>Date</u>	<u>Shares</u>	<u>Purchase Price</u>
December 28, 1999	4,307,312	\$ 397,201,727 <sup>201</sup>
January 3, 2000	15,892,025	1,648,791,354 <sup>202</sup>
January 10, 2000	10,141,037	1,160,339,562 <sup>203</sup>
February 28, 2000	32,195,692	3,399,999,848 <sup>204</sup>
June 6, 2000	<u>39,143,000</u>	<u>3,000,154,375</u> <sup>205</sup>
Total	101,679,066	\$ <u>9,606,486,866</u>

For each “tranch” the parties documented the following series of transactions, all of which occurred simultaneously:

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<sup>197</sup> See, e.g., Confidential Memorandum “Point Strategy” presented to Haim Saban (PSI-QUEL26512-14).

<sup>198</sup> Subcommittee interview of Mr. Steinberg (7/26/06); Subcommittee interview of Mr. Barrie of Bryan Cave (7/28/06).

<sup>199</sup> 11/16/00 HSBC Loan Approval Memorandum (HUI0001876-84) (“Barnville is an investment holding company of US marketable securities with a substantial loss. . . . Under a stock lending arrangement, Barnville has loaned to Jackstones Ltd. (Another Isle of Man co) a stock portfolio.”).

<sup>200</sup> Subcommittee interviews of Chuck Wilk (6/26/06 and 6/28/06). Mr. Wilk stated on 6/26/06 that what Barnville acquired from Jackstones was a promise to deliver stock, rather than the stock itself. He also characterized what Barnville purchased from Jackstones as the “right to economic performance of the stock.” However, he qualified that statement on 6/28/06 by saying that, while he believed that Barnville owned no actual stock, he did not know that for a fact.

<sup>201</sup> 12/28/99 Purchase Agreement (PSI-QUEL26591-94).

<sup>202</sup> 1/3/00 Purchase Agreement (PSI-QUEL26595-96).

<sup>203</sup> 1/10/00 Purchase Agreement (PSI-QUEL26597-99).

<sup>204</sup> 2/28/00 Purchase Agreement (PSI-QUEL26600-03).

<sup>205</sup> 6/6/00 Purchase Agreement (PSI-QUEL26604-07).

1. Jackstones agreed to sell Barnville specified shares of stock for cash. For example, the December 28 agreement stated: “On the Trade Date [December 28, 1999] the Vendor [Jackstones] shall sell as beneficial owner free from all liens, charges, encumbrances and any other security or quasi security interests ... and the Purchaser [Barnville] shall purchase the Purchase Shares.” The consideration for the sale “shall be USD 397,201,727 ... and shall be payable by [Barnville] to [Jackstones] on the Settlement Date [January 3, 2000].” The agreement further provided that “On the Settlement Date, [Jackstones] shall deliver to [Barnville], or procure delivery to [Barnville] of, all instruments of transfer in respect of the Purchase Shares together with all certificates and any other document which may reasonably be required to give full legal title and beneficial title to the Purchase Shares ... or which may be necessary to enable [Barnville] to procure the registration of the same in the name of [Barnville] or its nominee.”<sup>206</sup>
2. Barnville loaned the shares of stock back to Jackstones in exchange for “cash collateral” in the precise amount of the purchase price, to secure return of the shares when called for by Barnville. These loans were made pursuant to a master Securities Lending Agreement executed by Barnville and Jackstones on December 28, 1999, together with a series of “Confirmation” documents on the day of each purchase setting forth the details of the stocks and the amounts of the “cash collateral.”<sup>207</sup>
3. Because Barnville was simultaneously lending back to Jackstones all the shares it was purchasing on each settlement date, no shares ever changed hands between them.
4. Because each purchase agreement permitted Barnville to “set off against the Purchase Price any sum payable by [Jackstones] to [Barnville] on the Settlement Date,”<sup>208</sup> and because Jackstones owed Barnville “cash collateral” in the exact amount of the purchase price, the two amounts were “set off” and no money changed hands.

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<sup>206</sup> 12/28/99 Purchase Agreement (PSI-QUEL26591-94).

<sup>207</sup> 12/28/99 Securities Lending Agreement (PSI-QUEL26608-17); 12/28/99 Confirmation (PSI-QUEL26618-20); 1/3/00 Confirmation (PSI-QUEL26621-23); 1/10/00 Confirmation (PSI-QUEL26624-26); 2/28/00 Confirmation (PSI-QUEL26627-30); 6/6/00 Confirmation (PSI-QUEL26631-33).

<sup>208</sup> See, e.g., 12/28/99 Purchase Agreement, para. 4 (PSI-QUEL26592).

The five portfolio trades can be illustrated collectively in the following chart:

JACKSTONES	101,679,066 shares (purchase)	BARNVILLE
	101,679,066 shares (loan)	
	\$9,606,486,866 (cash collateral)	

\$9,606,486,866 (purchase price)

Thus, at the end of each “Settlement Date,” Barnville and Jackstones were exactly where they started, except that Jackstones was contractually obligated to return the “borrowed” shares to Barnville, and Barnville was obligated to return the “cash collateral” in the amount of the purchase price to Jackstones if and when the shares were “returned.”

In an email dated July 15, 2006, Euram Structured Products Group Head John Staddon provided written answers to questions posed by the Subcommittee that confirm the phantom nature of these transactions. Mr. Staddon stated:

“It was always the case that the portfolio of securities traded by and between Barnville and Jackstones was of a purely contractual book-entry nature. This was understood by all concerned given the dollar values of the portfolios in question. The sale and purchase of the securities were accomplished through contractual commitments (the Purchase Agreements and related confirmations) which gave rise to legal obligations which were recorded in the entities’ respective books and records. The settlement of these sale and purchase obligations (of delivery on the part of Jackstones and of payment of the purchase price by Barnville) were settled by a process of netting with equal and opposite obligations under stock lending transactions (the Securities Lending Agreements) entered into between them at the same time. Though the transactions occurred off-market, all prices for the constituent shares were determined by reference to market-published prices. ...

“Put another way, Jackstones sold short the underlying securities to Barnville, which it ‘covered’ through borrowing those same securities back from Barnville under the stock loan. From Barnville’s perspective, it was long the stock, but subject to the stock loan with Jackstones. Its purchase of those shares from Jackstones was funded by the cash collateral that Barnville was due to receive from Jackstones under this stock loan. For Jackstones, this creates a short position which renders it liable to re-deliver the stock upon any recall by Barnville or its assignee.

“Because the transactions were conducted in this manner ..., no physical transfer of shares were made. No transactions took place over any exchange and no cash transfers passed between bank accounts of the two companies. ...

“As just described, the stock loan transactions between Jackstones (as borrower) and Barnville (as lender) represents the flip side of the structure to the sale and purchase transactions. The same conclusions can be derived regarding the nature of the shares that were the subject of those loan transactions. ...”<sup>209</sup>

According to Mr. Staddon, the fact that the transactions creating the Barnville “portfolio” existed only on paper was well known to Quellos and its counsel:

“This however was always understood to be the case; Euram obtained assurances from Quellos that the book-entry nature of these transactions had been known by the counsel with whom they developed the strategy and that it would be disclosed to any client advisor and opinion provider involved in any subsequent implementation. However, Euram acted on directions of Quellos, including the content and timing of all trading activity and the subsequent transactional steps involving Quellos clients.”<sup>210</sup>

During the planning phase of one of the first POINT transactions, Mr. Staddon sent an email to Chuck Wilk, cautioning him to be sure the client understood what was going on with the Isle of Man part of the transaction: “I know that Chris [Donegan] has already discussed with Jeff [Greenstein] the matter of us needing ... an assurance that the client is fully apprised of the nature of the share trading between the two Isle of Man companies.”<sup>211</sup> Mr. Staddon told the Subcommittee that he was referring (in this and other conversations with Mr. Wilk on the subject) to the book entry nature of the trades. He told the Subcommittee: “we [Euram] were not prepared to accept the risk that the portfolio was described in any other way, or not at all, and which might suggest that the shares were traded on public exchanges.”<sup>212</sup> Mr. Wilk responded to Mr. Staddon: “Client ready to proceed on or about 4/15. Lew Steinberg [of Cravath] does not address the share exchange in his opinion because according to him the client should not know how the shares were contributed to the SPV.”<sup>213</sup> The client is introduced to the ‘product’ (i.e. the

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<sup>209</sup> 7/15/06 email from Mr. Staddon to the Subcommittee.

<sup>210</sup> Id.

<sup>211</sup> 4/4/00 email from Mr. Staddon to Chuck Wilk (PSI-QUEL22475-76, at 76).

<sup>212</sup> 7/24/06 email from Mr. Staddon to the Subcommittee.

<sup>213</sup> Mr. Steinberg told the Subcommittee that he did not remember any conversation such as that described by Mr. Wilk in his email to Mr. Staddon. He added that he would not advise one client (such as Quellos) not to reveal a material fact to another client (such as a POINT investor). He also said it was his understanding, as set forth in his legal opinion, that what the investment partnership acquired was actual shares of stock acquired from a hedge fund that had ownership of shares that had gone down in value while it held them, and that he had no idea what Mr. Wilk and Mr. Staddon were referring to in their email exchange about the “nature of the share trading between the two IoM companies.” Subcommittee interview with Mr. Steinberg (6/26/06).

HYPO structure) and purchases it as a high yield investment.”<sup>214</sup> This response did not satisfy Mr. Staddon, who replied:

“I obviously understand Lew’s approach, but there is a commercial risk that both you and I know only too well and that is that the client turns around under a certain scenario and claims to have been misled as to the nature of the share trading between the two IoM companies. Speaking for Euram, we either need to know that the client and its advisors are aware of how the share trades are entered into or, if this is not possible, then we need to understand how it is that there will be no possible come back from the client at a later stage if everything does not go to plan.”<sup>215</sup>

The Quellos emails do not contain a record of how this issue was resolved, nor do Euram’s records, but Mr. Staddon told the Subcommittee in a written statement that he was “certain that Euram would not have provided its services without having obtained assurances that the appropriate disclosures would be made, and for our part we proceeded on that basis.”<sup>216</sup>

The two POINT investors interviewed by the Subcommittee each stated that he had not been informed of the nature of the securities trades between Barnville and Jackstones or the fact that all of the rights and obligations in those transactions were completely offsetting.<sup>217</sup>

### **Relation of Barnville to Jackstones and Significance of Situs in Secrecy Jurisdiction**

Because the original purchases by Barnville from Jackstones of the securities in the portfolio from which the investors’ “baskets” were selected is the foundation of the entire POINT strategy, understanding the facts about those purchases and the degree to which they were arm’s length is critical to determining the allowability of the claimed tax losses. However, the true relationships among Barnville, Jackstones, and Euram (as well as other offshore entities discussed below) and the facts about those entities’ finances are secret under Isle of Man law and custom, and the trust companies and corporate administrators who created and administered

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<sup>214</sup> 4/4/00 email from Mr. Wilk to Mr. Staddon (PSI-QUEL22476).

<sup>215</sup> 4/4/00 email from Mr. Staddon to Mr. Wilk (PSI-QUEL22475).

<sup>216</sup> 7/19/06 letter from Subcommittee Minority Counsel to Mr. Staddon, with attachments and email reply dated 7/24/06. This resolution is also implied in an 4/28/00 email from Mr. Staddon to Mr. Wilk (PSI-QUEL10704) (“Finally, I know that we discussed this for Woody and his trades, but I also need confirmation from you that [client name redacted by Subcommittee] and/or his advisors is aware of the book entry features of the structure.”).

<sup>217</sup> Subcommittee interview of Mr. Johnson (7/20/06); Subcommittee interview of Mr. Saban (7/19/06).

those companies in the Isle of Man declined to provide any information to the Subcommittee about this and other similar matters.<sup>218</sup>

The Isle of Man Financial Supervision Commission did provide the Subcommittee with copies of public records pertaining to Barnville and Jackstones, but the records do not reveal those entities' beneficial ownership. Under Isle of Man law, companies chartered there are required to file annual reports listing the names of the owners of all company stock, the amount of capital invested in the company, the directors of the company, and, since about 1989, the company's principal trade or business. These returns are available for public inspection, and the Financial Supervision Commission provided copies of all returns filed on behalf of several entities requested by the Subcommittee.

The records show that Barnville was incorporated February 11, 1998, with one share of stock each subscribed to by Paul Moore on behalf of Claycroft Limited and Paul Moore on behalf of Dalecroft Limited.<sup>219</sup> Annual returns were filed on behalf of Barnville by Triskelion Trust Company Ltd. for every year since its incorporation until it was dissolved in August 2004. These returns show that Barnville's stock ownership remained the same, that its directors were always Paul Moore, Ann Nicholson, and Pamela Ann Young (all of the Isle of Man), that its principal business was "investments," and that its authorized capital was 2,000 British pounds of which 2 pounds had been paid in.<sup>220</sup>

Claycroft Limited and Dalecroft Limited are Isle of Man companies whose sole function appears to be to hold the shares of other companies and corporations as nominees for the true owners. Both were incorporated on August 14, 1981, by a firm of Chartered Accountants, Snelling Tucker Moore & Co.<sup>221</sup> The initial subscribers of the company stock were Neville Cooper Billington and Richard Lawford Duncan Tucker at one share each.<sup>222</sup> The subscribers immediately appointed members of Snelling Tucker Moore as directors.<sup>223</sup> By 1983, the two shares of each company had been transferred to David Henry Snelling, who owned one share of each company, and to Claycroft and Dalecroft, each of whom owned one share of the other's

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<sup>218</sup> 6/9/06 letter request by the Subcommittee to Standard Bank Investment Corporation (Isle of Man) Limited (owner of Triskelion Trust Company Limited) and 6/14/06 reply. The Subcommittee did not request information from Trident Trust in connection with this transaction, because Trident had recently declined to provide information on the Wyly related Isle of Man entities, as discussed below.

<sup>219</sup> Memorandum of Association of Barnville Limited.

<sup>220</sup> See, e.g., 2/12/01 Annual Return of a Company having a Share Capital of Barnville Limited.

<sup>221</sup> 8/14/81 Declaration of Compliance with Requirements of the Companies Act – Dalecroft Limited; 8/14/81 Declaration of Compliance with Requirements of the Companies Act – Claycroft Limited.

<sup>222</sup> Memorandum of Association of Dalecroft Limited; Memorandum of Association of Claycroft Limited.

<sup>223</sup> Subscribers' Resolution Appointing the First Directors of Dalecroft Limited; Subscribers' Resolution Appointing the First Directors of Claycroft Limited.

stock.<sup>224</sup> The annual returns were filed by a succession of entities<sup>225</sup> including Triskelion Trust Co. from 1999 through 2006.<sup>226</sup> In 1998, Mr. Snelling transferred his share of each company to Paul Moore, but Claycroft and Dalecroft continued to own one share of each other's stock.<sup>227</sup> This ownership continues to date. All returns for both companies show total authorized capital of 2,000 British pounds and two shares issued, with 2 British pounds of capital contributed. All returns of both companies since 1989 show the principal trade or business as "nominee."<sup>228</sup>

The Isle of Man records show that Jackstones Limited was incorporated on April 26, 1999, that its principal business was "holding company," and that the initial issue of one share of stock was subscribed to by Trident Nominees (IOM) Limited.<sup>229</sup> Annual corporate returns show that Trident Nominees was replaced as the shareholder in 2000 through Jackstones' dissolution in 2004 by Sanne Corporate Nominees Limited.<sup>230</sup> All these returns were filed by Trident Trust Company. Sanne Corporate Nominees Limited and its affiliate Sanne Corporate Services Limited appear to have some connection with Trident or its employees.<sup>231</sup>

Quellos representatives Chuck Wilk and Jeffrey Greenstein disclaimed any knowledge of Barnville's and Jackstone's ownership, other than to say that Euram must have had some relationship with those companies, because Quellos communicated with Barnville and Jackstones through Euram.<sup>232</sup> Chuck Wilk said Quellos relied on Euram, which he said told him

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<sup>224</sup> 3/4/83 Annual Return of a Company having a Share Capital – Dalecroft Limited; 3/4/83 Annual Return of a Company having a Share Capital – Claycroft Limited.

<sup>225</sup> From 1983 through 1987, the returns were filed by Snelling Moore & Co. From 1988 through 1998, they were filed by Europlan Trust Co. at the same address as Snelling Moore and Co., and from 1999 to 2006, they have been filed by Triskelion Trust Co., which used the same address as Europlan Trust had, until 2004, when Triskelion Trust was acquired by Standard Bank (IOM) and moved to their address.

<sup>226</sup> See, e.g., 1/14/00 Annual Return of a Company having a Share Capital – Dalecroft Limited; 1/14/00 Annual Return of a Company having a Share Capital – Claycroft Limited.

<sup>227</sup> 1/14/98 Annual Return of a Company having a Share Capital – Dalecroft Limited; 1/14/98 Annual Return of a Company having a Share Capital – Claycroft Limited.

<sup>228</sup> 1/14/00 Annual Return of a Company having a Share Capital – Dalecroft Limited; 1/14/00 Annual Return of a Company having a Share Capital – Claycroft Limited.

<sup>229</sup> Memorandum of Association of Jackstones Limited; 4/28/00 Annual Return of a Company having a Share Capital of Jackstones Limited.

<sup>230</sup> See, e.g., 4/28/00 Annual Return of a Company having a Share Capital of Jackstones Limited.

<sup>231</sup> The authorized signatories for Sanne Corporate Services Limited on behalf of Jackstones include David Bester, Richard Scott, and Gordon Mundy, three of the individuals from Trident Trust who served as officers of some of the Wyly related offshore corporations managed by Trident Trust.

<sup>232</sup> Subcommittee interview of Mr. Wilk (6/26/06 and 6/28/06); Subcommittee interview of Mr. Greenstein (6/28/06).

they knew the ownership of Barnville and Jackstones, in concluding that the two companies were independent of one another. Jefferey Greenstein said that Euram assured them the counterparties (Barnville and Jackstones) had the wherewithal to deliver on their mutual promises. Both insisted that Euram was a large and respectable European banking organization and that it was appropriate to rely on them for their aspects of the transaction.<sup>233</sup>

Euram Structured Products Group Head John Staddon told the Subcommittee that it was Quellos who wanted offshore entities involved in the creation of the portfolio:

“Soon after its inception in late 1999, Euram was approached by the Quellos organization to provide [execution] services for a transactional structure Quellos had developed with US counsel and which it had expected to implement with its own client base. Specifically, the structure in question (which was generically referred to by Quellos as the “Point” strategy) involved the deployment of two offshore entities which would engage in a mutual trading program relating to US publicly traded securities . . . .”

Mr. Staddon told the Subcommittee that Euram did not know who owned Barnville and Jackstones:

“Euram had no direct relationship with any of these entities. Euram was involved in seeking the services of a third party corporate administrator with suitable contacts in the Isle of Man who obtained the use of Barnville and Jackstones for the trading activity in question.<sup>234</sup> Claycroft and Dalecroft [the nominal owners of the Barnville shares] are known to us as companies that were typically used by the Isle of Man administrator (Treskillion Trust Company) as holders of subscriber shares for newly formed entities.

Euram has no and has never had any ownership interest in any of these entities. Nor did Euram control any of them. On one occasion Euram did obtain a power of attorney from the directors of Barnville and Jackstones to execute certain transaction documents on their behalf outside of Isle of Man working hours. We believe that Barnville and Jackstones were ultimately held under common beneficial ownership, although we do not have personal knowledge of the identity of the beneficial owner or owners. We likewise do not know the beneficial owners of Claycroft and Dalecroft.”<sup>235</sup>

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<sup>233</sup> Id.

<sup>234</sup> 7/24/06 email from Mr. Staddon responding to a 7/19/06 letter from the Subcommittee (clarifying that, although his dealings were with Triskelion Trust, Jackstones was actually administered by Sanne Corporate Services Limited, apparently at Triskelion’s behest).

<sup>235</sup> 7/15/06 email from John Staddon to the Subcommittee.

Although Quellos and Euram both claim to have no knowledge of who was behind Barnville and Jackstones, HSBC was told a different story when the POINT strategy was described to it in an effort to secure the bank's assistance in providing financing for three of the trades. For example, in a memorandum related to a loan committee recommendation, HSBC summarized what it understood from Quellos about Barnville and Jackstones:

“Barnville Limited and Jackstones Limited are Isle of Man companies each owned by a trusts [sic] with mutually overlapping boards. Both Barnville and Jackstones are Investment Companies organized and managed by EURAM Advisors, . . . a subsidiary of EURAM Bank AG from Vienna Austria. The Barnville and Jackstones boards are different enough so as not to be considered controlled by the same person or group of persons.”<sup>236</sup>

In an August 22, 2001 email relating to HSBC's request for ownership information in connection with its anti-money laundering due diligence, Euram's John Staddon wrote to Chuck Wilk:

“Barnville is owned jointly by Claycroft Limited and Dalecroft Limited, both Isle of Man companies. Jackstones is wholly owned by Sanne Corporate Nominees, Limited. Each of these corporate owners are nominee companies controlled and administered by two separate trustee and corporate administration operations in the IoM. I am not at all keen on revealing the ultimate beneficial owner. If there is persistence on it by HSBC, then I guess we can certify that the person in question is an existing client of Euram Bank and that we can testify for his reputation and good standing accordingly.”<sup>237</sup>

Although this email clearly suggests that one person was the beneficial owner of both Barnville and Jackstones, Mr. Staddon explained in a written statement submitted to the Subcommittee that what he was suggesting to Mr. Wilk in the above-quoted language is that:

“[I]f HSBC insisted upon knowing the identity of the ultimate beneficial owner(s) of those entities, then I would press for disclosure of their identities from the Isle of Man administrators. As a hypothetical way to resolve the question, those ultimate beneficial owners could then become clients of Euram Bank, which would undertake a ‘know your client’ review of them, from which we would then be able to provide an interbank assurance as to their reputations and net worth. This never came to pass, and so that process did not take place and the

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<sup>236</sup> Untitled memorandum pertaining to HSBC loan commitment (HUI0000885-87, at 86).

<sup>237</sup> PSI-QUEL08905.

individual(s) concerned did not become clients of Euram Bank. We did not seek to verify the ownership structure of those entities any further.”<sup>238</sup>

Chuck Wilk forwarded the Staddon email to Brian Hanson with the instructions to “keep this for our records but do NOT forward to HSBC. They approved the deal this morning without this information.”<sup>239</sup> When Barnville opened an account at HSBC in 2001, the account application, signed by Barnville director Paul Moore, indicated that the owners were Claycroft Ltd (50 %) and Dalecroft Ltd (50%). Moore also certified that the source of Barnville’s cash flow was not profits on the purchase and sale of securities, but “fees from sales transactions.” A narrative description of unusual expected account activity stated: “Barnville is an SPV set up to engage in trading/investment in technology stock. The HSBC A/C is used when stock is sold to 3<sup>rd</sup> parties. The amounts that flow through the account are large but then quickly go to zero as the revenues are used to buy stock from the market/other parties some in excess of \$100,000,000. Approx 3 transactions take place a year.”<sup>240</sup> When HSBC later updated its due diligence in 2003, its Know Your Customer form reported that “Barnville is a wholly owned subsidiary of European American Investment Bank, an Austrian Investment Bank. Barnville is used to facilitate the sale of investment assets.”<sup>241</sup>

HSBC did not have equivalent KYC information for Jackstones, which also had an account at the bank. However, the bank did receive powers of attorney giving Euram employees John Staddon and Rajan Puri authority to open and manage accounts for both companies,<sup>242</sup> and the account opening forms for both entities were forwarded together to Mr. Puri by HSBC.

From the above facts, it appears that there are several versions of Barnville/Jackstones ownership. In the final analysis, no one was able to tell the Subcommittee who was really behind Barnville and Jackstones or whether, as appears from the circumstances, they had common ownership. Quellos said they did not know who the owners were and that they relied on Euram to vouch for the Isle of Man entities. Euram said it was Quellos who wanted the paper portfolios created through two offshore entities in a “mutual trading program” and admitted arranging the Barnville/Jackstones “trades,” but insisted they did not know who owned the companies. HSBC did not require the information under their Know Your Customer due diligence practices at the time. The only people who possess this information, which is critical to determining the truth about these \$9.6 billion transactions, are the trust and corporate administrators in the Isle of Man, who are barred by law and custom from revealing it.

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<sup>238</sup> 7/24/06 letter from Mr. Staddon to the Subcommittee, responding to a Subcommittee letter dated 7/19/06.

<sup>239</sup> 8/22/01 email from Mr. Wilk to Mr. Hanson (PSI-QUEL08905).

<sup>240</sup> 12/26/03 HSBC Know Your Client form (HUI0002297-301).

<sup>241</sup> Id.

<sup>242</sup> Power of attorney and passport photo (Rajan Puri) for Barnville, Ltd. (HUI0002295, HUI0002302); powers of attorney (2) and passport photo (Rajan Puri) for Jackstones, Ltd. (HUI0002323-25).

Because Barnville and Jackstones were incorporated and administered in the Isle of Man, where strict financial secrecy is observed, it is also impossible to obtain direct evidence whether either of these companies had any assets other than the contracts with each other, or whether either company had any means of paying the other when the market inevitably moved the value of the stocks so that one gained and the other lost on the transactions. However, on the annual returns filed with the Isle of Man Financial Supervision Commission, both Barnville and Jackstones reported total authorized capital of 2,000 British pounds (of which 2 pounds were paid in for Barnville and 1 pound was paid in for Jackstones).<sup>243</sup> Each return of both Barnville and Jackstones, including the returns for the period in which Barnville and Jackstones were purportedly trading in securities to the tune of \$9.6 billion, reported a total outstanding indebtedness of “nil.”<sup>244</sup> It is doubtful, to say the least, that either had the ability to make good on obligations totaling over \$9.6 billion.

### **The POINT Transactions**

As previously noted, Quellos assisted six clients to conduct six separate transactions over the period 2000 through 2002. These transactions fell into two distinct groups that differed primarily in the degree to which they required outside cash to accomplish the trade. The first three transactions were arranged for Quellos clients Robert Wood Johnson, IV of New York, and two other individuals from New York and Texas. All of their trades were conducted and “unwound” in 2000, although the documentation was not completed until the following year. The second group of transactions involved two trades for two Quellos clients in New York and one transaction for Haim Saban of Los Angeles California. These trades were conducted and “unwound” in late 2000 and 2001, although their documentation was also not completed until 2002. Because the trades within each group were quite similar, the Subcommittee chose to focus on one transaction from each group – Mr. Johnson’s from the first group and Mr. Saban’s from the second. However, some emails pertaining to the other clients will be considered below, to the extent that they shed light on what happened to all of the transactions in the same group.

### **Reka Transaction (Robert Wood Johnson IV)**

Robert Wood Johnson IV is a member of the founding family of pharmaceutical giant Johnson & Johnson. He is chairman and CEO of The Johnson Company, Inc., and has owned the New York Jets football team since 2000. He is Executive Chairman of the Juvenile Diabetes

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<sup>243</sup> See, e.g., 2/12/01 Annual Return of a Company having a Share Capital of Barnville Limited; 4/28/00 Annual Return of a Company having a Share Capital of Jackstones Limited.

<sup>244</sup> Section 79 of the Isle of Man Companies Act 1931 defines the “registrable charges” that must be reported as indebtedness on the annual returns as including “a charge on book debts of the company.” A representative of the Isle of Man Attorney General has advised the subcommittee that Barnville’s claimed obligation to return the cash collateral to Jackstones might create such a charge, but that it would be necessary to review the documents to be sure. 7/27/06 email from Lindsey Bermingham of the Isle of Man Attorney General’s office to the Subcommittee.

Foundation and is active in numerous other charities.<sup>245</sup> He is referred to as “Woody” in some Quellos documents. He was represented in many of his dealings with Quellos by Johnson Family Chief Financial Officer Joel Latman.

Mr. Johnson told the Subcommittee that his purchase of the New York Jets in 2000 was financed in part by the proceeds of the sale of securities at a substantial capital gain. Since, in any large financial enterprise such as his, taxes are viewed as one of many expenses, he asked Larry Scheinfeld, his long term financial accountant at KPMG, to begin looking for ways he could mitigate the capital gain tax on the securities sales he was planning. This was around the time Mr. Scheinfeld left KPMG to join Quellos. After a few followup inquiries by Mr Johnson, Mr. Scheinfeld indicated he might have found an idea that would help. Mr. Johnson said he did not remember any details, but that Mr. Scheinfeld proposed a method of deferring taxation of the capital gain to future years.<sup>246</sup>

It appears from the documents reviewed by the Subcommittee that Quellos was proposing a loss importation strategy for Mr. Johnson before the POINT strategy was developed,<sup>247</sup> and he was expressing an active interest in POINT as early as October 28, 1999.<sup>248</sup> Mr. Johnson had tentatively decided to purchase the POINT strategy by December 20, 1999, when Mr. Scheinfeld emailed Mr. Wilk and Mr. Greenstein: “Joel [Latman] called, he has given us the full speed ahead (whatever that means) . . .”<sup>249</sup> Mr. Greenstein asked in response: “Are we firm on 100 or 200 [million dollars]?”<sup>250</sup> Mr. Wilk answered: “\$300MM; 150 for [redacted by Subcommittee] and 150 for Woody. Ain’t capitalism great!”<sup>251</sup> On January 11, 2000, Chuck Wilk emailed Larry Scheinfeld: “Well I guess congratulations are in order but boy do we have our work cut out for us now on POINT.” Mr. Scheinfeld replied: “Now I just hope Woody doesn’t get cold feet or have the IRS select his return for audit!”<sup>252</sup>

The fees for the transaction were pegged to the amount of the loss. For example, an internal Quellos email written at a time when the amount of loss needed by Mr. Johnson was

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<sup>245</sup> Bloomberg Profile on Robert Wood Johnson IV (PSI-QUEL06922-27).

<sup>246</sup> Subcommittee interview of Mr. Johnson (7/20/06).

<sup>247</sup> Memorandum on Quadra Custom Strategies, LLC Gain Deferral Trade “given to Woody by LBS” (PSI-QUEL10925-26).

<sup>248</sup> 10/28/99 email on “POINT” from Mr. Scheinfeld to Mr. Greenstein (PSI-QUEL10600)(“Woody called to make sure everything is moving forward.”). See also 12/22/99 email from Mr. Wilk to Mr. Scheinfeld (PSI-QUEL22601)(“Woody called today to make sure we are working on his case. I assured him we were.”).

<sup>249</sup> 12/20/99 email from Mr. Scheinfeld to Mr. Wilk (PSI-QUEL11570).

<sup>250</sup> 12/20/99 email from Mr. Greenstein to Mr. Scheinfeld and Mr. Wilk (PSI-QUEL11570).

<sup>251</sup> 12/20/99 email from Mr. Wilk to Mr. Greenstein (PSI-QUEL11570).

<sup>252</sup> 1/11/00 email from Mr. Wilk to Mr. Scheinfeld and response (PSI-QUEL10680).

thought to be \$135 million stated: “The total [present value] fee of 2.7mm is 2% of the 135mm notional amount of the trade.”<sup>253</sup> The fee was not necessarily to be paid in the form of a transaction fee, but was nevertheless known to be a fee calculated as a percentage of the loss. For example, in the Johnson case, the fee took the form of a stream of monthly payments under an “advisory agreement,” but was still seen by Quellos as a transaction fee. An October 25, 2001 email between Quellos employees Brian Hanson and Andrew Robbins referred to the “2% fee paid in form of advisory agmt w/RWJ for \$2.9 [million].”<sup>254</sup> In an interview with Subcommittee staff, Chuck Wilk pointed out that any number can be expressed as a percentage of any other number, and denied that Quellos’ fee for setting up the transaction was intended to be a percentage of the loss.<sup>255</sup> However, Brian Hanson stated that he believed Quellos’ fee was tied to the losses generated, and that he most likely learned that from Mr. Wilk.<sup>256</sup> He also said that a fee that was two percent of the loss was the target, although he was not sure if the fee ended up at precisely two percent on all the trades. He indicated that he typically would feed in a factor of two percent for Quellos’ fee whenever he would run a computer model of a POINT transaction. Jeffrey Greenstein stated that the amount of the loss generated by the transaction was the “starting point for the fee in negotiations.”<sup>257</sup> However, in an email to Chuck Wilk on planning one client’s transaction, he observed that an increased loss would result in increased fees because the fees “are based on the loss amount.”<sup>258</sup>

According to Mr. Wilk, the POINT strategy was originally designed to have the client’s purchase of the LLC from Barnville funded with cash or borrowing. However, that was changed for the first three transactions because Mr. Johnson had another business transaction pending that was using up his cash and borrowing ability. Quellos therefore arranged for the POINT transactions for Mr. Johnson and another client to be “seller financed,” or funded with Mr. Johnson’s entity’s promise to pay for the trading company with the loss stock in the future. Since Quellos had things set up that way when the third client decided to invest, Quellos used the same form for his transaction, but later followed the original plan for the next three transactions.<sup>259</sup>

Quellos presented the POINT trade to Mr. Johnson’s representatives as an opportunity to purchase a tax loss for cash, some of which might be offset by fluctuations in value of the stock

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<sup>253</sup> 4/17/00 email from Mr. Baier to Norm Bontje, Mr. Wilk, and Mr. Scheinfeld (PSI-QUEL10633).

<sup>254</sup> 10/25/01 email from Mr. Hanson to Andrew J. Robbins (PSI-QUEL25004).

<sup>255</sup> Subcommittee interview of Mr. Wilk (6/6/00).

<sup>256</sup> Subcommittee interview of Mr. Hanson (6/27/00).

<sup>257</sup> Subcommittee interview of Mr. Greenstein (6/28/00).

<sup>258</sup> 11/10/00 email from Mr. Greenstein to Mr. Scheinfeld and Mr. Robbins, cc: Mr. Wilk (PSI-QUEL25003).

<sup>259</sup> Subcommittee interview of Mr. Wilk (6/26/00).

purchased. On February 11, 2000, Jeffrey Greenstein wrote to Joel Latman at the Johnson Company:

“We approximate the upfront cash requirements to be 6-7% of the anticipated losses (\$300,000,000) plus the NPV of 1% paid over multiple years. This cash requirement is a worst case scenario. If the basket of stocks modestly appreciates (between 1-5% from the purchase price) then all or a portion of the cash requirement will be available on expiration of the six month collar. If the stocks appreciate 5% or more then the maximum cash return will generate a net profit (after fees/costs) of 3% on the entire \$300,000,000. Depending on market movements during the six month collar we may have the flexibility to liquidate the position early and recoup a good portion of the initial cash.”<sup>260</sup>

That the securities investment was viewed as a way to cover part of the fees if the stock went up is also suggested by an internal Quellos email discussing a conversation with a client’s lawyer about when to get out of the trade:

“Leslie just phoned me to talk about profitability. Amongst a few other items, he wanted to let me know that they want out as soon as they’re in the black (net of fees).”<sup>261</sup>

Quellos and the lawyers made numerous references to the “optics” of the transactions and the need to document their “economics.” Internally, Quellos referred to the transaction as a “tax trade,”<sup>262</sup> but for documents going to third parties, an attempt was always made to emphasize the non-tax aspects of the trade. For example, in an email on April 4, 2000, Chuck Wilk wrote Chris Hirata: “The first transaction is scheduled to close 4/15. . . . We need to put a ‘one pager’ together describing the trade in both economic and tax terms (but a little fuzzy on the tax piece).”<sup>263</sup>

Internal Quellos memoranda show that, although the warrants were held out as providing the potential profit and the non-tax business purpose of the structure, Quellos never intended that the warrants would actually be sold into the market. Rather, Quellos intended that the warrants would be redeemed, giving back the premiums that were supposed to be the source of the economic profit. A draft outline of the POINT trade dated August 5, 1999 explained three different reasons why the warrant was critical to the tax purpose of the scheme. First, the Trading Partnership (which had to hold the loss stock in order to give the tax loss to the U.S.

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<sup>260</sup> 2/11/00 fax from Mr. Greenstein to Joel Latman (PSI-QUEL10920).

<sup>261</sup> 11/19/01 email from Mr. Hanson to Mr. Robbins and Mr. Wilk (PSI-QUEL25005).

<sup>262</sup> See, e.g., 4/11/00 email from Mr. Scheinfeld to Bart Anderson and John Baier (PSI-QUEL10631) (“Woody will be using the money in his account to do his tax trade.”).

<sup>263</sup> 4/4/00 email from Mr. Wilk to Mr. Hirata (PSI-QUEL22490).

taxpayer), could be justified as being necessary for a non-tax purpose of making the warrant more marketable.<sup>264</sup> Second, the outline explained that the warrant would also help the structure look like a normal European financial product: “the equity ownership of the SPV now has a payoff pattern that resembles securities regularly issued by European investment banks and commonly referred to as BLOCS or HYPOS.”<sup>265</sup> Third, the outline made clear that the source of the purported economic profit on the transaction was going to be the warrant premium: “The premium received from selling the option/warrant is used to pay the owner an attractive yield substantially above comparable securities.”<sup>266</sup>

The projections prepared by Quellos for Mr. Johnson and his advisors confirm that the purported ability of the transactions to produce economic profit was almost entirely dependent on the premium earned from the sale of the warrant, or the “BLOC” portion of the structure. These projections claimed that, with a \$54,085,290 premium from a warrant invested to produce extra income, the POINT strategy would produce a profit for Mr. Johnson of from \$20 million to \$76 million, under virtually every scenario. However, subtracting the warrant premium from the calculations shows that, if the warrant were never issued into the market to produce the premium, the strategy would lose money unless the underlying stock went up substantially, and even then the amount of possible income would be much smaller.<sup>267</sup>

In other words, if the warrant were removed from the calculus, the prospect for profit was all but eliminated unless the prices of the stocks in the portfolio rose very substantially. The

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<sup>264</sup> 8/5/99 email from Mr. Greenstein to Mr. Wilk (PSI-QUEL22581-82)(“attached are some initial thoughts.”) and attached draft outline (“To satisfy warrant purchasers concern regarding Fund’s ability to deliver underlying stock if the warrant is exercised, Fund creates bankruptcy remote entity and deposits asset(s) in SPV (*that must be taxed as a partnership for U.S. tax purposes.*)”) (Emphasis in original).

<sup>265</sup> Id.

<sup>266</sup> Id.

<sup>267</sup> One series of projections presented three different scenarios: One year duration of the trade with the warrant outstanding, one year duration with the warrant hedged, and five year duration with the warrant outstanding. The first one year projection showed profits of \$22 million to \$60 million regardless of whether the stock in the “basket” went down 20 percent, stayed flat, or went up 20 percent. Schedule labeled “POINT - One Year Duration (Warrant Outstanding)” (PSI-RWJ000268). However, if the \$54,085,290 to be earned on the warrant premium is subtracted from the calculation, the projections would show a \$32 million loss if the stock declined 20 percent, a \$14 million loss if the stock stayed flat, and a \$6 million profit only if the stock went up 20 percent by the end of the year. The second one year projection, with the warrant “hedged,” showed \$4 million to \$7 million losses if the stock stayed flat or declined 20 percent, but a \$1.5 million profit if the stock went up 20 percent. Schedule labeled “POINT - One Year Duration (Warrant Hedged)” (PSI-RWJ000269). If the warrant premium and interest (and offsetting hedging costs) are eliminated from the calculation, the projections would again show a \$32 million loss if the stock declined 20 percent, a \$14 million loss if the stock stayed flat, and a \$6 million gain if the stock appreciated 20 percent. The five year projection showed a loss of \$10 million if the stock declined 50 percent, a \$24 million profit if the stock stayed flat, and a \$76 million profit if the stock went up 50 percent. Schedule labeled “POINT - Five Year Duration (Warrant Outstanding)” (PSI-RWJ000270). However, if the warrant premium and earnings are removed from the calculation the projected results would be a \$78 million loss if the stock declined 50 percent, a \$44 million loss if the stock stayed flat, and an \$8 million profit if the stock went up 50 percent.

evidence reviewed by the Subcommittee shows that there was never any intent to profit from the issuance of a warrant. According to the August 5, 1999 outline of the POINT transaction, the next step after the U.S. taxpayer purchases the SPV [Trading Partnership] containing the loss stock and the warrant premium, and puts the previously held stock that is about to realize a gain into the SPV [Trading Partnership], is to liquidate the assets and redeem the warrant.<sup>268</sup> A second version of the outline created six days later stated the plan more clearly: “Subsequent to the closing on the ownership units, [Quellos] evaluates the economic benefit of leaving the covered warrants out in the market and decides to ... redeem the warrant.”<sup>269</sup>

Although a Warrant document and a subscription agreement were signed by the Trading Partnership and a Euram subsidiary in each of the transactions, no money ever changed hands. Each subscription agreement contained a provision permitting the subscriber to “put” the warrant back to the issuer at any time if the underlying stock was sold,<sup>270</sup> and another provision permitting the subscriber to hold on to the premium (in an account in the name of the issuer)<sup>271</sup> until the warrants were exercised or put back to the issuer.<sup>272</sup> In each actual transaction, the underlying stock was sold within one to two months and the warrant was returned to the issuer, with no gain or loss to either party. That all this was pre-arranged is indicated not only by the 1999 outlines, but by the fact that the warrant “unwind” documents for at least one of the other transactions were prepared in advance of the transaction.<sup>273</sup> A draft checklist for the same transaction showed the “warrant unwind agreement” scheduled for 14 days after the warrant was to be issued.<sup>274</sup> In addition, in the Saban transaction, discussed below, some of the profit

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<sup>268</sup> 8/5/99 email from Mr. Greenstein to Mr. Wilk and attached draft outline (PSI-QUEL22581-82)(“attached are some initial thoughts.”).

<sup>269</sup> 8/11/99 email from Mr. Wilk to Mr. Greenstein and attached draft outline (PSI-QUEL22589-91).

<sup>270</sup> See, e.g., Titanium Trading Partners/EA Investment Services Ltd. Subscription Agreement at para. 6 (PSI-QUEL26697-703).

<sup>271</sup> It is not clear that the BVI entity EA Investment Services Ltd. ever had any funds with which to pay the premium. When Quellos needed an account statement to document the premium amount and interest earned for one of the transactions, it had to provide EA Investment Services with a format to use in preparing a statement. 7/27/00 email from Mr. Hansen to Rajan Puri (PSI-QUEL11432-33)(“I assume that at some point we are going to get account statements from these guys, right??? Maybe you can work on them for some. Also, how about EurAm statements that reflect the Warrant premium deposit and accrued interest??? I sent John [Staddon] a copy of what we think a statement should look like.”). See also 7/31/00 email from Mr. Puri to Mr. Hirata (PSI-QUEL11267)(sending back “draft BVI interest statements” for Quellos review).

<sup>272</sup> See, e.g., Titanium Trading Partners/EA Investment Services Ltd. Subscription Agreement at para. 2(c) (PSI-QUEL26697-703).

<sup>273</sup> See, e.g., 9/4/01 email from Shaikh Arfan [Euram] to Mr. Hansen (PSI-QUEL23128-30).

<sup>274</sup> Draft “Titanium Checklist” (PSI-QUEL29273-77).

projections actually assumed that the warrant would be put back, and the cost of doing so exactly cancelled out the premium received.<sup>275</sup>

The warrant issued by the trading partnership was even referred to by Euram as a “virtual” warrant. In an email on the drafting of the warrant documents, Rajan Puri of Euram explained to Chris Hirata and Chuck Wilk why a particular drafting suggestion was not being accepted:

“John [Staddon] consciously excluded element (b) . . . from his draft; this is because we believe this is an unusual term, which is unnecessary given the “virtual” nature of the warrant issue . . . the last thing we want to do is draw attention to this element of the structure, by inserting unusual, or non-market standard terms into the documents.”<sup>276</sup>

It is clear from the correspondence that the “economics” were designed to improve the appearance of the transactions for tax purposes, and that all parties were in reality focused almost exclusively on the tax loss to be acquired. For example, an email from Quellos employee Andrew Robbins to Mr. Wilk on April 17, 2000, described a conversation with Mr. Johnson’s representatives in which they asked for more details on a series of questions.<sup>277</sup> All of the questions pertained to the costs of implementing the plan and how the costs would be financed. Neither this email nor any other makes any mention of a concern on the part of Mr. Johnson or his representatives over the profit making aspects of the transaction.<sup>278</sup> A week later, Joel

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<sup>275</sup> Profit/Loss Projections labeled “2000 Trading Partners, LLC” (PSI-QUEL36835-51).

<sup>276</sup> 4/18/00 email from Mr. Puri to Mr. Hirata and Mr. Wilk (PSI-QUEL13285-86).

<sup>277</sup> 4/17/00 email from Mr. Robbins to Mr. Wilk (PSI-QUEL22570).

<sup>278</sup> A different POINT investor apparently did not realize that the investment in the basket of stock was hedged against loss if the stock prices declined after the transaction started and thought that the decline in tech stocks then underway would result in a real loss. Several days into his trade, he wrote Mr. Greenstein:

“Dear Jeff:

“For two years now I have studiously averted the overhyped NASDAQ. My disdain for those stocks must have been obvious from my lack of interest in choosing the ones which went into our portfolio. I had no idea that your structure was a speculation on the NASDAQ and had I known I would have never entered into it. I cannot understand how you in all good conscience could even suggest such a thing after April's carnage. It really makes me question [Quellos'] judgement and worry about the other money I have with you. I have been absolutely miserable for the past two weeks as a result of this partnership. I want you to draw up a very clear schedule which explains how the puts lose value as they get closer to expiry so that we don't just sit there like slugs waiting for some miracle which would have no logical basis to occur. I feel I was misled by you and you need to figure out a way of getting me out of this. Every day we get closer to expiry. I have never been afraid of risk when there is a logic for it, and an upside but there is none here, and we have no control.”

Latman sent a fax to Mr. Robbins transmitting documents on the formation of two entities being formed by Mr. Johnson for use in the transaction and concluding: “The amount of loss that we can use should be \$145 [million].”<sup>279</sup> Mr. Robbins immediately wrote Chuck Wilk that “The number they want is \$145.0.”<sup>280</sup>

The Johnson trades took place on May 5, 2000. As it was ultimately documented, the following events took place on May 5:

- Barnville contributed the Johnson “basket” of stocks selected from the original Barnville/Jackstones portfolio to Reka Limited, a Cayman Islands Limited Liability Company previously formed on April 11, 2000,<sup>281</sup> for the purpose of holding the shares, in exchange for 1,000 shares of Reka stock.<sup>282</sup>
- Woodglen I LLC (owned 99.9% by Mr. Johnson and .1% by his wholly owned corporation Woodglen I Inc.)<sup>283</sup> purchased 99.9% of Reka from Barnville for \$103,838,510, payable on August 17, 2000 or earlier “unwind date.” Payment of the purchase price was secured by a pledge of the Reka shares back to Barnville. Woodglen I LLC paid Barnville cash of \$3,466,248 as “prepaid interest.”<sup>284</sup>
- Woodglen I Inc. (a corporation wholly owned by Mr. Johnson)<sup>285</sup> purchased .1% of Reka from European American Corporate Services Limited (EAICS)(a Euram subsidiary) for \$103,942, payable on August 17, 2000 or earlier “unwind date.” Payment of the purchase price was

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Mr. Greenstein wrote back to suggest a telephone conversation to discuss the situation and try to put his mind at ease, and forwarded the exchange of messages on to Larry Scheinfeld and Chuck Wilk with the comment: “I believe we have a problem brewing. Obviously we need to make sure this doesn’t happen again. One thing, Joel [Latman] and Woody get it!” (PSI-QUEL11598).

<sup>279</sup> 4/24/00 fax from Mr. Latman to Mr. Robbins (PSI-QUEL06938).

<sup>280</sup> 4/24/00 email from Mr. Robbins to Mr. Wilk (PSI-QUEL10863).

<sup>281</sup> 4/11/00 Memorandum of Association of Reka Limited (PSI-QUEL27162-63).

<sup>282</sup> 5/5/00 Contribution Agreement (PSI-QUEL01776-79).

<sup>283</sup> 8/11/00 notes of telephone call from Mr. Latman to Mr. Hirata (PSI-QUEL13182).

<sup>284</sup> 5/5/00 Purchase Agreement (PSI-QUEL07163-68); 11/30/00 Amended and Restated Purchase Agreement (PSI-QUEL07051-57); 11/30/00 Amended Agreement (PSI-QUEL12680-81).

<sup>285</sup> 8/11/00 notes of telephone call from Mr. Latman to Mr. Hirata (PSI-QUEL13182).

secured by a pledge of the Reka shares back to EAICS. Woodglen I Inc. paid EAICS cash of \$3,470 as “prepaid interest.”<sup>286</sup>

- Barnville, Reka, and Jackstones entered into a “Novation Agreement”<sup>287</sup> to reflect the change in their positions under the Barnville/Jackstones stock lending agreement as a result of transfer of the “shares” to Reka. Since Reka had received Barnville’s right to return of the shares on loan to Jackstones, Jackstones agreed to deliver the stock on demand to Reka; Reka acknowledged its right to the shares was subject to Jackstones’ right to return of the “cash collateral” and assumed Barnville’s obligation to return the cash collateral, but only to the extent of the present value of the stock.<sup>288</sup>
- Barnville gave Reka its note for \$103,942,452 to cover the share of the cash collateral obligation to Jackstones assumed by Reka under the Novation Agreement.<sup>289</sup>
- Reka purchased a collar<sup>290</sup> from Barnville to protect it against a decline in value of the basket of stock. The net cost of the collar was \$2,380,282 on May 5 and \$720,905 on May 22, 2000.<sup>291</sup>
- Reka issued a call warrant on the basket of stock to EA Investment Services Ltd., (EAISL) (a British Virgin Islands company controlled by Euram) for a premium of \$50,547,000.<sup>292</sup> The warrant contained a provision that, if the basket of stock was sold by Reka, EAISL reserved the right to “put” the warrant back to Reka at any time, in exchange for a return of the entire premium, plus all interest earned while it was invested.

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<sup>286</sup> 5/5/00 Purchase Agreement(PSI-QUEL07044-49); 11/30/00 Amended and Restated Purchase Agreement (PSI-QUEL07036-42); 11/30/00 Amended Agreement (PSI-QUEL12677-78).

<sup>287</sup> 5/5/00 Novation Agreement (PSI-QUEL07170-74).

<sup>288</sup> Barnville was still obligated to return cash collateral equal to the loss amount if Reka demanded delivery of the stock, because Reka did not assume that obligation.

<sup>289</sup> 5/5/00 Promissory Note (PSI-QUEL07137); Amended and Restated Promissory Note (PSI-QUEL07138-39).

<sup>290</sup> A collar is a securities option transaction, sometimes involving a combination of a purchase of a put option, to protect against a decline in value of stock held by the purchaser, and the sale of a call at a higher price to generate income used to pay for the put.

<sup>291</sup> 5/5/00 Equity Option Transaction Confirmation (Put) (PSI-QUEL07059-63); 5/5/00 Equity Option Transaction Confirmation (Call) (PSI-QUEL07065-68).

<sup>292</sup> 5/5/00 Subscription Agreement (PSI-QUEL07141-47); 5/5/00 Warrant (PSI-QUEL07149-61).

Reka agreed to let EAISL hold the premium in an interest bearing account.

At the end of the day on May 5, 2000, the parties had the following obligations to each other under the trade documents:

Jackstones owed Reka the shares of stock worth \$103,942,452;

Reka owed Jackstones cash collateral worth \$103,942,452;

Barnville owed Reka on a note for \$103,942,452,<sup>293</sup> and

Woodglen I LLC and Woodglen I Inc. together owed Barnville a total of \$103,942,452.

After the trade date, Reka was holding a right to delivery of the shares from Jackstones, and Jackstones held a right to payment of the purchase price. Whichever way the market moved, one side or the other would be in the position of losing money. That is, if the stock prices went up, Jackstones would have to acquire shares from the market at the higher price to deliver to Reka. Conversely, if the prices went down, Reka could expect to receive less valuable shares and have to pay the full purchase price to Jackstones.<sup>294</sup> As soon as the above arrangement was in place, each party hedged the risk that the stock would move in the wrong direction as to it. Reka did this by purchasing a “collar” from Barnville.<sup>295</sup> The collar was a combination of options on the stock in Reka’s basket that protected Reka against a decline in stock value, but also limited the amount of profit it could make if the prices went up. Reka paid Barnville \$3,101,187 for the net cost of the collar.<sup>296</sup> Jackstones did not directly hedge its risk that it might have to deliver more valuable stock to Reka, but Barnville purchased from Bank of America a financial product called a “call spread” that would give Barnville the benefit of any rise in the price of the basket to the same extent that Reka could benefit from an upward price movement as against Jackstones.<sup>297</sup> The cost of the call spread to Barnville was exactly covered by the

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<sup>293</sup> Reka also owed Jackstones the balance of the cash collateral equal to the loss amount of \$144,901,611 on the Reka shares removed from the original portfolio.

<sup>294</sup> Alternatively, the party on the losing side could make a net cash payment to the other, rather than going through the steps of Jackstones acquiring and delivering stock to Reka, which would then have to sell them.

<sup>295</sup> Normally, a collar combination of options is purchased through a broker from the market from a financial institution that has the financial strength to make good on the obligations. In this instance, the “counter party” on the collar transaction was Barnville.

<sup>296</sup> 3/13/02 email from Mr. Hanson to Amanda Nussbaum, a lawyer for Mr. Johnson (PSI-QUEL06807).

<sup>297</sup> Barnville’s call spread with Bank of America, set at 100 and 107 percent of the basket price (PSI-QUEL08644-46), was a mirror image of the collar that Reka had with Barnville, where the put was at 100 percent and the call was at 107 percent (PSI-QUEL06803). As a consequence, for every dollar that Jackstones would have

“prepaid interest” that Mr. Johnson’s acquisition company, Woodglen I LLC, paid Barnville on the note for the purchase price of the 99.9 percent interest in Reka, plus the collar fees paid to Barnville through Reka.<sup>298</sup>

After the trade was executed and while the parties were following the market looking for an appropriate point to exit the transaction, Chuck Wilk began to express concern about the disproportionate ownership of the two “partners” in Reka. Mr. Wilk wrote John Staddon:

“What I do not like is that one purchaser owns 99.9999999998% and the other purchaser who bought the nominee shares owns .000000000002%. With identical rights and obligations the IRS is very likely to say we only have one member not two and therefore are not a partnership. Game set and match IRS. However, if we can give the nominee shareholder some special rights (such as managing member, super-voting or economic preference) then we have an argument that there are two partners.”<sup>299</sup>

Mr. Staddon replied:

“When we first discussed the issue of the spvs having to be capable of partnership treatment, you only mentioned that there needed to be more than one owner of shares (which is what we have). The only way of introducing different rights at this stage is to amend the applicable articles of association by creating two different classes of shares. This action can only be instituted from this point onwards and then at the behest of the new owners. I am not sure whether that would be helpful given that at the time of original purchase the two sets of shares carried the same rights.”<sup>300</sup>

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to pay Reka if the price of the basket rose after 5/5/00, Barnville would receive a dollar from Bank of America under the call spread, up to 107 percent of the original basket price. If Jackstones had to pay Reka more than that, Reka would have to pass the excess along to Barnville under the collar. Conversely, if the basket price went down after 5/5/00, requiring Reka to take from Jackstones securities worth less than the original purchase price Reka was obligated to pay Barnville, Reka had a right under the “put” side of the collar to sell the securities to Barnville for the original purchase price.

<sup>298</sup> In a 4/28/00 email from Mr. Greenstein to Mr. Staddon on an identical trade being conducted for another Quellos client at about the same time as the Johnson trade, Mr. Greenstein explained: “Obviously the cost of the call spread will equal the combination of the pre-paid interest and the net debit on the options. This amount will be forward [sic] to Bank of America. A similar e-mail will be prepared for Woody’s trade.” (PSI-QUEL10705).

<sup>299</sup> 5/15/00 email from Mr. Wilk to Mr. Staddon (PSI-QUEL09058-60, at 59).

<sup>300</sup> 5/15/00 email from Mr. Staddon to Mr. Wilk (PSI-QUEL09058-60, at 58).

Mr. Wilk replied that he thought they would shift some ownership to the minority partner on the existing trades and perhaps employ different classes of stock for future trades.<sup>301</sup> However, it does not appear that any of this was done.

On June 5, 2000, Mr. Johnson, his representatives, and Quellos decided to “unwind” the POINT trade. This unwind entailed reselling the basket of stock to Jackstones, terminating the stock lending transaction as to the Reka basket, unwinding the collar between Reka and Barnville and the call spread between Barnville and Bank of America, cancelling the Reka warrant, and cancelling out the remaining obligations. These were largely accomplished in the following steps, all on June 5:

- Execution of an “Unwind and Purchase Agreement” in which Reka resold the basket of stock to Jackstones for \$112,276,243 – a nominal \$8,333,791 profit over the original sale price of \$103,942,452. Since Reka still owed the purchase price from the original trade, this unwind resulted in a net obligation of Jackstones to Reka of \$8,333,971.<sup>302</sup>
- Execution of a “Termination Agreement” that unwound the Reka collar with Jackstones for a net payment due from Reka to Barnville of \$2,596,167.<sup>303</sup>
- A “Tripartite Set-Off Agreement” in which Jackstones’ \$8,333,791 debt to Reka was satisfied by (1) Jackstones’ agreeing to satisfy Reka’s \$2,596,167 debt to Barnville under the collar unwind, and (2) Barnville’s assumption of the remaining \$5,737,624 balance in exchange for Jackstones’ note for that amount. Thus at the end of this step, Barnville owed Reka \$5,737,624, and held Jackstones’ note for that amount.<sup>304</sup>
- Barnville unwound its call spread with Bank of America, receiving from the bank \$5,737,623.35.<sup>305</sup> This amount is credited to Reka through Treskelion Trust Company<sup>306</sup> in settlement of Reka’s obligation under the Tripartite Set-Off Agreement.

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<sup>301</sup> 5/15/00 email from Mr. Wilk to Mr. Staddon (PSI-QUEL09058-60, at 58).

<sup>302</sup> 6/5/00 Unwind and Purchase Agreement (PSI-QUEL07077-80).

<sup>303</sup> 6/5/00 Termination Agreement (PSI-QUEL07119-20).

<sup>304</sup> 6/5/00 Tripartite Set-Off Agreement (PSI-QUEL07070-71).

<sup>305</sup> 6/5/00 Bank of America N.A. Notice of Full Trade Unwind (PSI-QUEL08653).

<sup>306</sup> 6/8/00 Bank of America Securities Wire Request (BA PSIQ00077); June 2000 Extract from Triskelion Trust Company Statement for Barnville Limited (PSI-QUEL06916).

- EA Investment Services Limited exercised its “put” right under the Reka Warrant, returned the warrant to Reka, and kept the premium, which it had been holding for Reka, plus the interest it had purportedly been accruing to the benefit of Reka.<sup>307</sup>

At the conclusion of the unwind, the only obligations outstanding that involved any of the Johnson entities were the original purchase debt on the basket owed by Woodglen I LLC and Woodglen I Inc. to Barnville, in the total amount of \$103,942,452 and the \$103,942,452 note from Barnville to Reka under the “Novation” on May 5, 2000.<sup>308</sup> The Subcommittee has not located any documents evidencing the offsetting of these two obligations, but email communications between Euram and Quellos indicate that this was planned. On March 24, 2000, John Staddon wrote Chuck Wilk at Quellos that leaving the debt under the stock lending agreement payable by the Isle of Man entity (Barnville) to the Cayman entity (Reka) “works out quite nicely when it comes to payment of the deferred consideration by Delaware LP [the Woodglens] in that we can effectively set-off the two amounts (given that Cayman co is a sub of Delaware LP at such time, this should be relatively straightforward – in fact, I will referelct [sic] it in the sale and purchase agreement when it comes to the payment of the defrred [sic] price.”<sup>309</sup> In fact, the right to set off the Woodglens’ purchase debt against any obligations Barnville might owe to the Woodglens or their affiliates or subsidiaries is included in the two Woodglen agreements for the purchase of Reka.<sup>310</sup> Whether or not a document was prepared to effect a set-off of these two debts, it is clear that they cancelled each other out, so that neither the Woodglens and their Subsidiary Reka nor Barnville had a net obligation to the other.

After the trade was unwound, Quellos and Euram turned their attention to preparing the documents to reflect what had purportedly taken place on May 5 and June 5, 2002. On June 7, Brian Hanson wrote John Staddon at Euram on another client’s trade: “Now that the unwind documents are fairly settled, we really need to push on getting all the documentation for each trade finished, signed, and filed. Particularly, we need to focus on [client name redacted by Subcommittee] this week. If you could send me final copies of all his docs (opening and closing) signed by the Isle of Man folks, then I will ensure that they are sent to [client] and signed. . . . We should then focus on Woody and [client name redacted by Subcommittee] early next week.”<sup>311</sup> Work actually began on the Johnson documents after June 17: “I have spoken with the client contact for the investors in Reka and Burgundy and have bought us some time.

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<sup>307</sup> 6/6/00 EA Investment Services Limited letter to Reka Limited (PSI-QUEL07122); 6/30/00 EA Investment Services Limited Statement of Account (PSI-QUEL07181).

<sup>308</sup> None of the evidence available to the Subcommittee indicates what, if anything, happened to the \$5,737,624 note Barnville held from Jackstones under the Tripartite Set-Off Agreement.

<sup>309</sup> 3/24/00 email from Mr. Staddon to Mr. Wilk (PSI-QUEL10844).

<sup>310</sup> Woodglen I LLC Purchase Agreement, section 5.2 (PSI-QUEL07163-68, at 64); Woodglen I Inc. Purchase Agreement, section 5.2 (PSI-QUEL07044-49, at 45).

<sup>311</sup> 6/7/00 email from Mr. Hanson to Mr. Staddon (PSI-QUEL10075).

The expectation on their part is that we will have draft documents for the purchase of Reka and Burgundy by Monday. We are still reviewing the documents for Reka.”<sup>312</sup> In fact, the drafting process lasted the remainder of the year, with the final “document wrapup” occurring in January 2001.<sup>313</sup>

In an interview with Subcommittee staff, Chuck Wilk of Quellos insisted that preparing documents after the fact to confirm securities transactions was normal practice throughout the industry, citing the preparation of trade confirmations after market trades, dated “as of” the trade date, as an example.<sup>314</sup> However, the Quellos and Euram emails establish that the parties were doing more than confirming precise dollar and share amounts that could not have been known before the moment of trade, as occurs with normal securities trades. Nor were the documents in question dated “as of” May 5 and June 5, 2000. The Quellos and Euram emails establish that, months after the trades took place, the purported terms of the transactions were changing in significant ways during the drafting and editing process.<sup>315</sup> As to the dates on the documents,

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<sup>312</sup> 6/15/00 email from Mr. Hanson to Rajan Puri at Euram (PSI-QUEL09558).

<sup>313</sup> 1/9/01 record of meeting between Mr. Hanson and Mr. Latman (PSI-QUEL10149); 1/9/01 record of meeting between Mr. Hanson and Mr. Puri (PSI-QUEL10151). Apart from the documentation of the trades themselves, Quellos was making changes to the accounting journal entries on the entities’ books as much as 16 months after the events. See 9/14/01 record of meeting between Andy Robbins, Mr. Hanson and Mr. Latman (PSI-QUEL10223).

<sup>314</sup> Subcommittee interview of Mr. Wilk (6/28/06).

<sup>315</sup> See, e.g., 6/26/00 email from Mr. Staddon to Mr. Hanson and reply (PSI-QUEL10367-69, at 68)(discussing what the split between Woodglen I LLC and Woodglen I Inc. should be (99-1 or 99.9-.01)); 7/13/00 email from Mr. Puri to Mr. Hirata (PSI-QUEL11242)(“I’m happy with your changes to:

- Global Call Warrant document
- Subscription Agreement
- Purchase Agreement (B’ville - Woodglen LLC)
- Put option
- Termination Agreement
- Tripartite set-off”);

7/14/00 email from Mr. Puri to Paul Moore, Director of Barnville (PSI-QUEL09562-63)(“. . . d) Termination Agreement - As part of the Unwind of the Tranch2, a Termination Agreement was signed by the following - Woodglen Inc, Woodglen LLC, Barnville Ltd, Reka Limited and Euram Corporate Services Ltd, to allow various netting arrangements. This unwind process has now been scaled back (due to personal tax considerations of the end-client) so that the termination agreement should simply refer to the unwind of the call and put options executed between Barnville and Reka. Therefore, rather than cross-out a number of the signatures on the original 5-way Agreement, can you simply re-execute on behalf of Barnville, the following signature page please . . .”); 9/29/00 email from Mr. Staddon to Mr. Hirata (PSI-QUEL09541-52)(“Attached is a form of Unwind Agreement by which I think we can document the close out of the novated stock loans and associated repayment of the cash collateral (or as is most likely part repayment) by Barnville to Jackstones. As you will see, I have completely eliminated any residual cash collateral obligation under the Stock Loan Agreements by having Barnville execute promissory notes in favour of Jackstones. . . . I also attach a revised form of Novation Agreement which provides a bit more specifics on the treatment of the cash collateral obligation. The new clause 3 is I think necessary in order to explain why LLC would be prepared to allow Barnville to retain the original cash collateral pot albeit subject to keeping the obligation to return it upon the due redelivery of the Borrowed Securities.”); 10/26/00 email from Mr. Scheinfeld to Mr. Latman (PSI-QUEL20464)(“I spoke to Chuck yesterday. We are in agreement that the best plan is the one we

nothing on the face of any of the documents suggested to a reader that they were prepared after the dates they bore.

The way Mr. Johnson's transaction was structured, the "gain stock" that was to be shielded from tax by the Reka loss was not placed inside of Reka where the loss was being generated, so it was not possible to mix the loss stock with the gain stock to cancel out the taxable gain, as originally planned for the POINT transactions. Instead, when the loss stock was sold, another feature of partnership tax law was going to be used to get the loss out to where Mr. Johnson's gain stock was. Under U.S. tax law, a partnership loss is passed out to the partners, who are allowed to claim their shares of the loss on their own tax returns, but only to the extent of their investment, or "tax basis" in their partnership interests.<sup>316</sup> If their partnership basis is less than the loss realized by the partnership, some of the loss can go unused. After the Reka trade was complete, Mr. Johnson and his advisors decided that Mr. Johnson could use additional partnership basis in Reka. Chuck Wilk told Subcommittee staff that he recalled Mr. Johnson's lawyer Ira Akselrad saying "we want more basis in the entity than we currently have." Mr. Wilk assumed that the reason for wanting more basis was "to get more tax attributes [losses] out."<sup>317</sup>

Over the period June through September 2000, there was considerable discussion within Quellos about how to document the additional basis and what date to use for the transaction. The date was critical, because of the reason being used to justify the need for an additional contribution of capital that would provide the additional tax basis. On June 27, 2000, Mr. Staddon asked Quellos for an email explaining the "rationalization/argumentation for the additional note."<sup>318</sup> Mr. Wilk wrote Brian Hanson: "we went over this before. The additional borrowing is to secure the warrant indenture which states that at any time if the warrant is not 'covered' the partnership must have a multiple of the shortfall in other collateral. The borrowings injected into the partnership by the investor is to secure that 'uncovered' position."<sup>319</sup> The problem with this explanation is that the warrant had already been unwound, or cancelled, on June 5, 2000, seven weeks before this discussion took place. For this explanation to look reasonable, it would be necessary to backdate all documents pertaining to the injection of additional capital to a date prior to the warrant's unwind. Rajan Puri at Euram sent Chris Hirata

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discussed with the contribution and subsequent loanback. He tried to call you yesterday to finalize. Hopefully, you can talk today and then you can run it past Ira for his input. I believe this is the best solution. . . .").

<sup>316</sup> This "partnership basis" must be distinguished from the basis the partnership has in its own assets. The partnership's basis in its own assets is what determines the amount of loss when it sells the assets, while the partner's "basis" in his partnership interest determines how much of the partnership's loss he can personally use.

<sup>317</sup> Subcommittee interview of Mr. Wilk (6/28/06).

<sup>318</sup> 6/27/00 email from Mr. Hansen to Mr. Wilk (PSI-QUEL39692).

<sup>319</sup> 6/27/00 email from Mr. Wilk to Mr. Hansen (PSI-QUEL39692).

at Quellos draft notes for the “additional basis creation” on July 13, 2000,<sup>320</sup> and Chris Hirata apparently contacted John Staddon at Euram to discuss the possibility that the investor would contribute cash to support the additional basis. Mr. Staddon responded:

“I got your message about how you think the additional capital injection into Reka is to be structured. The trouble is that I do not see how this can work. I had assumed that we would be having a circular funding pattern between the Woodglen entities, Reka and Barnville – such that no cash would need to actually pass i.e. purely book entry. If I have understood you correctly, you are in fact looking for the Reka capital to be invested in Euram fixed income instruments, the proceeds for which presumably could then be invested by Euram in Barnville paper. Unlike the pure book entry affair that I had originally understood, this would involve actual funding, balance sheet utilisation and a regulatory capital cost, somtehing [sic] which we can not accommodate in the amounts required for these structures.”<sup>321</sup>

All further discussions of the subject involved documenting the additional capital contribution by book entry, or offsetting obligations. On August 1, 2000, Mr. Puri emailed Chris Hirata: “CHRIS – question for you re the docs for increasing the basis in Reka/Burgundy [a related transaction] . . . what do you want to use as the effective date (bear in mind that if we need to back-date it significantly . . . ie to BEFORE the date of the unwind . . . we may have a problem with the Cayman guys).”<sup>322</sup> Later the same day, Mr. Puri sent draft promissory notes pertaining to the additional basis transaction, with the comment: “we are awaiting confirmation from the Caymans guys as to: . . . the dating options we have (since I presume the flows will simply be book entry, Cayman are likely to be uncomfortable with back-dating entries . . . does this cause you a problem?)”<sup>323</sup>

The Cayman administrators of Reka did have a problem with backdating the documents when the subject was discussed with them. In an August 15, 2000, email dealing primarily with an issue involving the dating of a corporate resolution pertaining to a directorship of Woodglen I Inc., Mr. Puri related the following to Chris Hirata and Brian Hanson of Quellos:

“i) Citco [formerly Curacao International Trust Company](as a director of Reka Ltd) will NOT be party to an attempt to back-date the appointment of Woodglen – this has come directly from Nick Braham (Citco Global Internal Counsel).

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<sup>320</sup> 7/13/00 email from Mr. Puri to Chris Hirata (PSI-QUEL10534).

<sup>321</sup> 7/17/00 email from Mr. Staddon to Chris Hirata (PSI-QUEL09556).

<sup>322</sup> 8/1/00 email from Mr. Puri to Mr. Hanson and Chris Hirata (PSI-QUEL10511).

<sup>323</sup> 8/1/00 email from Mr. Puri to Chris Hirata and Mr. Hanson (PSI-QUEL10394).

“ii) The appointment of Woodglen as a co-director can be made via ordinary resolution by the current shareholders (ie Woodglen Inc, LLC) and ratified by the Board of directors (ie Citco), but such ratification can only happen real time (ie now) . . . which is no good to you.

“iii) It seems the only compromise Citco would be willing to make on this would be a resolution that alluded to the intention of appointing Woodglen as a director in early May, which did not happen due to an administrative oversight . . . however, this note and the associated appointment could only be signed as effective now; therefore, Roy’s view is that such a resolution would be self-defeating if it was ever subject to review.

“iv) Unfortunately, Citco’s stance also has ramifications for the attempt to increase the basis via the capital injection by Woodglen into Reka . . . . Citco will not permit the execution of back-dated documents, particularly where the documents have such a material impact on the economics of the structure.

“Finally, Roy mentioned to me that he was surprised that (as disclosed to him during your conversations with him) the ‘other SPV providers in the IoM would be willing parties to such a back-dating exercise’. . . didn’t push him on this, and do not know whether he was told the identity of the IoM guys, but I’m sure that you do not need reminding how sensitive this whole exercise is and therefore the need for complete discretion.”<sup>324</sup>

The corporate resolution on the Woodglen directorship was not ultimately backdated,<sup>325</sup> but virtually all other documents pertaining to the Johnson trade were, including all of the documents pertaining to the additional capital contribution. The contribution was to be effectuated by:

- \$40,000,000 contributions of capital to Reka by Pledges of Woodglen I LLC (\$39,960,000) and Woodglen I Inc. (\$40,000),<sup>326</sup>

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<sup>324</sup> 8/15/00 email from Mr. Puri to Chris Hirata and Mr. Hanson (PSI-QUEL13288).

<sup>325</sup> The Caymanian directors of Reka added Woodglen I Inc. as a Reka director on August 29, 2000 (PSI-QUEL07116).

<sup>326</sup> Woodglen I LLC Cash Contribution Pledge dated May 5, 2000 (PSI-QUEL07132); Woodglen I Inc. Cash Contribution Pledge dated May 5, 2000 (PSI-QUEL07133); Reka Limited Directors’ Resolution recording the \$40,000,000 as a contribution to its share premium account (PSI-QUEL07123).

- \$40,000,000 35-year loans from Barnville to Woodglen I LLC and Woodglen I Inc., to finance the “cash” contributions to Reka’s capital;<sup>327</sup> and
- a \$40,000,000 purchase of a Barnville 35-year debenture<sup>328</sup> by Reka,<sup>329</sup>

All of the relevant documents were dated May 5, 2000.

As a result of these three sets of documents, the two Woodglens purportedly owed Barnville \$40,000,000 on the notes, Barnville owed Reka \$40,000,000 on the 35-year debenture, and Reka’s books showed a \$40,000,000 capital charge in favor of Woodglens. None of the documents reviewed by the Subcommittee contain any indication that any cash changed hands in these transactions or that they amount to anything other than the “pure book entry affair” involving a “circular funding pattern” described in Mr. Staddon’s email on July 27, 2000. In addition, the email records establish that all of these documents, which were dated May 5, 2000, were still being passed around for signature as late as September 2000.<sup>330</sup>

Just as the POINT trade itself was unwound on June 5, 2000, the circular flow of liabilities supporting the additional capital contribution was unwound in a three-way “Termination Agreement” among Reka, Barnville, and the two Woodglen entities dated November 30, 2000.<sup>331</sup> This agreement provided that Reka wished to make a “distribution in specie” (a return of capital) to the two Woodglen entities by assigning to them the Barnville Debenture. As a consequence of this part of the agreement, the Woodglens held a 35-year \$40,000,000 debenture from Barnville, and Barnville held 35-year notes from the Woodglens totalling \$40,000,000. The termination agreement provided that each would redeem its obligation to the other in a complete setoff of the liabilities. As a result of this agreement, the parties were in the same position they were before the May 5, 2000, documents were signed in late September, and no real capital was invested in Reka. The Subcommittee has found no email

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<sup>327</sup> \$39,960,000 Promissory Note from Woodglen I LLC to Barnville dated May 5, 2000 (PSI-QUEL07134); \$40,000 Promissory Note from Woodglen I Inc. to Barnville dated May 5, 2000 (PSI-QUEL07135).

<sup>328</sup> A debenture is an unsecured bond, or long-term debt instrument.

<sup>329</sup> Debenture dated May 5, 2000 (PSI-QUEL07125-30).

<sup>330</sup> See, e.g., 9/21/00 email from Siobhan Gillespie at Citco to Mr. Hanson at Quellos (“To enable us to get the debenture signed off would you please provide us with signed copies of the documents, copies of which were emailed to Roy on September 1<sup>st</sup> (the file notes should at least be initialed)”) and email from Mr. Hanson forwarding the Gillespie email to Mr. Hirata (“OK - so they’re looking for signed copies of the promissory notes and initialed copies of the file notes before they will sign the debenture. First, do you think this is really necessary and second, have we even gotten Joel [Latman] to a point where he is comfortable enough with the issue to be willing to sign them?”) (PSI-QUEL09624-26, at 24); 9/27/00 email from Mr. Hirata to Mr. Hanson (“Please bring copies of the Promissory Note/Note to File/Debenture for RJWIV [sic] and [redacted by Subcommittee] to Chuck ASAP. Thx.”) and reply (“They’re printing as we speak”)(PSI-QUEL27291).

<sup>331</sup> Termination Agreement dated November 30, 2000 (PSI-QUEL07093-97).

or other document that directly explains why this part of the transaction was unwound. However, one email from Mr. Wilk to Mr. Staddon on October 12 suggests that one of Mr. Johnson's lawyers was concerned that the three-way lending transaction was subject to challenge because the liabilities were completely offsetting:

“In regards to the triangular loans (i.e. loan from Barnville to Woodglen/ contribution by Woodglen to Rekka/purchase by Rekka of debt security from Barnville) is it possible for Rekka to purchase debt security from Euram (or an affiliate)? Ira Axelrod [sic][Mr. Johnson's lawyer] does not like the circular nature of the structure (and I don't blame him) and wants a proposal that Cravath accepts that will make him more comfortable with the basis and at risk rules (IRC 465).”<sup>332</sup>

Mr. Johnson's advisors apparently decided not to use this transaction to claim additional partnership basis, because the net effect of unwinding the three-way transaction was to reduce Mr. Johnson's basis back to where it started before the notes and debenture were signed. In addition, it appears that Mr. Johnson made a \$20 million cash contribution to capital before the end of the year,<sup>333</sup> which would support an addition to basis in that amount.

In the final analysis, even though the market price of the stocks supposedly in the basket went up, the fees and costs of the POINT transaction far exceeded the amount Mr. Johnson “made” in the month he held the “stocks.” According to a calculation of profit and loss prepared by Quellos, the gross profit of \$8,333,791 that he purportedly made when the basket of stock was sold back to Jackstones was reduced by the costs of the collar to a “trading gain” of \$2,636,436, which was further reduced by the prepaid interest (representing Barnville's cost of the call spread at Bank of America<sup>334</sup>) and Quellos' fee of \$2.9 million to a net loss of

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<sup>332</sup> 10/12/00 email from Mr. Wilk to Mr. Staddon (PSI-QUEL25006-07, at 06).

<sup>333</sup> Woodglen I LLC and Woodglen I Inc. Journal Entries as of 12/31/00 (PSI-QUEL12583-84).

<sup>334</sup> The only part of the entire Johnson POINT transaction having any economic reality was the one part involving a third party outside the closed system of the taxpayer, the promoters, and the entities they controlled – the call spread option package purchased by Barnville from Bank of America. Every other obligation or payment was cancelled out by some other obligation or payment (except for the promoters' fees), and the profit on the Bank of America call spread was the source of the additional funds Jackstones “owed” Reka when the benchmark stock prices went up. If the prices had gone down, on the other hand, Barnville would have lost the fees it paid for the call spread, all of which came from the prepaid interest and collar fees paid by Mr. Johnson and his entities, but Jackstones would have owed no money to Reka, and Reka would have been protected against loss by the “collar.” In other words, Mr. Johnson stood to “make” money only to the extent the call spread made money, and stood to lose only the cost of the call spread (paid through his fees to Barnville). The net effect of the entire POINT transaction, apart from the tax loss, was the same as if Mr. Johnson had directly purchased a call spread from the bank. The fees he paid to Quellos and Euram (plus the fees he paid to his own tax advisors) were therefore wholly attributable to the tax loss he was purchasing.

\$3,733,282.<sup>335</sup> In a “synopsis of the trade profitability” sent to one of Mr. Johnson’s lawyers, Quellos nevertheless concluded that the trade was arguably profitable:

“The portfolio was liquidated for \$112,276,243 generating a profit of \$8,333,791. The investment advisory fees associated with Quellos were paid separately by RWJIV pursuant to an investment advisory agreement spanning a 24 month period that requires the payment of \$120,000 per month. There was an additional \$20,000 that was paid by Reka. Using these figures one could argue that Reka generated a net profit of \$2,636,437 over the 31 day period not accounting for the fees of \$1,450,000 and the \$2,900,000.”<sup>336</sup>

Quellos fee of \$2,900,000 was 2 percent of the target tax loss of \$145,000,000,<sup>337</sup> and Euram’s fee of \$1,450,000 was one percent of the loss.<sup>338</sup>

On August 29, 2000, almost three months after Mr. Johnson’s POINT transaction was unwound, Cravath, Swaine & Moore issued a legal opinion on the tax consequences of the transaction.<sup>339</sup> The opinion begins with a five-page summary of the facts on which it was based. Although it is dated after the transaction, the opinion names none of the entities involved in the transaction, and it describes the transaction in prospective terms, beginning “Investor proposes to purchase a 99.9 percent membership interest in a non-U.S. limited liability company (“SPV”)....” It describes the formation of the SPV (Reka), the contribution of the “stocks” by the offshore “fund” (Barnville), and the issuance of the covered warrants in the past tense, although these events occurred simultaneously with the purchase of Reka on May 5, 2000. The only purpose it ascribes to the formation of Reka was to issue the warrants, which it describes in detail. It describes the anticipated financing of the purchase by the “fund” and the acquisition of a collar. The summary does not discuss the anticipated length of time the stocks will be held by the SPV, but states that they may be sold after consultation with the investment advisor. There is no mention of a possible tax purpose for the transaction until the final paragraph of the summary, which states that the investor anticipates “substantial” pre-tax return on its investment (based on the investment of the warrant premium and the potential increase in the stock value) “in relation to the potential U.S. Federal income tax benefits attributable to the built-in loss in the stocks held

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<sup>335</sup> Robert W. Johnson IV – Reka Limited Summary as of June 5, 2000 (PSI-QUEL00339).

<sup>336</sup> 3/13/02 email from Mr. Hanson to Ms. Nussbaum (PSI-QUEL06807).

<sup>337</sup> 10/25/01 email from Mr. Hanson to Mr. Robbins (PSI-QUEL25004); Quellos fee was calculated as a percentage of the loss, but it was paid in \$120,800 monthly installments over two years. 7/1/00 Relationship Agreement (PSI-QUEL27257-62).

<sup>338</sup> 6/29/00 email from Mr. Puri to Mr. Hanson (“As I mentioned to you several days back, the Euram 1% fees appear to have been calculated based on the losses the clients were aiming to generate (totalling USD4.45 [million]) . . . I think therefore that Euram are due another USD33k – does this make sense to you?”)(PSI-QUEL27141-42, at 41).

<sup>339</sup> 8/29/00 Memorandum for R.W. Johnson, IV, and attached opinion letter (PSI-RWJ000241-64).

by SPV.”<sup>340</sup> There is no indication anywhere in the opinion of the amount of anticipated tax benefit or the amount of anticipated profit the factual summary is comparing.

The remainder of the 23-page opinion consists of a legal analysis based on the stated facts. The bulk of the legal analysis pertains to legal principles called the “economic substance” and “business purpose” doctrines, and the opinion concludes that the investor will “more likely than not” be able to claim the tax loss built in to the “shares” acquired from Barnville. This conclusion is based completely on the assumed fact that the investor is expected to realize a significant pre-tax profit.<sup>341</sup> The opinion also analyzes the transaction in reference to several other technical tax rules and concludes that it passes muster, again on the basis of the assumed facts.

As described above, the evidence examined by the Subcommittee indicates that some of the assumed facts in the opinion are incorrect (such as the existence of shares of stock purportedly held by Reka), some are inaccurate or incomplete (such as the sequence of the contribution of the shares, the issuance of the warrant, and the purchase of Reka), and some important facts are omitted (such as the fact that no economic benefit can be realized from the premium if the warrant is cancelled). When these matters were reviewed with Lewis Steinberg of Cravath, he stated that he relied completely on Quellos and the taxpayer’s other advisors to assure that the factual statement was accurate and indicated that, after a draft opinion was circulated, neither Quellos nor Mr. Johnson’s advisors expressed any problem with the facts as described.<sup>342</sup> He further explained that his job as a tax practitioner was to include a full description of all known facts that appear relevant to the anticipated opinion, and that it is a given of tax practice that such an opinion may only be relied upon to the extent that it reflects the facts as known to the client. In his expressed view, it is not incumbent on a tax practitioner who has been asked to give an opinion on a set of facts to investigate the correctness of those facts in the absence of an apparent inconsistency with what he knows to be true.

Particularly with regard to the nature of the assets to be contributed to Reka by Barnville, Mr. Steinberg stated that his understanding was as stated in the opinion: that Reka owned real shares of stock that it had acquired in the ordinary course of its business as an investment fund, and that the source of those facts was Quellos.<sup>343</sup>

Quellos registered the Johnson POINT transaction as a tax shelter on November 14, 2000, by filing Form 8264, application for Registration of a Tax Shelter.<sup>344</sup>

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<sup>340</sup> Id., at 1-5.

<sup>341</sup> Id., at 9.

<sup>342</sup> Subcommittee interview of Mr. Steinberg (7/26/06).

<sup>343</sup> Id.

<sup>344</sup> 11/14/00 Form 8264, Application for Registration of a Tax Shelter (PSI-RWJ00146-47).

Mr. Johnson told Subcommittee staff that he was not able to use all of the loss generated through the POINT transaction on his 2000 tax return. In addition, he stated that, in 2002, when the IRS made a public offer to taxpayers in potentially abusive tax shelters that it would waive penalties if they disclosed their involvement and paid all tax and interest,<sup>345</sup> Mr. Johnson made such a disclosure, which led to an IRS audit. When the IRS challenged the losses claimed in conjunction with the POINT transaction, he agreed to the adjustments proposed.<sup>346</sup> Mr. Johnson has not yet paid the additional tax and interest, because the IRS has not yet sent him a final computation. However, his estimate of the additional tax due on the disclosure form, after taking into account some operating losses from other years, was approximately \$17,000,000.

### **The Disappearing Losses**

In May 2000, while Quellos was in the midst of the Johnson/Reka transaction, the market for technology stocks enjoyed a period of recovery, which meant that the losses built into the Barnville-Jackstones paper portfolio were diminishing. Mr. Scheinfeld sent an email to Mr. Greenstein and several other Quellos principals on May 15, listing the transactions in process and observing: “Looks like we have no more room on the POINT trade. We should be very careful about selling any more.”<sup>347</sup> Mr. Greenstein replied “Big trade pending w/ [client name redacted by Subcommittee] At this point I think we need to notify people that it is truly first come first served. Since the losses are dependent on market moves, who knows how many we will have at any point in time.”<sup>348</sup> Mr. Greenstein added later in the day:

“just to give you a perspective on timing – this morning we had approximately 1.4 bln in usable losses, on the close we had about 1.15 billion. If the market moves to where [client name redacted by Subcommittee] is break-even it will probably be down to about 700 mln. We will try to add more positions to generate losses but they are a function of market moves. As bad as it sounds, the ‘snooze you lose’ comment may unfold for those who can’t make decisions in a timely manner. Without being too aggressive, we should make people who are considering this trade aware of the timing ramifications.”<sup>349</sup>

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<sup>345</sup> IRS Announcement 2002-2, 2002-1 CB 304.

<sup>346</sup> Subcommittee interview of Mr. Johnson (7/20/06).

<sup>347</sup> 5/15/00 email from Mr. Scheinfeld to Mr. Greenstein, et al. (PSI-QUEL12073).

<sup>348</sup> 5/15/00, 7:48 a.m., email from Mr. Greenstein to Mr. Scheinfeld, Mr. Wilk, and Mr. Robbins (PSI-QUEL12073).

<sup>349</sup> 5/15/00, 1:24 p.m., email from Mr. Greenstein to Mr. Scheinfeld, Mr. Wilk, and Mr. Robbins (PSI-QUEL12073).

The following day, Mr. Greenstein updated the others on the status of the paper portfolio: “under \$900 in losses as of now.”<sup>350</sup>

### **Evolution of POINT to a Financed Deal**

After the first three trades, there was a question whether Cravath would write additional tax opinions, and Quellos was looking for another firm to write opinions for additional trades. On August 21, 2000, Mr. Scheinfeld wrote Mr. Wilk: “Will we be able to do any more transactions this year?? I want to get back to two clients who are pretty far down the road. I would think 9/15 would be a drop dead date. Do you anticipate hearing back from any reputable firms? I want to be honest with these prospects.”<sup>351</sup> Mr. Wilk responded:

“As of now, I would guess no losses for 2000 but that we could start a trade that had 2001 losses. Akin Gump has written this opinion for a corporate client but they definitely [sic] require more time between events than we did on the first three trades. Jim Barry is back from vacation this week and I will speak with him on opining. Bryan Cave is a remote possibility (given their fee structure). I believe Sherman [sic] and Sterling opined for the Lehman trade and I will try to get a contact name. Jeff and I spoke and decided that in future trades we will try to have bank borrowing and actual cash purchases. All that said if we can get a firm commitment [sic] to opine and we started early in September and we had favorable market volatility) we may be able to generate 2000 loss.”<sup>352</sup>

Mr. Scheinfeld asked in response to the above message from Mr. Wilk: “would it be of any help to you if I called Bryan Cave?”<sup>353</sup> and Mr. Wilk replied: “I would like to keep you on the sidelines or in our back pocket until we need a trump card (lots of cliches). It may be that given the current atmosphere we need to pay the law firms more and give them a guarantee.”<sup>354</sup>

However the transaction was financed, the risk and reward to the client were the same – the collar around the “basket” ensured that no money would be lost, whether the “rights” to stock were bought and sold within the structure, as in the Johnson trade, or whether borrowed cash was used to buy real stock from the market to sell back to the market. By the same token, the collar limited the amount of possible profit to the point where it was virtually impossible for the stock “profit” to exceed the total fees and transaction costs to the client, regardless of whether the deal was funded with cash or with mutual obligations of the parties, as with the Johnson trade. The

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<sup>350</sup> 5/16/00 email from Mr. Greenstein to Mr. Scheinfeld, Mr. Wilk, and Mr. Robbins (PSI-QUEL12073).

<sup>351</sup> 8/21/00 email from Mr. Scheinfeld to Mr. Wilk (PSI-QUEL22487).

<sup>352</sup> 8/21/00 email from Mr. Wilk to Mr. Scheinfeld (PSI-QUEL22487).

<sup>353</sup> 8/21/00 email from Mr. Scheinfeld to Mr. Wilk (PSI-QUEL22486).

<sup>354</sup> 8/21/00 email from Mr. Wilk to Mr. Scheinfeld (PSI-QUEL22486).

primary reason for wanting to use cash, thus, seems to be the improvement to the “optics” or appearances of the transaction that would come with the use of cash and the involvement of third parties in aspects of the deal.

The next POINT trade done by Quellos, for another New York investor, did involve actual cash for the purchase of the Trading Partnership, named Platinum Trading Partners,<sup>355</sup> and the cash was borrowed from a bank. The injection of cash required modifications to other aspects of the trade, and actually eliminated the need for some of the documents used to “unwind” the internal obligations created in the earlier transactions to make up for the lack of cash.<sup>356</sup>

### **Titanium Transaction (Haim and Cheryl Saban)**

Haim Saban is a producer of children’s television programming, and is best known for introducing the Mighty Morphin Power Rangers to children’s TV. According to Mr. Saban, he started in the children’s entertainment business selling music for cartoons and expanded that business into the production of cartoons, and then into the international distribution of cartoons. He purchased the rights to the Power Rangers during a trip to Japan in the 1980s and spent a number of years trying to sell the idea to distributors in the United States. When he finally succeeded in convincing a Fox executive to give him a contract, the show was an immediate hit with children. Out of the Power Ranger success, Mr. Saban formed a partnership with Rupert Murdoch that outbid Disney on the acquisition of the Family Channel, and turned that network into Fox Family Worldwide, Inc. (FFWW), of which Mr. Saban and his interests owned approximately 50 percent.<sup>357</sup>

Mr. Saban told the Subcommittee that, in late 2000 or early 2001, he had decided that he would be selling his interest in FFWW in the near future, probably to Disney, at a profit approximating \$1.5 billion, and asked his long time advisor, tax lawyer Matthew Krane, to start thinking about tax planning and estate planning with respect to the money he expected to be

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<sup>355</sup> At this point, Quellos was selecting the entity names from a list of metals and crayon colors. See 9/27/00 email from Mr. Hirata to the Quellos Conversion Trade Group: “Don’t know if I like this theme. Here are some more ideas though (some approved off the original list, some new). How about metals? (i.e. Steel, Titanium, Platinum, etc.) – Sienna, Coral, Cyan, Silver, Cerulean, Chestnut, Mahogany, Shadow, Orchid, Cobalt” (PSI-QUEL20423) and reply from Mr. Hanson: “I was working with a limited list of colors (not the whole box of 64) – I like the additions. Metals sound cool.” (PSI-QUEL20423-24, at 23).

<sup>356</sup> 9/26/00 email from Mr. Hanson to Mr. Puri (PSI-QUEL09441-42, at 41)(“**Stock Lending Unwind Agreement (new)** . . . This document should be drafted to reflect the fact that the investor, via the Delaware LP, is calling the portfolio of stocks from Jackstones pursuant to their rights under the Lending Agreement. I think that, if worded properly, this document could replace the Tripartite Set-Off Agreement and Unwind and Purchase Agreement. Since payment is made in full on day one and this document shows all shares being transferred to the LP on day one, the Tripartite Agreement seems unnecessary. The Unwind document is no longer valid since the purchase is fully funded up front. Let's just make sure that the LP is clearly not liable to repay any of the collateral obligation that Jackstones has to Barnville”)(emphasis in original).

<sup>357</sup> Subcommittee interview of Mr. Saban (7/19/06).

receiving from the sale. According to Mr. Saban, for a number of months, Mr. Krane said he had no ideas but, at some point in 2001, he brought Mr. Wilk from Quellos to a meeting with Mr. Saban to present a tax planning idea. Mr. Saban remembers Mr. Krane trying to explain a complicated transaction using a sheet of paper with “a lot of triangles and arrows.” Mr. Saban said that he told Mr. Krane that he should know Mr. Saban would never understand such a transaction. Instead of listening to a complicated explanation, Mr. Saban said he had two questions for Mr. Krane and Mr. Wilk: (a) is the transaction kosher, and (b) will a reputable law firm issue an opinion in writing that it is kosher? According to Mr. Saban, they said “Yes, to both.”<sup>358</sup>

Mr. Saban told the Subcommittee that his objective in talking to Mr. Krane and Mr. Wilk was not to make money on the stock market but to save money on taxes, and the plan that they presented to him was a tax planning strategy, not an investment strategy. Mr. Saban told the Subcommittee that the benefit of the plan was supposed to be “full tax deferral of the Disney sale, ad infinitum.” There was a discussion of profit potential on a stock portfolio that was mentioned later, but Mr. Saban told the Subcommittee that his understanding was that the reason for the investment aspect of the plan was that there had to be a business reason for the plan or it “wouldn’t hold water.” He said that there was supposed to be an economic profit that would be earned on an investment but that the plan involved the purchase of a “collar” that would limit the downside risk and would also limit the upside. He told the Subcommittee that he had not been concerned with the details of the transaction because it had the “Matt Krane stamp on it,” as well as the approval of a major law firm. However, he told the Subcommittee that he clearly understood that this was a tax plan that needed economic substance to hold water, and not a financial investment transaction that came with tax advantages.<sup>359</sup>

Records of email messages obtained by the Subcommittee establish that the size of the POINT trade Quellos and Mr. Saban were negotiating was keyed not to an amount of money he wanted to invest in the basket of stock, but to the amount of the loss embedded in that basket. For example, on July 17, 2001, Mr. Hanson informed Mr. Puri of Euram that:

“The trade for Saban is becoming rather imminent. We have been asked by the client to present them with two scenarios. One basket with losses of \$750M and one basket with \$800M. Only one basket will be chosen at the end of the day but since the economics have not yet been nailed down we need to be prepared to consider both scenarios. ... I need you to verify that the per share basis values are correct, that the shares under either scenario are available and that the total losses are as shown. ... I have been told that there is absolutely no margin for error with this trade due to its size and our excellent relationship with the client. I cannot

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<sup>358</sup> Id.

<sup>359</sup> Id.

stress enough that we make sure that everything ties out as far as the available shares and corresponding losses....”<sup>360</sup>

Mr. Saban did not have sufficient cash to fund an \$800 million purchase, so Quellos arranged for a loan to finance the transaction and the collar on the basket of securities. The loan was to come from HSBC Bank, which had outbid several other banks in negotiations with Quellos. HSBC is one of the world’s largest banking institutions. It operates 9,500 offices in 76 countries throughout the world,<sup>361</sup> serving 125 million customers.<sup>362</sup> It has over 200,000 shareholders<sup>363</sup> and had net income of \$888 million in the three months ending March 31, 2006.<sup>364</sup> The company has been operating since 1865, when the Hong Kong Shanghai Banking Corporation limited was established.<sup>365</sup> Today, the HSBC Group includes member institutions around the world in sectors ranging from securities to trustee services to personal and commercial banking.<sup>366</sup>

HSBC was told by Quellos that the purpose of the loan was to fund a financial transaction that combined the potential for making a profit with substantial tax advantages. One document prepared by HSBC in connection with the loan approval process stated: “The deferral of ~\$700-750 million for 5 to 10 years is the economic benefit that provides Quellos with its fee. Assuming a risk free rate on triple tax exempt municipal bonds of 3.75% annually compounded money for five years on \$700 million, Quellos would save Saban ~\$140 million after tax over five years.”<sup>367</sup>

On August 30, 2001, HSBC processed an amendment to the loan approval to increase the amount of the loan because Silverlight Enterprises LP, the Saban partnership that held half of the FFWW stock and that was going to be the borrower on the loan, had reevaluated the amount of loss it wanted to acquire.<sup>368</sup> In addition, over the period August 30 through the time of the trade, Quellos had HSBC recalculate the price of the collar several times, as Mr. Saban’s need for loss

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<sup>360</sup> 7/17/01 email from Mr. Hanson to Mr. Puri (PSI-QUEL39463).

<sup>361</sup> HSBC Website, [www.hsbc.com/hsbc/about\\_hsbc](http://www.hsbc.com/hsbc/about_hsbc) (viewed on 7/12/06).

<sup>362</sup> Id. at [www.hsbc.com/hsbc/investor\\_center/fast\\_facts](http://www.hsbc.com/hsbc/investor_center/fast_facts) (viewed on 7/12/06).

<sup>363</sup> Id.

<sup>364</sup> HSBC 10-Q for the period ending 3/31/06 at 6.

<sup>365</sup> HSBC Website at [www.hsbc.com/hsbc/about\\_hsbc](http://www.hsbc.com/hsbc/about_hsbc) (viewed on 7/12/06).

<sup>366</sup> Id. at [www.hsbc.com/hsbc/about\\_hsbc/group-members](http://www.hsbc.com/hsbc/about_hsbc/group-members) (viewed on 7/12/06).

<sup>367</sup> Untitled HSBC memorandum (HUI0000885-87, at 86).

<sup>368</sup> 8/30/01 email from Ms. Pan to Mr. Teanor and attached Recommendation for Amendment of Loan (HUI0004119-20)(“Silverlight has an additional basis [sic], which it wants to defer. At this time \$70 million dollar portfolio with the appropriate losses has become available.”).

basis changed<sup>369</sup> or as the market changed the total price of the shares needed to achieve the target loss.<sup>370</sup>

Quellos told HSBC that “Barnville buys entities with losses that existing shareholders can not use the tax deductions, ie foreign entities with investment losses in the US equity markets but can not write off the losses. They warehouse these losses until a buyer is located that can take advantage of the situation. Jackstone will short the stock holdings in the entities purchased by Barnville as a hedge and entered a stock borrowing arrangement with Barnville to secure the short position.”<sup>371</sup> According to HSBC, Quellos did not tell HSBC about the circular nature of the stock transactions between Barnville and Jackstones. HSBC told the Subcommittee that it believed that Barnville actually owned equity securities, which it had loaned to Jackstones to cover Jackstones’ short sales into the market.<sup>372</sup>

As in the case of the first three transactions, the Saban trade was intended to be short term, notwithstanding the written terms of the documents, such as the warrant, which was for a stated term of five years.<sup>373</sup> Mr. Saban told Subcommittee staff that he understood the stock investment was to have a “quick turnaround” (although he did not know why).<sup>374</sup> Quellos had the warrant unwind agreement drafted weeks before the transaction commenced.<sup>375</sup>

The timing of the Saban trade was tied to the timing of the sale of the FFWW stock to Disney, and was being pushed back a few days at a time during August and September 2001.<sup>376</sup> It was finally expected to take place over several days beginning on or shortly after September

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<sup>369</sup> 9/7/01 email from Mr. Ramquist (Quellos) to Mr. Schreiber (HSBC) (HUI0004197)(“Subject: saban basket – hey rusty – the loss amount has been revised–again(!) can you call myself or chris hirata when you ahve [sic] a moment? Want to discuss a couple of parameters.”).

<sup>370</sup> See, e.g., 9/5/01 email from Mr. Hirata to Mr. Schreiber (HUI0004169-72)(“Rusty,... attached is the latest version of the stock portfolio using closing prices as of today, September 5<sup>th</sup>. Lastly, the collar will be struck at 100%/108% and should expire January 2, 2002 (~115 days based on a trade date of September 10, 2001).”).

<sup>371</sup> 8/20/01 email from Ms. Pan (HSBC Private Banker) to Mr. Schreiber (HSBC Derivatives Desk)(HUI0004041); Subcommittee deposition of Mary Pan (7/25/06).

<sup>372</sup> Subcommittee deposition of Russell Schreiber (7/18/06) at 18-21.

<sup>373</sup> 9/21/01 Global Call Warrant (PSI-QUEL23726-39).

<sup>374</sup> Subcommittee interview of Mr. Saban (7/19/06).

<sup>375</sup> 9/4/01 email from Mr. Shaikh (Euram) to Mr. Hansen (PSI-QUEL23128-30).

<sup>376</sup> See, e.g., 9/5/01 email from Mr. Hirata to Mr. Schreiber (HUI0004169-70); 9/6/01 email from Mr. Hirata to Mr. Schreiber at HSBC (PSI-QUEL23117-18).

11, but the attack on the World Trade Center and the resulting turmoil in the markets pushed the date back several more days.<sup>377</sup>

The Saban POINT transaction actually began on September 21, 2001. Mr. Saban held his FFWW stock in two parts, about half in his own name and half through a partnership named Silverlight Enterprises LP. Because of a loophole in the partnership tax law (which was closed in 2004), Quellos was able not only to shield Mr. Saban's own FFWW stock from tax, but also to eliminate the tax on the Silverlight shares through the same transaction – a total of \$1.5 billion completely shielded by a \$712,080,170 “loss”<sup>378</sup> acquired from Barnville.

At the Titanium Trading Partners level, the transaction was essentially the same as the Johnson transaction, except that because Mr. Saban used (borrowed) cash in his transaction, it was possible to pass the cash around, and use it to buy actual securities, which eliminated the need for some of the documentation required for the Johnson transaction to set up and unwind debt relationships among the various entities.

In rough outline, the transaction took place in the following steps on September 21, 2001:

- HSBC loaned \$800 million to Silverlight,<sup>379</sup> a partnership of Haim Saban, family members, and family trusts,<sup>380</sup> which owned approximately \$830 million of FFWW stock.<sup>381</sup>
- Silverlight contributed \$732 million of the HSBC cash to the capital of Titanium Acquisition Corporation (TAC), a Delaware corporation formed on August 17,

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<sup>377</sup> On 9/13/01, HSBC Private Banker Ms. Pan drafted a recommendation to modify the loan distribution terms:

“In light of the market situation, the stock market will only reopen on Monday 9/17/01 but it may not be feasible to purchase \$760 million of stocks and execute the collar transaction of this size until a few days later when the market is settled. However, to meet the tax code requirement, Silverlight must be funded by 9/17/01 before we can have the collar in place. Approval is thus requested to allow funding of the loan on 9/17/01 (subject to proper documentation) with the funds being placed in a collateralized account in name of Silverlight Enterprises, L.P. until the collar can be executed.”

9/13/01 email from Ms. Pan to Mr. Yu and Mr. Schreiber (HUI0004252). Russell Schreiber modified the recommendation by inserting the words “business purpose and” before “tax code requirement.” 9/13/01 email from Mr. Schreiber to Ms. Pan and Mr. Yu (HUI0004253).

<sup>378</sup> Chuck Wilk Representation Certificate attached to Bryan Cave Tax Opinion (HUI 0001169-70).

<sup>379</sup> HSBC summaries of account activity pertaining to Saban transaction (HUI0000023-35).

<sup>380</sup> 7/13/06 letter from King & Spaulding LLP to the Subcommittee at 1-2.

<sup>381</sup> 8/22/01 HSBC Credit Memorandum (HUI0000720-40).

2001,<sup>382</sup> for the purpose of acquiring the trading partnership with the basket of stock. Silverlight received TAC stock in return. At the same time, Silverlight loaned the balance of the \$800 million loan to TAC in exchange for a \$68 million debenture.<sup>383</sup>

- Pursuant to the TAC operating agreement<sup>384</sup> and an Assignment of Rights Agreement,<sup>385</sup> Barnville contributed a basket of stock selected by Quellos from the Barnville/Jackstones portfolio to Titanium Trading Partners (TTP), a Delaware Limited Liability Company (LLC) formed by Barnville and Euram subsidiary EAICS that elected to be taxed as a partnership. The basket of stock was worth approximately \$680 million, but had a purported cost basis, based on the Barnville/Jackstones trades, of \$1.481 billion.<sup>386</sup> In addition, Barnville contributed approximately \$88.7 million of additional securities that it acquired with the funds received from TAC in the next steps of the transaction several days later. The \$88 million additional shares did not have any built in loss.<sup>387</sup> The combined value of the total basket was approximately \$769 million as of September 21.
- Barnville, TTP, and Jackstones entered into the previously mentioned “Assignment of Rights Agreement,” similar to the Novation Agreement in the Johnson trade. Under this agreement, the three parties acknowledged that what Barnville contributed to TTP was its rights to return of the shares from Jackstones under the stock lending agreement, and Jackstones agreed to deliver the shares on demand to TTP, rather than to Barnville. Barnville retained the obligation to return the cash collateral to Jackstones if TTP called for delivery of the shares.<sup>388</sup>
- TTP issued a Global Call Warrant to Euram subsidiary EAISL for a premium of \$345,273,000.<sup>389</sup> The warrant contained a provision that, if the basket of stock was sold by TTP, EAISL reserved the right to “put” the warrant back to TTP at any time, in exchange for a return of the entire premium, plus all interest earned while it was

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<sup>382</sup> Organization Meeting by Written Consent of Sole Shareholder of Titanium Acquisition Corporation (PSI-QUEL24925-26).

<sup>383</sup> 7/13/06 letter from King & Spaulding LLP to the Subcommittee at 2. A debenture is an unsecured bond or debt instrument.

<sup>384</sup> Operating Agreement of Titanium Trading Partners, LLC (PSI-QUEL26640-77).

<sup>385</sup> Assignment of Rights Agreement (PSI-QUEL26679-96).

<sup>386</sup> Chuck Wilk Representation Certificate attached to Bryan Cave Tax Opinion (HUI0001169-70)

<sup>387</sup> Id.

<sup>388</sup> Assignment of Rights Agreement (PSI-QUEL26679-96).

<sup>389</sup> Subscription Agreement (PSI-QUEL26697-703); 9/21/01 Global Call Warrant (PSI-QUEL23726-39).

invested. TTP agreed to let EAISL hold the premium in an account on EAISL's books.

Three days later, on September 24, 2001, the following additional steps occurred:

- TAC used \$769 Million of the cash received from Silverlight to purchase a 99 percent interest in TTP from Barnville,<sup>390</sup> and Ms. Saban purchased the remaining 1 percent of TTP shares from Euram's subsidiary for \$7.8 million.<sup>391</sup>
- In a step which did not occur in the Johnson transaction, Barnville transferred \$667 million<sup>392</sup> of the cash borrowed from HSBC to Jackstones, as a return of the cash collateral and Jackstones transferred the cash to HSBC to purchase shares of the same stocks as in the original basket, for delivery to TTP's custody account at HSBC. Because HSBC required that all accounts through which the cash or securities flowed be maintained at HSBC, these transactions happened almost simultaneously.<sup>393</sup> Under a Stock Loans Unwind Agreement executed September 24,<sup>394</sup> the payment from Barnville to Jackstones fulfilled Barnville's obligation to return approximately half of the original "cash collateral" related to these shares.<sup>395</sup>
- Barnville transferred an additional \$101 million directly to HSBC to acquire additional securities for TTP's account,<sup>396</sup> representing the shares it purportedly contributed on September 21.
- TTP purchased a collar from HSBC on the complete basket of stock. The collar included a "put" at 100 percent of the original purchase price, to protect against any decline in the value of the securities, and a "call" at 108 percent of the purchase price,

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<sup>390</sup> Membership Interest Purchase Agreement – Titanium Acquisition Corporation and Barnville Limited (PSI-QUEL24404-26).

<sup>391</sup> Membership Interest Purchase Agreement – Cheryl Saban and EAICS (PSI-QUEL24438-58).

<sup>392</sup> The difference between this amount and the amount of securities purportedly contributed to TTP on September 21 appears to result from market swings in the volatile stocks in the basket over the three day period.

<sup>393</sup> Subcommittee deposition of Russell Schreiber (7/18/06) at 53; HSBC Cash Flows Diagram (HUI0000477) and Transaction Breakdown (HUI0000421).

<sup>394</sup> Stock Loans Unwind Agreement (PSI-QUEL26713-17).

<sup>395</sup> The cash collateral attributable to the shares in the TTP basket would have been equal to the original purchase price of approximately \$1.481 billion, not just the present fair market value of \$769 million. The Subcommittee found no document explaining why Jackstones would give up the shares to TTP when Barnville was giving back cash collateral equal to only the present, diminished value of the stock instead of the full original purchase price it was entitled to.

<sup>396</sup> HSBC Silverlight Enterprises LLP Transaction Breakdown (HUI0000421).

which would limit the amount of profit to 8 percent of the purchase price.<sup>397</sup> In other words, because of the collar, the taxpayer could not realize an economic loss on the securities while his partnership held them, and his possible gross profit, before costs and fees, was capped at 8 percent.

Throughout this process, HSBC required that all bank accounts and securities custody accounts for all entities involved in the POINT transaction be maintained at the bank, so that the bank would have complete control over the funds and the real stock through all steps in the process.<sup>398</sup> As a result, the money never left the bank, but passed from account to account, until the point came to purchase securities, and then the securities were moved from one HSBC custody account to another, so that the bank's security interest securing the loan would at all times be protected until the stock was sold. At that point, the proceeds would again be placed and maintained in accounts at the bank until the loan was repaid.

As of September 24, 2001, HSBC estimated that its total fees on the transaction would be \$8,890,000.<sup>399</sup>

While the Titanium Trading Partners transaction was playing out, Mr. Saban's partnership, Silverlight, which now owned 99 percent of Titanium Acquisitions, as well as about \$830 million of FFWW stock with a very low basis, engaged in another step in the transaction that was unique to Mr. Saban's case. Because approximately half of Mr. Saban's FFWW interest was held by Silverlight, Quellos added an additional step to Mr. Saban's POINT transaction that would eliminate and not just defer the tax on Silverlight's FFWW stock. On September 28, 2001, Silverlight transferred all of the TAC stock it had just acquired to Mr. and Mrs. Saban in complete liquidation of their partnership interests. At the same time, Silverlight transferred the Debenture it had acquired from Titanium Acquisition Corporation to another Silverlight partner in liquidation of its interest. As a result of these two distributions, Silverlight claimed an increase, or "step up," in the tax basis of its remaining assets – the FFWW stock – in the amount of about \$760 million, which allowed it to sell \$760 million of the FFWW stock essentially tax free. This tax savings was in addition to the tax saved on Mr. Saban's half of the FFWW stock based on the loss stock now contained in Titanium Trading Partners. At the time, this "step up" in basis was allowed (assuming the underlying POINT transaction had economic substance) by section 734(b)(1)(B) of the tax code. In other words, the way this provision of the partnership tax law was written in 2001, Quellos was able to design this part of the POINT

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<sup>397</sup> 9/24/01 Collar Confirmation (PSI-QUEL23686-93).

<sup>398</sup> 8/22/01 HSBC Credit Memorandum ("All parties to this transaction must have accounts with HSBC such that loan the proceeds [sic] and the stock portfolio and the collar will all be controlled in-house.") (HUI0000720-40, at 37).

<sup>399</sup> 9/24/01 email from Mr. Yu to Joseph M. Petri (HUI0004357)(although a portion of the loan fees projected in this email were subject to being reduced if the loan were paid off before the full 120 day term, the full amount was actually paid.) See also Titanium Trading Partners LLC Daily Report as of November 13, 2001 (PSI-QUEL28891).

transaction to, in theory, allow Mr. Saban a double tax benefit for his investment. Section 734(b)(1)(B) was amended in 2004 to avoid this result in future cases.<sup>400</sup>

After the TAC stock was distributed to the Sabans and Silverlight took its step up in basis, it sold the FFWW stock to Disney on October 24, 2001, and reported a loss on the sale of approximately \$2 million.<sup>401</sup> It used the cash received from the sale to pay off the \$800 million HSBC loan that financed the POINT transaction.<sup>402</sup>

After the September 24, 2001 acquisition of the securities and the purchase of the collar, Mr. Saban, his representatives, and Quellos began to closely monitor the securities, looking for an appropriate time to get out of the trade with as much gross profit as possible, considering the volatility of the market. Quellos provided daily summaries of the stock prices to assist in this process.<sup>403</sup> After approximately two months, Mr. Saban decided he wanted to liquidate the portfolio to avoid losing the gains that had been made since September 24. Quellos thought there was still some prospect for additional upward movement in the prices, and Mr. Saban agreed to a compromise, in which they would sell off 75 percent of the basket and hold the rest. A day later he decided to sell completely. As a result, the securities were sold over the two day period of November 12<sup>404</sup> and 13, 2001.<sup>405</sup> The collar was unwound in two stages on the same dates,<sup>406</sup> and the Global Call Warrant was put back to Titanium Trading Partners by EAISL,<sup>407</sup> which cancelled the premium that was purportedly due to Titanium on the warrant.<sup>408</sup>

By the time the Titanium Trading Partners basket was sold and the warrant unwound, Mr. and Mrs. Saban had contributed their FFWW stock, through intermediaries, into Titanium

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<sup>400</sup> American Jobs Creation Act of 2004, section 833(c)(1). P.L. 108-37, 118 Stat. 1418, 1591 (10/22/04).

<sup>401</sup> 7/13/06 letter from King & Spaulding LLP to the Subcommittee.

<sup>402</sup> 10/23/01 email from Ms. Pan to Adam Chesnoff and Matthew Krane (PSI-QUEL23097).

<sup>403</sup> See, e.g., 9/26/01 email from Mr. Hirata to Mr. Chesnoff, Mr. Saban, and Mr. Krane transmitting Daily Performance Update (PSI-QUEL39489); 9/26/01 sample Daily Report (PSI-QUEL28976).

<sup>404</sup> 11/12/01 email from Mr. Schreiber to Mr. Hansen, Re Partial buyout of Collar (PSI-QUEL23448).

<sup>405</sup> 11/13/01 email from Mr. Schreiber to Mr. Hansen (PSI-QUEL23447).

<sup>406</sup> 11/12/01 collar unwind transaction confirmation (PSI-QUEL24475); 11/13/01 Amended Transaction Cancellation Agreement (PSI-QUEL23695-96).

<sup>407</sup> 11/16/01 letter from EAISL to Titanium Trading Partners LLC (PSI-QUEL26718-19).

<sup>408</sup> 12/31/01 EAISL Statement of Account (PSI-QUEL23701).

Trading Partners<sup>409</sup> and Titanium Trading Partners had sold the FFWW stock to Disney.<sup>410</sup> The built-in loss claimed on the Barnville basket when HSBC sold the securities on November 12 and 13, 2001, together with the costs incurred on the unwind of the collar, amounted to approximately \$699 million, which more than offset the approximately \$686 million realized on the sale of FFWW to Disney.<sup>411</sup>

Thus, Mr. Saban was able to offset approximately \$1.446 billion in gain from FFWW stock sales, \$760 million through Silverlight and \$686 million through Titanium Trading Partners.

As was the case in the 2000 Reka transaction, Quellos and Euram prepared the operative documents for execution long after the fact, notwithstanding that they all bore dates of September 21 and 24, 2001. For example, in an email dated June 4, 2002, Brian Hanson of Quellos wrote to Mr. Saban's representative Matthew Krane:

“Attached is a copy of the WRITTEN CONSENT OF THE SOLE DIRECTOR OF TITANIUM ACQUISITION CORPORATION prepared by Bryan Cave [tax counsel retained by Quellos for the Saban transaction] with respect to the paid-in capital account. Bryan Cave has indicated to us that any amounts that are not declared as paid-in-capital are considered surplus under Delaware law. The resolution should be dated 9/24/01.”<sup>412</sup>

Similarly, in September 2002, a year after the events, Quellos decided to create an entire set of books for Titanium Trading Partners because Bryan Cave needed to say in their opinion that they had inspected the books. Brian Hanson wrote Arfan Shaikh at Euram: “[W]e need to construct what has been deemed the ‘books and records’ of TTP. Bryan Cave is opining to certain elements of the transaction that require that they have seen such books and records.”<sup>413</sup> Mr. Hanson asked that Euram send over what they had, and a week later Mr. Arfan responded with the following message:

“I’m couriering over the Saban material today so you should get it tomorrow. ... You should, however, note the following:

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<sup>409</sup> 7/13/06 letter from King & Spaulding LLP to the Subcommittee; Copies of Stock assignments (KS-00001022, 24, 26, 35, 43, and 50).

<sup>410</sup> 7/13/06 letter from King & Spaulding LLP to the Subcommittee.

<sup>411</sup> Id.

<sup>412</sup> 6/4/02 email from Mr. Hanson to Mr. Krane (PSI-QUEL39555).

<sup>413</sup> 9/25/02 email from Mr. Hanson to Mr. Shaikh (PSI-QUEL39559).

“1. All the documents have been executed by our counterparties (by which I mean Barnville, Jackstones, European American Investment Corporate Services, EA Investment Services and Titanium Trading Partners (for the brief time we were the managing member)). A number of documents have not been signed by your counterparties. As you know, I have chased for these signatures on many occasions (and I know you have also done this). I expect as a quid pro quo for providing these documents that we will receive a full bible of transaction documents that were executed.

“2. I have no confidence that the documents that I am sending you were the ones that were shown or signed by your clients. I think that the body of the documents are fine but I do recall that cash flows and maybe the portfolio of stock was adjusted at the last minute without our involvement. For this reason, I would ask that you look at the schedules of the relevant agreements to ensure that the stocks, numbers and purchase price are as you understand them to be.

“3. In particular, the irrevocable instructions to HSBC present me with the biggest problems. These were changed on a number of occasions ( even though they were meant to be ‘irrevocable’) and we were not involved in any of these alterations. I chased HSBC for their countersignature on these documents for months and finally got some unsatisfactory faxed signature pages where the numbers had been altered (without our prior consent). I would recommend that you check these very thoroughly before handing them over to the lawyers.

“4. We had no involvement in Titanium Trading Partners (other than negotiating the operating agreement) and Titanium Acquisition Corp. We therefore can contribute very little to the books and records of those corporations.”<sup>414</sup>

Notwithstanding the defects in the documents as of October 2, 2002, Quellos was able to produce a set of books for Titanium Trading Partners that satisfied the legal opinion writers by November 25, 2002, when the opinions were delivered.<sup>415</sup>

The firm Quellos decided to use for the Saban tax opinions was Bryan Cave. Founded in Saint Louis, Missouri, in 1873,<sup>416</sup> Bryan Cave now has offices in thirteen cities, including Los Angeles, New York, Shanghai, and Kuwait.<sup>417</sup> Its practice areas include “regulatory/tax,”

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<sup>414</sup> 10/2/02 email from Mr. Shaikh to Mr. Hanson (PSI-QUEL26915-17).

<sup>415</sup> U.S. Federal Income Tax Opinion to Titanium Trading Partners LLC (KS-00001092-1192); U.S. Federal Income Tax Opinion to Silverlight Enterprises LP (KS-00001226-1327).

<sup>416</sup> Bryan Cave website, [www.bryancave.com/firm/history.asp](http://www.bryancave.com/firm/history.asp) (viewed 7/13/06).

<sup>417</sup> Id. at [www.bryancave.com/firm/locations.asp](http://www.bryancave.com/firm/locations.asp).

“business/transactional,” and litigation.<sup>418</sup> The firm’s lawyers practice in Client Service Groups (CSGs), or Industry Practice Teams, one of which is Tax Advice and Controversy.<sup>419</sup>

The first work Bryan Cave did for Quellos on the POINT transactions was at the very end of the Robert Wood Johnson IV transaction, when he and his advisors decided to move assets from Reka, which was a Cayman Islands entity, to Reka I LLC, which was established in Delaware. This process, which Quellos referred to as “domesticating” the partnership entities, required the preparation of legal documents, and Bryan Cave was retained to do this.<sup>420</sup> Later, the firm became involved in the second group of POINT transactions. Bryan Cave not only prepared the legal opinions for the Saban transaction, they assisted in drafting transactional documents, some in advance of the transaction, as well as the detailed factual representations it asked Mr. Saban to sign, on which the opinion was premised. The process followed seems to have been to determine the desired result to be reached in the opinions, and then to draft documents and factual representations that supported that result.

For example, in an email dated approximately three weeks before the Saban transaction commenced, Bryan Cave attorney Lana Phillips sent Quellos draft consents relating to the Saban trading partnership, which was to be called Titanium Trading Partners LLC, with the following comments:

“These 4 consents were drafted in one document to make them easier for us to keep track of. Unfortunately, when they were drafted they were not done in any particular order, so that when you open the whole document to print, the order of the consents inside seems a bit confusing. Sorry about this. I’d rather not indicate the sequence of these documents in their titles because the creation and ownership of the LLC by Barnville and EAICS must be completely independent from the later transfer to and ownership by TAC [Titanium Acquisition Corporation] and Cheryl [Saban]. Showing a clear sequence seems to betray that independence. When these documents are sent to be executed, we will place them in correct order and give explicit instructions as to the order of signing. To make your review easier for now, I have included boxes in the upper right-hand showing ‘DRAFT - Document \_\_\_.’... Once we’ve received final approval, we will take off the “DRAFT” legend and send out the final copies for signature. (I will also be sure to take off the document number from these docs.)”<sup>421</sup>

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<sup>418</sup> Id. at [www.bryancave.com/practice/practice.asp](http://www.bryancave.com/practice/practice.asp).

<sup>419</sup> Bryan Cave website, [www.bryancave.com/practice/csglist.asp](http://www.bryancave.com/practice/csglist.asp) (viewed 7/23/06).

<sup>420</sup> See, e.g., 8/23/00 email from Mr. Robbins to Mr. Hirata (PSI-QUEL27131)(“can you gather a documentation package for Burgundy and Reka for Bryan Cave”); 9/22/00 email from Lana Phillips (Bryan Cave) to Eric Schuehle (PSI-QUEL27125)(“am working with Betsy Smith on the domestication of both Burgundy and Reka.”).

<sup>421</sup> 9/4/01 email from Ms. Phillips to Mr. Hanson (PSI-QUEL23126)

In other words, the consents were part of a carefully orchestrated series of steps that all of the participants needed to understand, but the documents were being drafted to create the appearance that they were being separately executed by independent parties engaged in an arm's length transaction.

The legal opinions prepared by Bryan Cave<sup>422</sup> were based on extensive factual representation statements signed by various persons, including Mr. Saban, who signed representation statements on behalf of himself,<sup>423</sup> Titanium Acquisition Corporation,<sup>424</sup> and Titanium Trading Partners.<sup>425</sup> Mr. Saban told the Subcommittee that he did not read these representation statements before signing them and that, on reading some of the representations now, could not have attested to the matters covered if he had read them at the time. He said the extent of his discussions with Bryan Cave lawyers was a single meeting in which he spent about half an hour answering their questions about the investment portion of the plan. Otherwise, all of his communications with Bryan Cave were through his personal tax lawyer, Matthew Krane, who handled all of the technical matters. Some of the items he said were completely inaccurate, such as the statement in paragraph 16 of his own representation statement<sup>426</sup> that he had numerous meetings with Matt Krane to resolve their differences over how his partnership Silverlight should invest in Titanium Trading Partners. He told the Subcommittee that he never wanted to invest partnership funds in things Matt Krane said were inappropriate, as the representations said. With respect to a number of other paragraphs, he said that if he had been asked to read the document at the time, he would have said to take the paragraphs out, because he had no idea what they were talking about.<sup>427</sup> He also signed detailed factual representations for Titanium Acquisitions and Titanium Trading partners, but said he had no idea what role the foreign entities played in the transaction.<sup>428</sup>

The statement of facts in the opinion itself contains an extensive recitation of events, and enumerates one or more business purposes for every aspect of the structure designed by Quellos. However, the statement of facts does not mention that tax consequences were ever discussed or

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<sup>422</sup> U.S. Federal Income Tax Opinion to Titanium Trading Partners LLC (KS-00001092-1192); U.S. Federal Income Tax Opinion to Silverlight Enterprises LP (KS-00001226-92).

<sup>423</sup> Haim Saban Representation Certificate attached to Bryan Cave Tax Opinion to Titanium Trading Partners LLP (KS-00001092-1192, at 1158-62).

<sup>424</sup> Titanium Acquisition Corporation Representation Certificate attached to Bryan Cave Tax Opinion to Titanium Trading Partners LLP (KS-00001092-1192, at 1185-90).

<sup>425</sup> Titanium Trading Partners Representation Certificate attached to Bryan Cave Tax Opinion to Titanium Trading Partners LLP (KS-00001092-1192, at 1191-92).

<sup>426</sup> Haim Saban Representation Certificate attached to Bryan Cave Tax Opinion to Titanium Trading Partners LLP (KS-00001158-62).

<sup>427</sup> See, e.g., *Id.*, paras. 21, 24, 25, 27, 29, and 31.

<sup>428</sup> Subcommittee interview of Mr. Saban (7/19/06).

considered. In fact, the only statements pertaining to tax losses are one reference to the amount of the basis acquired and the decline in value of the stocks, and a sentence at the end of the fact recitation that “the amount of gains and losses with respect to those sales of the Portfolio is set forth in a chart labeled Exhibit A.”<sup>429</sup> There is no suggestion in the statement of facts that the Sabans were acquiring a tax loss over \$700 million more than their investment in Titanium Trading Partners. The legal analysis portion of the Bryan Cave opinion states in several places that the parties involved in Titanium Trading Partners expected to make, and had a purpose of making a pre-tax profit independent of any tax benefit, but without characterizing the amount of the expected profit or comparing it with the expectation of a tax loss.

John Barrie of Bryan Cave, who wrote the opinion, told the Subcommittee that he and his associates prepared the representations after extensive consultation with Mr. Saban’s lawyer Matthew Krane, and after one meeting of about an hour with Mr. Saban and Mr. Krane during which Bryan Cave satisfied themselves that Mr. Saban understood the outlines of the transaction and had a profit motive for entering into the transaction. His recollection was that the representations were sent to Mr. Saban in New York for review and that Bryan Cave got a confirmation by voicemail that he had read and understood them and agreed with them.<sup>430</sup>

Some of the key facts in the opinion, such as the basis in the loss stock, were attested to by Chuck Wilk of Quellos in a representation letter signed by him.<sup>431</sup> Other important facts were contained in representations signed by Barnville and others, including verification of what was contributed to Titanium Trading Partners,<sup>432</sup> and Bryan Cave appears to have relied on those representations. Mr. Barrie told the subcommittee that Bryan Cave primarily looked to Quellos for information about the Barnville Portfolio. Although there was an ambiguity in the representation when it said Barnville contributed its “positions” in certain stocks, Mr. Barrie told the Subcommittee that he understood that what Barnville contributed to Titanium Trading Partners was outright ownership of shares.<sup>433</sup> He said he was not informed that Barnville had acquired the securities from Jackstones in a short sale that was immediately covered by a loan of the same stocks back to Jackstones, or that the purchase price owed to Jackstones was offset by an equal amount of cash collateral owed to Barnville by Jackstones.<sup>434</sup> However, a Bryan Cave memorandum dated June 28, 2002, listing documents they required for their “due diligence” prior to issuing an opinion includes the Barnville/Jackstones stock purchase agreements, the

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<sup>429</sup> Bryan Cave Tax Opinion to Titanium Trading Partners LLP at 18-19 (KS-00001092-1192, at 1185-90).

<sup>430</sup> Subcommittee interview of Mr. Barrie (7/28/06).

<sup>431</sup> See, e.g., Chuck Wilk Representation Certificate attached to U.S. Federal Income Tax Opinion to Titanium Trading Partners LLC (KS-00001092-1192, at 1169-78).

<sup>432</sup> See, e.g., Barnville Limited Representation Certificate attached to U.S. Federal Income Tax Opinion to Titanium Trading Partners LLC (KS-00001092-1192, at 1188-90).

<sup>433</sup> Subcommittee interview of Mr. Barrie (7/28/06).

<sup>434</sup> Id.

global securities lending agreement, and the confirmations of individual securities loans corresponding to each stock purchase agreement.<sup>435</sup>

Unlike Mr. Steinberg of Cravath, Swaine & Moore, Bryan Cave does not appear to have assisted in the design of the basic POINT structure, although they did extensive transactional work to mesh the POINT structure with Mr. Saban's existing structure of family trusts and partnerships. They also did considerable work on the drafting of transaction documents which gave them full knowledge of the sequence of steps in the transaction and the close proximity in time of many of the planned steps. For example, they were fully aware that the five year warrant was extinguished shortly after the Sabans acquired Titanium Trading Partners. However, Mr. Barrie indicated that he was not aware that the elimination of the warrant had any effect on the profit calculations.<sup>436</sup>

The fees charged by Bryan Cave for work on the point transaction were billed to Quellos. Their fees for the Saban transaction totaled \$1.3 million.<sup>437</sup> However, since they were billed to and paid by Quellos, they are included within Quellos fees.<sup>438</sup>

Mr. Saban told Subcommittee staff that Matthew Krane explained that the total fees on the Quellos transaction would be around \$50 million.<sup>439</sup> He does not remember if Krane gave him an estimate of how much "profit" he might make on the stock transaction, but he said he thought he ultimately made some money on that part of the deal, considering only the fees relating to the stock transaction itself. However, he also said he considered that the total fees were for the total package (the tax transaction and the stock transaction) and said he clearly did not make enough on the stock trade to cover the total amount of fees and costs.<sup>440</sup>

In fact, the total gross profit on the trade reported to Mr. Saban by Quellos was \$129,927,084, which was reduced by the costs associated with the collar to \$13,167,623. After

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<sup>435</sup> 7/28/02 Bryan Cave Memorandum to Mr. Wilk and Mr. Krane (PSI-QUEL23703-08).

<sup>436</sup> Subcommittee interview of Mr. Barrie (7/28/06).

<sup>437</sup> Id.

<sup>438</sup> 3/1/01 Letter Agreement, Re: Haim and Cheryl Saban, the Alpha Family Trust, Silverlight Enterprises, L.P. (KS-00001062-72).

<sup>439</sup> In a letter dated 7/13/06, Mr. Saban's counsel provided the Subcommittee with a schedule of professional fees related to the POINT transaction and the Fox Family World Wide sale. This schedule included \$7,688,611 for Euram and \$53,909,930 for Quellos. The letter stated that the expenses on the schedule (totaling over \$90 million in all) contained some attributable to the FFWW sale to Disney and that they had no clear way of breaking the fees out according to subject. However, the Subcommittee has seen no documents suggesting that Quellos actually provided any services to Mr. Saban other than in connection with the POINT transaction.

<sup>440</sup> Subcommittee interview of Mr. Saban (7/19/06).

subtracting additional loan fees, Euram's structuring fee of \$7,688,611,<sup>441</sup> and interest expenses, Quellos estimated the total gain to be \$1,827,183.<sup>442</sup> However, this estimate did not take into account any of the fees paid to Quellos in connection with setting up the POINT structure. The total paid under the initial compensation agreement was \$46,312,500.<sup>443</sup> In addition, under a separate agreement,<sup>444</sup> Quellos received a 17 percent "performance fee" in the amount of \$7,597,430<sup>445</sup> that was paid out of the "gross profit" on the stock trade. Taking this performance fee alone into account would reduce the "profit" to a \$6 million loss. Taking all the Quellos fees into account would produce a true economic loss on the trade of around \$40,000,000. Of course, if the transaction is viewed in the context of its true purpose of generating \$1.5 billion in tax losses, it was extremely profitable.

Quellos' total compensation for the Saban POINT trade was \$53,909,930, which Quellos allocated between Silverlight and Titanium Trading Partners.<sup>446</sup> The compensation agreement under which the fees were paid expressed them as a percentage – 3.25 percent – of the total gross proceeds on the sale of FFW stock, up to a maximum of \$1,490,000.<sup>447</sup> Since the target was "full tax deferral of the Disney sale, ad infinitum" (approximately \$1.5 billion, including the losses at both the Titanium Trading Partners and Silverlight levels), setting the fee at a percentage of the sales proceeds was effectively the same as pegging it to the loss.

When shown the circular nature of the trades between Barnville and Jackstones that created the basis for the tax loss, and the emails between Euram and Quellos regarding the need to inform the client's representatives of the nature of those trades, Mr. Saban told Subcommittee staff that he was never informed of that and had no idea of how the losses were created. His reaction to this information was: "You have before you a very disappointed person, who feels misled, lied to, cheated."<sup>448</sup>

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<sup>441</sup> The report does not attribute this fee to Euram, but Mr. Saban's counsel has informed the Subcommittee that this was the amount of Euram's total fee. 7/13/06 letter from King & Spaulding LLP to the Subcommittee.

<sup>442</sup> 11/13/01 Titanium Trading Partners Daily Report (PSI-QUEL26588).

<sup>443</sup> 10/24/01 email from Mr. Wilk to Ms. Pan (HUI0004387).

<sup>444</sup> Investment Advisory Agreement (KS-00001080-88).

<sup>445</sup> 11/13/01 email from Mr. Hirata to Ms. Pan (PSI-QUEL39534); 11/19/01 wire transfer instructions (PSI-QUEL40188).

<sup>446</sup> 7/13/06 letter from King & Spaulding to the Subcommittee at 6; 10/24/01 email from Mr. Wilk to Ms. Pan (HUI0004387).

<sup>447</sup> 3/1/01 Letter Agreement, Re: Haim and Cheryl Saban, the Alpha Family Trust, Silverlight Enterprises, L.P. (KS-00001062-72).

<sup>448</sup> Subcommittee interview of Mr. Saban (7/19/06).

## VIII. THE WYLY CASE HISTORY

The case histories just discussed provide recent examples of how U.S. persons, guided by U.S. and offshore professionals, have engaged in increasingly sophisticated efforts to hide assets, shift income offshore, and dodge U.S. taxes. The following case history shows how, over a thirteen-year period from 1992 to 2005, two U.S. citizens, Sam and Charles Wyly, guided by an armada of attorneys, brokers, and other professionals, transferred at least \$190 million in stock options and warrants to a complex array of 58 offshore trusts and shell corporations. It shows how the Wyllys and their advisers directed the exercise of those stock options and warrants, used the shares to generate investment gains, and used at least \$600 million in untaxed offshore dollars to provide substantial loans to Wyly interests, finance business ventures, acquire U.S. real estate, and purchase furnishings, art, and jewelry for the personal use of Wyly family members.

This case history illustrates the roles played by legal, financial, and other professionals, as well as offshore service providers, to build and manage the Wyly-related offshore network and conceal the Wyllys' continued direction and enjoyment of the offshore assets. It also illustrates the use of a number of offshore mechanisms that raise policy concerns, including stock option-annuity swaps; pass-through loans using an offshore vehicle; securities traded by offshore entities associated with corporate insiders; and the use of hedge funds and other investment vehicles to control use of funds placed offshore. Together, these transactions comprise the most elaborate offshore operations reviewed by the Subcommittee.

### A. Introduction

The Subcommittee began its investigation of this case history in April 2005, after Sam and Charles Wyly filed a publicly available SEC form disclosing their association with certain offshore entities that owned substantial shares of a public company, Michaels Stores Inc., that has long been associated with the Wyllys.<sup>449</sup> To examine this matter, the Subcommittee consulted with securities, tax, trust, and offshore experts, conducted numerous interviews, and issued about 40 subpoenas. Subcommittee staff reviewed over 1.5 million pages of documents, including SEC filings, legal pleadings, correspondence, electronic communications, memoranda, trust agreements, incorporation documents, and financial records. While many persons cooperated with the investigation, others did not. Most Isle of Man and Cayman entities and residents, citing financial privacy laws in their jurisdictions that criminalize the disclosure of client-related information, declined to provide information, documents, or interviews in response to Subcommittee requests.<sup>450</sup>

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<sup>449</sup> See 4/7/05 Schedule 13D filed by Sam and Charles Wyly regarding Michaels Stores Inc.

<sup>450</sup> The Isle of Man entities that declined Subcommittee interview requests were Close Trustees (IOM) Ltd., IFG International, Inc., Lorne House Trust Company Ltd., the IOM office of Trident Trust Company, and Wychwood Trust Ltd. The Cayman entities and persons who declined Subcommittee interview requests were Michelle Boucher, Irish Trust Company, J.D. Hunter, Security Capital Ltd., and Queensgate Bank and Trust Co. Ltd. The Cayman law firm Maples and Calder consented to an interview but provided extremely limited information.

This part of the Report examines the offshore structure constructed for Sam and Charles Wyly. The evidence obtained by the Subcommittee shows that the Wyly brothers and their representatives exercised significant direction over the trust assets and investment activities of the offshore trusts established to benefit their families, raising U.S. tax, securities, and anti-money laundering compliance concerns.

U.S. tax treatment of trust income depends in large part upon the extent of control retained by the person who funded the trust, often called the grantor. If a grantor places assets in an irrevocable trust and gives up all control over the assets and the trust, the tax code generally treats the trust as a separate taxpayer that pays tax on the income earned from its assets. If the trust distributes income to a beneficiary, the trust gets a deduction for the amount distributed, while the beneficiary pays tax on the amount received, so that the income is taxed only once. On the other hand, if a grantor directly or indirectly retains significant control over the trust or trust assets, the tax code generally treats the trust as a “grantor trust” and generally attributes its assets and income to the grantor. In some cases where a grantor has in form established an irrevocable, independent trust, but in reality retained control over the operation of the trust and the trust’s assets, courts have ruled that the trust was a sham and attributed the trust assets and income to the grantor for tax purposes. In this case history, while the Wyllys and their representatives, acting with the advice of counsel, repeatedly represented that the offshore trusts established to benefit their families were independent entities for U.S. tax purposes, in fact, the Wyllys and their representatives continued to exercise significant direction over the trusts’ assets and investment activities.

U.S. securities law also often turns on the issue of control to determine when an entity must report stock holdings, observe trading restrictions, or refrain from selling securities while in possession of material nonpublic information about a public company. During the period examined in this Report, Sam and Charles Wyly were directors and large shareholders of three publicly traded corporations, Michaels Stores, Sterling Software Inc., and Sterling Commerce Inc. Accordingly, under U.S. securities law, both men held the status of corporate insiders, affiliates, and large shareholders of these three corporations, and were subject to special disclosure requirements, trading restrictions, and insider trading prohibitions. During the same period, both men transferred to the offshore entities compensatory stock options and warrants representing the right to purchase millions of shares in these three public corporations.

While the Wyllys and their representatives, on the advice of counsel, represented that the offshore entities holding the securities were independent legal entities for securities purposes, the Wyly representatives continually conveyed detailed information to the offshore entities on when and how to exercise the stock options and warrants, and trade the shares. Wyly representatives also directed the offshore entities to arrange their stock holdings to avoid SEC disclosure requirements for large shareholders. In addition, Wyly representatives repeatedly characterized the offshore entities as exempt from trading restrictions on affiliates, and conveyed directions for the entities to engage in securities transactions even during periods when the Wyllys may have had material, nonpublic information raising insider trading concerns. Due to Isle of Man secrecy laws and the decision of the Wyllys and the three public corporations not to include the offshore

entities in their SEC disclosure filings, for many years U.S. regulators and the investing public were unaware of the extent of these offshore stock holdings and trading activity. This case history raises policy concerns about the extent to which executives of U.S. public companies may be using offshore entities to circumvent U.S. securities requirements for corporate insiders.

Control is also key to many U.S. anti-money laundering laws which, for example, require U.S. financial institutions to determine the “beneficial owner” of an offshore trust or corporation before opening an account, to ensure they know who the client is and prevent suspicious persons from gaining entry into the U.S. financial system. When U.S. financial institutions pressed the Wyly-related offshore entities to disclose their beneficial owners, the offshore entities refused to provide specific names of the persons behind the trusts and corporations. Despite their inability to obtain required beneficial owner information, the financial institutions did not close the accounts held in the name of the offshore entities until the fall of 2004, after receiving subpoenas from U.S. law enforcement seeking information about the accounts.

A similar situation arose with respect to the obligation of U.S. financial institutions to file 1099 forms with the IRS reporting certain types of investment and dividend income paid to U.S. account holders. Here, the offshore entities filed W-8BEN forms with the U.S. financial institutions, representing that they were independent foreign entities not subject to 1099 reporting requirements. Although the financial institutions were aware of the entities’ relationship to the Wyllys, they chose not to treat them as U.S. accountholders subject to 1099 reporting.

In all of these activities, the Wyllys were aided by an armada of lawyers, brokers, financial professionals, and offshore service providers. These facilitators set up the offshore entities, provided advice and guidance on how best to structure, operate, and coordinate them, and provided legal, transactional, and administrative services that purportedly enabled the Wyllys to maintain direction over the offshore assets without negating the offshore entities’ status as allegedly independent actors for U.S. tax and securities purposes. Although many of these professionals took steps to create the appearance that the offshore trusts were independent entities, couching instructions to the offshore trustees as “recommendations” and obtaining paperwork from the trustees to buy, sell, or transfer trust assets, the reality behind these actions was that the Wyllys and their representatives continued to exercise significant direction over the assets they had moved offshore.

This case study underscores the fundamental incompatibility of U.S. tax, securities, and anti-money laundering requirements with existing practices in many offshore jurisdictions. Under U.S. law, who has control of assets is often a key factor in determining an individual’s tax, securities, and anti-money laundering obligations. As this and other case studies examined by the Subcommittee reveal, offshore jurisdictions typically permit trust grantors and beneficiaries to exert significant control over trust assets and activities, without compromising the allegedly independent legal status of the trusts and trustees. Given that secrecy laws in many offshore jurisdictions where offshore trusts are located make it virtually impossible to detect the identity of trust grantors and beneficiaries, and to determine the extent of their control over trust assets and activities, the potential for abuse is vast. U.S. law enforcement can and should be

strengthened to counter such abuse, and where necessary, U.S. laws themselves should be strengthened.

## **B. Case History Summary**

The Report examines the inception and development of the Wyly offshore structure over a thirteen year period, from 1992 to 2005, and analyzes key tax, securities, and anti-money laundering issues.

The first section examines how the offshore trusts functioned. The evidence shows that Sam and Charles Wyly exercised significant direction over the trust assets and the investment activities of the trusts established to benefit their families. The Wyllys and their representatives typically conveyed their decisions about trust assets to individuals named in the trust agreements as “trust protectors.” These trust protectors, who were selected by the Wyllys, were in constant communication with Wyly family members and their representatives. The trust protectors used a steady stream of telephone calls, correspondence, faxes, and electronic mail to convey decisions to the trustees of the offshore trusts. The trust protectors typically worded these decisions as “recommendations” to the offshore trustees who, in form under Isle of Man trust law, retained final decisionmaking authority over trust assets, but in practice simply carried out the “recommendations” provided to them. Over the thirteen years examined by the Subcommittee, the offshore trustees rarely questioned a “recommendation” made by a Wyly trust protector and typically implemented the “recommendation” within days of receiving it. The Subcommittee saw no evidence that the trustees acted independently to initiate or implement financial transactions or investments on their own.<sup>451</sup> Rather, the offshore trustees appear to have functioned as administrative cogs to implement the decisions conveyed to them by Wyly representatives about trust assets and activities.

Section two examines how assets were transferred to the offshore trusts. It shows how, over a ten year period from 1992 to 2002, Sam and Charles Wyly transferred offshore over 17 million stock options and warrants that had been awarded to them as compensation from Michaels, Sterling Software, and Sterling Commerce. They transferred these stock options and warrants, collectively worth at least \$190 million, to the offshore shell corporations owned by the offshore trusts benefitting their families. For most, the Wyllys received in exchange annuity agreements in which the offshore corporations promised to make future annuity payments to the Wyllys. Wyly legal counsel provided written legal opinions concluding that, because the stock options and warrants had been exchanged for annuities of equivalent value, the Wyllys did not have to pay taxes on the gains realized when the offshore corporations exercised the stock options and warrants. Instead, Wyly legal counsel advised that the Wyllys owed taxes only if and when they actually received the promised annuity payments from those corporations years later. Wyly legal counsel also provided assurances to the three public corporations that had issued the stock options to the Wyllys. They advised the public corporations that the offshore corporations

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<sup>451</sup> Because none of the offshore service providers supplied documentation or interviews to the Subcommittee, this analysis is necessarily based on information provided by other parties.

were independent of the Wyllys, and the public corporations thus did not have to not report any compensation to the IRS when the offshore corporations exercised the options, as no tax was due on the compensation until the promised annuity payments were made. In 2003, the IRS announced that similar stock option transactions were potentially abusive tax shelters, that the stock option holders should have paid tax on their stock option compensation, and the corporations issuing the stock options should have reported the compensation in 1099 or W-2 filings. The IRS later announced an initiative allowing persons and corporations who participated in such stock option transactions to settle their potential tax liabilities with reduced penalties. Michaels Stores applied to participate in this settlement initiative; the Wyllys did not.

Section three of this case history examines how the offshore entities used the stock options and warrants to generate millions of dollars in untaxed investment gains. Their first step was to exercise the stock options and warrants to obtain shares in the three U.S. corporations. The offshore entities then sold some shares for cash, pledged others to obtain loans, and engaged in a raft of other securities transactions such as collars, call options, equity swaps, and variable prepaid forwards. The decisions to engage in these transactions were made by the Wyllys and their representatives, and conveyed by the trust protectors to the offshore trustees who implemented them. Relying on advice from counsel, the Wyllys did not pay taxes on any of the offshore trusts' trading gains, even though the U.S. tax code generally requires that income earned by a trust controlled by a U.S. person who funded or is a beneficiary of the trust be attributed to that U.S. person for tax purposes. The Wyly legal position was that the offshore trusts were independent entities whose income was not attributable to any U.S. person.

The Wyllys also did not include the stock holdings of the offshore entities in their filings with the SEC until 2005, even though SEC regulations require large stockholders to disclose all of the shares they beneficially own as well as shares held by groups with whom they acted in concert to buy or sell the securities. Wyly legal and securities advisers took the position that the offshore trusts were independent entities whose securities did not have to be reported in the Wyly filings. Wyly legal advisers and representatives also helped the offshore entities to circumvent SEC disclosure requirements for major shareholders, represented to U.S. financial institutions that the entities were exempt from SEC trading restrictions on affiliates, and helped the offshore entities conduct securities transactions during periods when the Wyllys may have had material insider information. The brokers who carried out these securities transactions, with one exception, treated the offshore entities as nonaffiliates, even though they knew the Wyllys and their representatives exercised significant direction over the investment activities of the offshore entities. The three public corporations failed to disclose the offshore holdings in their SEC filings, even though they knew the offshore entities had large stock holdings and were associated with the Wyllys. As a result, for many years until 2005, U.S. securities regulators and the investing public were unaware of the extent of the Wyly-related offshore stock holdings and trading activity.

The next four sections of the Report examine how the Wyllys utilized untaxed offshore dollars to advance their business and personal interests in the United States. Each of these sections contains additional evidence of the extent of Wyly direction over the offshore assets. Section four shows how millions of untaxed dollars were returned to Wyly interests in the

United States using pass-through loans funneled through a Cayman shell corporation called Security Capital. Section five shows how more than \$600 million in untaxed dollars were invested in Wyly-related business ventures, including two hedge funds, a private equity fund, an offshore insurance company, and a U.S. energy business, all of whom used these funds on U.S. investments. Section six shows how about \$85 million in untaxed dollars were used to acquire U.S. real estate and build houses for use by Wyly family members. It also shows how untaxed dollars were used to finance real estate loans that supplied millions of offshore dollars to Wyly family members for their personal use in the United States. Section seven shows how nearly \$30 million in untaxed dollars were used to purchase furnishings, artwork, and jewelry for the personal use of Wyly family members. Each of these transactions was the result of decisions initiated and planned by the Wylys and their advisors, and not by the offshore trustees or the executives of the offshore corporations who executed them. Law firms provided guidance on how to structure these transactions purportedly to comply with U.S. tax and securities laws and drafted the paperwork needed for them to function; brokers facilitated the multi-million-dollar international wire transfers that financed this activity.

The final section examines issues related to compliance with U.S. anti-money laundering (AML) laws. Many of the offshore entities opened accounts with U.S. securities firms or the securities divisions of U.S. banks. For decades, U.S. banks have been obligated to “know their customers,” including the natural persons behind offshore corporations and trusts, to ensure that bank services are not misused to further misconduct. In 2001, the Patriot Act extended that requirement to U.S. securities firms who, until then, had operated AML programs on a voluntary basis. In provisions that became effective in 2002, the Patriot Act explicitly required U.S. banks and securities firms that open a private account with at least \$1 million for a non-U.S. person to “ascertain the identity of the nominal and beneficial owners” of the account.

In 2003, two U.S. financial institutions repeatedly asked the Wyly-related offshore entities to provide the names of their beneficial owners. While the offshore entities let it be known that they were associated with the Wyly family, they would not disclose the names of specific individuals associated with particular offshore entities. The offshore entities also submitted W-8BEN forms to the financial institutions, representing that they were independent foreign entities not subject to certain IRS requirements for reporting investment income paid to U.S. persons, even though U.S. taxpayers exercised significant direction over the offshore entities’ assets and investment activities. The financial institutions accepted the W-8BEN forms and allowed the accounts to continue operating without sufficient beneficial owner information, continuing to facilitate multi-million-dollar securities transactions and wire transfers across international lines. In the fall of 2004, however, after receiving subpoenas from U.S. law enforcement seeking information on the accounts held in the name of the offshore entities, the financial institutions closed the accounts.

Sam and Charles Wyly reaped a number of benefits from their offshore activities, including years-long deferral of taxes on millions of dollars in stock option compensation, nonpayment of taxes on millions of dollars in capital gains held by the offshore trusts they directed, a ready source of capital for their business ventures, and a ready source of funds to finance their personal interests. Among those affected by these offshore activities are the U.S.

Treasury, U.S. taxpayers who have to make up the lost revenue, and the investing public who were kept in the dark about the offshore stock holdings and trading activity of entities controlled by the directors of three publicly traded corporations.

### **C. Wyly Business Background**

To understand the investment activities undertaken by the Wyly-related offshore entities, background information about the business careers of Sam and Charles Wyly is necessary.<sup>452</sup> Both are successful businessmen who developed a number of privately held and publicly traded companies into profitable concerns. Samuel E. Wyly and Charles J. Wyly, Jr. were born in Lake Providence, Louisiana, and grew up during the Depression. Their first business venture was the University Computing Company, which they founded in 1963, developed into a nationwide computer service and software provider, and later sold in 1987. During the 1960s and 1970s, the brothers founded Datran Inc., a company intended to build transmission lines for computer communications; began Earth Resources Co., an oil refining and mining company; and acquired the Bonanza Steakhouse chain which they turned into a successful franchise business.

In 1981, the Wyly brothers, their colleague Sterling Williams, and others founded Sterling Software Inc. and developed it into a leading provider of business software and services, specializing in large data management. The company went public in 1983. In December 1995, it spun off a separate company, Sterling Commerce, Inc., specializing in software which enabled businesses to exchange information electronically. Sterling Commerce was incorporated in December 1995, and went public in March 1996. In 2000, both companies were sold. Sterling Software was sold to Computer Associates International, Inc. in a \$4 billion stock swap. Sterling Commerce was sold to SBC Communications, Inc. in a \$4 billion cash transaction. The Wyls had significant stock holdings in both of the companies that were sold.

The Wyly brothers also operated companies unrelated to the software field. In 1983, they purchased Michaels Stores, Inc., an arts and crafts retail chain, and over the following 20 years, took it public and expanded the chain to more than 1,000 stores. In 2006, Michaels announced that it was being sold to a consortium of private equity groups for \$6 billion.<sup>453</sup> In 1997, the brothers acquired Green Mountain Energy Resources, an energy company specializing in the marketing of clean energy. In March 1999, the company filed paperwork with the SEC to go public, but never did, instead attracting private investments from two energy companies, BP Amoco and Nuon NV, a Dutch utility.

In addition to these and other domestic business ventures, the Wyly brothers founded several businesses with offshore components. In 1990, Sam and Charles Wyly founded their first hedge fund, Maverick, which sponsored both domestic and offshore funds. Begun as a

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<sup>452</sup> The following information is taken from materials provided to the Subcommittee by the Wyls, and from various legal pleadings and SEC submissions.

<sup>453</sup> See, e.g., "Consortium Buys Michaels for \$6 Billion," New York Times (7/1/06).

Wyly family venture, Maverick was opened to other investors in 1993, and now manages assets in excess of \$11 billion. In 1994, the Wyly brothers and the Wyly family's legal counsel, Michael French, founded an offshore insurance company, Scottish Annuity Company (Cayman) Ltd. A companion company, Scottish Annuity & Life Holdings, Ltd., later renamed Scottish Re Group Ltd., went public in 1998, and recently purchased substantial insurance holdings in the United States. In 1995, the Wyly brothers founded another Cayman company called Irish Holdings Ltd.<sup>454</sup> Its only subsidiary, Irish Trust Company (Cayman) Ltd., holds trust company and mutual fund administrator licenses in the Cayman Islands. It provides administrative services to the Wyly-related offshore hedge funds and the Wyly-related offshore trusts and corporations. In 2000, Charles Wyly founded a private investment fund called First Dallas, which includes an offshore company, First Dallas International. In 2001, Sam Wyly founded a second hedge fund, Ranger, which, like Maverick, sponsors both U.S. and offshore investment funds.

Many of the offshore entities associated with the Wyly brothers were structured to benefit their children and wives.<sup>455</sup> Sam and Charles Wyly also established numerous domestic trusts, corporations, and partnerships to hold assets and conduct business, many of which also were structured to benefit their children and wives. A number of these domestic entities had dealings with the Wyly-related offshore entities. In addition, as the children of Sam and Charles Wyly came of age, they also entered the business world, establishing both domestic and offshore trusts, corporations, and partnerships. This Report does not address the Wyllys' domestic investments and holdings, except as they pertain to matters related to the Wyllys' offshore operations. It also does not discuss many of the offshore entities established by or on behalf of the Wyly children.

#### **D. Going Offshore**

Sam and Charles Wyly apparently first became interested in moving assets offshore during the early 1990s. In the spring of 1991, at the request of Sam Wyly, Sharyl Robertson, a key employee of the Wyly family,<sup>456</sup> attended a conference given by an advertised offshore

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<sup>454</sup> Irish Holdings was initially owned by the Bessie and Tyler Trusts, two Isle of Man trusts established to benefit Sam and Charles Wyly and their families. See, e.g., "The Irish Trust Company (Cayman) Ltd. Application for a Restricted Trust License," (PSI00120946-52); 6/6/96 memorandum from Sam to Charles (PSI00109863-64) ("Irish Trust company will remain owned 2/3 by Sam's Family and 1/3 by Charles' Family."). For more information about Irish Holdings and the Irish Trust Company, see below.

<sup>455</sup> In 1955, Charles married Caroline D. ("Dee") Wyly, and had four children, Martha, Charles ("Chip"), Emily and Jennifer. In 1960, Sam Wyly married Rosemary Acton and had four children, Evan, Laurie, Lisa and Kelly. In 1976, Sam Wyly divorced and, two years later in 1978, married Victoria L. ("Torrie") Steele. They had two children, Andrew and Christiana. Sam Wyly and his second wife separated in 1988 and divorced in 1990. In 1994, Sam married his current wife, Cheryl Wyly.

<sup>456</sup> The Wyly family employed a number of persons to administer their personal financial affairs; for many years, Ms. Robertson supervised these employees. More information about Wyly family employees and Ms. Robertson is provided below.

expert, David Tedder.<sup>457</sup> Ms. Robertson recalled that this conference had been open to the public and was attended by 20 to 40 other individuals. Afterward, Ms. Robertson wrote a 35-page memorandum entitled, “Asset Protection and Tax Deferral,” summarizing the information provided, and sent it to Sam and Charles Wyly, Michael French, and others.<sup>458</sup>

The Robertson memorandum summarized a wide range of issues presented by Mr. Tedder, including the type of assets that can be protected offshore, the establishment of domestic and foreign trusts, probate and wills, deferred compensation, tax havens, and offshore insurance. In each case, the memorandum described the topic in terms of asset protection and tax avoidance. The memorandum repeatedly referred to the IRS as a “creditor” against whom assets may be protected. Excerpts from her memorandum include the following:

“The three major sources of creditor problems – unknown creditor, IRS – inheritance, IRS – income tax. ...  
Whenever possible eliminate inheritance tax – Tedder says everyone can reduce it to zero. ...  
Whenever possible reduce income tax – both domestically and foreign. ...  
Never let a creditor get your asset, no matter how bad your mistake. (In 18 years of practice, Tedder’s firm has never had a creditor successfully pierce the asset protection setup)....  
You should own some minimal property at death in your name. Tedder recommends \$100. Why? Creditor[s] have a cutoff period of four months to make a claim against an estate, they are forever barred from making a claim thereafter. This includes all creditors – the known, unknown and the IRS. ...  
REAL ESTATE ... Sell Equity to FS [Foreign System] on a prom. note & Shared Appreciation ... Tedder mentioned (no names) two big real estate corporations sheltering \$45,000,000 a month thru this arrangement. ...  
If you own more than 30% of a corporation a creditor can force dissolution of the corporation with a judgment award. ... A creditor cannot force the sale of a partnership interest. ...  
The FLP [Family Limited Partnership] accomplishes the same thing as the Children’s Trust without being irrevocable. You still control and have access to the funds. ... You can always get funds out of the partnership and avoid the

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<sup>457</sup> Subcommittee interview of Ms. Robertson (3/9/06). Mr. Tedder, a lawyer based in California, apparently was not known to the Wylys prior to 1991, and stopped providing legal advice to them after 1993. Written presentation to the Subcommittee by Wyly legal counsel (5/15/06). Mr. Tedder apparently spent much of his career providing advice and services to U.S. citizens seeking to move assets offshore. In 2003, he was convicted of money laundering, conspiracy to defraud the United States, and assisting a wagering enterprise, for helping to conceal the movement of funds between U.S. gamblers and an offshore sports betting operation. He was fined \$1 million, forfeited in excess of \$2 million, and sentenced to five years in prison, a term which he is now serving. See United States v. Tedder, 403 F.3d 836 (7<sup>th</sup> Cir. 2005).

<sup>458</sup> Robertson interview (3/9/06); 6/12/91 memorandum from Ms. Robertson to Sam, Charles, and Evan Wyly, Mike French, and Ethel Ketter, on “Asset Protection and Tax Deferral” (PSI\_ED00042362-97)(hereinafter “Robertson memorandum”).

creditor by taking the funds as salary, loan or a contribution to a new joint venture. ...

FOREIGN SECURITY TRUST (FST) ... Transfer LP [limited partnership] interest of your FLP to your FST. At transfer there is no gift tax and no inheritance tax because it is not a completed delivery. Thru your ownership of the GP of the FLP no control has been lost. ... [Tedder's] firm currently has 3000 FST's in place. ...

Tedder recommends the following jurisdictions – Cayman, BVI, Isle of Man, Cook Islands. ... There are 43 tax havens where less than 2% tax is paid and 60 tax holiday countries. ...

FOREIGN INSURANCE Why? Asset protection and tax benefits. It is not really insurance and works like this: Cash → Foreign Insurance + Term Insurance ... 94% you control investing ... Funds are unavailable to any creditors. A U.S. judgment would not be adhered to. ... If you need access to the funds, you go to a foreign bank and borrow the funds, pledging the foreign insurance as collateral. The foreign insurance compounds tax free until you bring back in. ... There is no reporting obligation to the US on a foreign insurance policy. ... Good for asset protection and secrecy. ...

FOREIGN NON-GRANTOR TRUST ... Be sure your foreign trust documents have a 24 hour clause. This keeps the foreign trustee honest. He knows at any time with 24 hours notice you can change trustee and/or jurisdiction. ...

ANNUITIES ... Cash can be invested anyway you want. ... Creditors can't get at ... You can get cash out of Foreign Corp. thru salary or loan. ... Goes to beneficiary tax free out of your estate ... The IRS will address soon, if you wish tax advantage of this loophole do now. Tedder considers this the best estate planning tool. This is an aggressive tax mode to take – be sure to file every tax form available and any support schedule that seems pertinent.”

Ms. Robertson recommended that Sam and Charles Wyly attend a subsequent Tedder conference and, three months later, Ms. Robertson and the brothers did.<sup>459</sup> Mr. French, then legal counsel to the Wyly family, told the Subcommittee that he, along with Sam and Charles Wyly, also attended a Tedder conference for about 20 persons in New Orleans.<sup>460</sup> Ms. Robertson said that the Wyly brothers, Mr. French, and she attended followup meetings with Mr. Tedder and his associates, including another California attorney, Michael Chatzky. She said that in late 1991 or early 1992, the Wyllys made the decision to move assets offshore.<sup>461</sup>

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<sup>459</sup> Subcommittee interview of Ms. Robertson (3/9/06). This conference apparently took place in September 1991. See Robertson memorandum at PSI\_ED00042362, 69, 70, 73, 74, 76, 85, 87, 90.

<sup>460</sup> Subcommittee interview of Mr. French (4/21/06). Mr. French told the Subcommittee that, at the time, he was unfamiliar with offshore matters and provided no legal advice to the Wyllys on this topic.

<sup>461</sup> Subcommittee interview of Ms. Robertson (3/9/06).

Ms. Robertson told the Subcommittee that she and Mr. French were the key persons who worked with outside professionals to establish offshore entities for Sam and Charles Wyly in 1992. She said that Mr. French worked with outside legal counsel to address various legal issues, while she handled various administrative issues.<sup>462</sup> According to Mr. French, he and Ms. Robertson traveled to the Isle of Man to meet with several corporate service providers and discuss creating an offshore structure for the Wyls.<sup>463</sup> Sam Wyly apparently also traveled to the Isle of Man to meet with offshore service providers.<sup>464</sup> The first Wyly-related offshore trusts and corporations were established in March 1992.

## **E. The Facilitators**

Like the case histories discussed earlier, Sam and Charles Wyly did not venture offshore alone. They relied on U.S. and offshore professionals to help establish and manage the offshore entities, open U.S. and offshore bank and securities accounts, provide legal advice and opinions, move assets offshore, conduct securities transactions, make investments, create new domestic and offshore entities for various business ventures, and develop mechanisms to transfer offshore dollars into the United States.

### **(1) Domestic Facilitators**

**U.S. Legal Counsel.** U.S. legal counsel played a key role in helping the Wyls operate offshore. Wyly representatives told the Subcommittee that U.S. legal counsel were routinely consulted about prospective offshore transactions and routinely provided advice and paperwork.<sup>465</sup> The evidence supports that assertion, showing that U.S. lawyers helped identify and negotiate with offshore service providers to establish and manage the Wyly-related offshore entities, devised ways to move Wyly assets offshore purportedly without incurring an immediate tax liability, provided legal advice on securities issues, designed various structures to allow offshore dollars to be invested in U.S. businesses and real estate, and drafted reams of needed paperwork.

For example, three California law firms, Tedder, Chatzky & Berends; Pratter, Tedder & Graves; and Chatzky and Associates, provided legal advice and helped produce written legal opinions supporting the 1992 and 1996 stock option-annuity swaps used to move millions of

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<sup>462</sup> Id.

<sup>463</sup> Subcommittee interview of Mr. French (4/21/06).

<sup>464</sup> Subcommittee interview of Ms. Robertson (3/9/06).

<sup>465</sup> Subcommittee interviews of Ms. Robertson (3/9/06), Ms. Hennington (4/26/06), and Mr. French (4/26/06); written presentation to the Subcommittee by Wyly legal counsel (5/15/06).

stock options and warrants offshore.<sup>466</sup> Meadows, Owens, Collier, Reed, Cousins & Blau, a Texas law firm specializing in tax and real estate matters, developed a new type of U.S. management trust for the Wyls that allowed offshore entities to pay 99 percent of U.S. real estate acquisition and operating costs.<sup>467</sup> On several occasions, Meadows Owens represented the offshore entities, for example meeting with Lehman Brothers and SBC when questions arose about whether the offshore entities were subject to Wyly control. Meadows Owens also drafted numerous documents associated with the Security Capital pass-through loans and other transactions involving the offshore entities. Jones, Day, Reavis & Pogue, a major law firm with which Mr. French was then affiliated, provided international tax and securities advice and acted as outside counsel to Michaels Stores.<sup>468</sup> Jackson & Walker provided legal advice on corporate and securities matters, including advising some of the offshore entities on their SEC filing obligations.<sup>469</sup> Morgan Lewis & Bockius provided a legal opinion regarding the creation of the foreign grantor trusts established to benefit the Wyly family and advising on their U.S. tax treatment.<sup>470</sup>

According to the Wyls' current legal counsel, one of the Wyls' key legal advisers was Michael French, who served as "General Counsel to the Wyly Family" from 1992 until early 2001.<sup>471</sup> Mr. French told the Subcommittee, however, that when he worked for the Wyls, he did not consider himself to be the family's general counsel, and took a position with the Wyls because he wanted to leave legal practice and work on business matters. During his tenure with the Wyls, Mr. French served as a director of Michaels, Sterling Software, and the Wyly-related hedge fund Maverick, and became a key investor and executive at Scottish Re Group.<sup>472</sup> From 1992 until 2000, Mr. French also served as a "trust protector" for the Wyly-related offshore

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<sup>466</sup> Subcommittee interviews of Ms. Robertson (3/9/06) and Mr. French (4/21/06, 6/30/06). See also legal opinions cited in Report section on Transferring Assets Offshore, below. The key lawyers at these firms working on Wyly-related matters included David Tedder and Michael Chatzky.

<sup>467</sup> See Report section on Funneling Offshore Dollars Through Real Estate, below. The key lawyers at Meadows Owens working on Wyly-related matters included Rodney Owens (now deceased), Charles Pulman, and Alan Stroud.

<sup>468</sup> Written presentation to the Subcommittee by Wyly legal counsel (5/15/06). The key lawyers at Jones Day working on Wyly-related matters included Robert Estep and John McCafferty.

<sup>469</sup> See Report section on Converting U.S. Securities into Offshore Cash, below. One of the key lawyers at Jackson & Walker working on Wyly-related matters was Mr. French, who worked at the law firm from 1970 to 1995, and served as managing partner from 1988 until 1992.

<sup>470</sup> One of the key lawyers at Morgan Lewis working on Wyly-related matters was Charles Lubar.

<sup>471</sup> See, e.g., written presentation to the Subcommittee by Wyly legal counsel (5/15/06).

<sup>472</sup> See, e.g., SEC filings for Michaels, Sterling Software, and Scottish Re Group; 12/21/00 "Settlement Agreement and Mutual Release" between Mr. French and the Wyls (F000282-89).

trusts.<sup>473</sup> In late 2000, Mr. French and the Wyls decided to sever their business ties. In December 2000, Mr. French and the Wyls signed a written agreement in which Mr. French ceased acting as legal counsel to the Wyly family, resigned from his trust protector positions, and relinquished his ownership interest in several Wyly-related business ventures.<sup>474</sup> He retained his ownership interest and executive position in the Scottish Re Group, and the Wyls left the management of that venture.

**U.S. Financial Institutions.** In addition to U.S. legal advisers, the Wyly-related offshore entities used the services of U.S. financial institutions to handle their financial needs. Throughout the thirteen years examined in this Report, the Wyly-related offshore entities obtained brokerage services primarily from one individual, Louis Schaufele, a U.S. stock broker based in Dallas, Texas. He opened and administered U.S. securities accounts for the offshore entities, helped them exercise stock options, buy and sell U.S. securities, obtain loans, hedge stock prices, move assets among accounts, and wire transfer substantial funds across international lines.

During the period under review, Mr. Schaufele worked at three U.S. securities firms, taking the offshore accounts with him each time he moved positions. From 1992 until 1995, he worked for Credit Suisse First Boston (CSFB). Over a three-year period, CSFB opened about 20 accounts for the offshore entities.<sup>475</sup> From 1995 until early 2002, Mr. Schaufele worked for Lehman Brothers which, over the seven-year period, opened about 125 accounts for the offshore entities.<sup>476</sup> From early 2002 until 2004, Mr. Schaufele worked for Bank of America in two of its securities divisions and in association with its private bank.<sup>477</sup> Over this three-year period, Bank of America opened about 65 accounts for the offshore entities.<sup>478</sup> When Mr. Schaufele first moved to Bank of America in 2002, its private bank already had an extensive domestic relationship with the Wyly family.<sup>479</sup> For the next two years, he continued to handle transactions

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<sup>473</sup> For more information, see Report section on Directing Trust Assets, below.

<sup>474</sup> The purpose of the agreement was to “sever all direct and indirect business and professional relationships between French and the Wyls, to resolve all claims that French has asserted against the Wyls, and to forever end all disputes between French and the Wyls.” See 12/21/00 “Settlement Agreement and Mutual Release” between Mr. French and the Wyls (F000282-89).

<sup>475</sup> See CSFB list of accounts (CSFB0015938-41)(showing accounts from 1992 to 1995).

<sup>476</sup> See Lehman Brothers list of accounts prepared by the Subcommittee Minority Staff (showing accounts from 1995 to 2002).

<sup>477</sup> For more information, see section on Hiding Beneficial Ownership, below.

<sup>478</sup> See Bank of America list of accounts provided to the Subcommittee on 10/24/05 (produced without bates numbers)(showing accounts from 2002 to 2005).

<sup>479</sup> See, e.g., 5/27/04 email from Phil White of Bank of America to Greg Strieby and others, summarizing Wyly relationship (BA005624).

for the Wyly-related offshore entities, while the family's long-term private banker, Marta Ingram, handled their domestic accounts.

**Wyly Family Office.** In addition to using outside U.S. legal and financial professionals, Sam and Charles Wyly hired a number of financial and tax professionals to administer their personal financial affairs and those of other Wyly family members. These employees worked at a succession of Wyly-controlled domestic companies in Dallas, most recently Highland Stargate, Inc.<sup>480</sup> For ease of reference, these domestic companies are collectively referred to in this Report as the Wyly family office. From the mid-1980s until the late 1990s, the head of the Wyly family office was Sharyl Robertson, who began working for the Wyllys in 1979.<sup>481</sup> When Ms. Robertson left the Wyly family office to become chief financial officer of Maverick in the late 1990s, she was replaced briefly by Elaine Spang who, in turn, was replaced by Keeley Hennington. Ms. Hennington remains the head of the Wyly family office today. Her husband, Keith Hennington, has served as the family's tax adviser. The family office has employed other staff as well.

The family office handled a variety of matters for the Wyllys, including answering telephones, handling correspondence, opening and administering bank and securities accounts, overseeing financial transactions, administering transactional paperwork, managing property, tracking Wyly domestic and offshore assets, and preparing financial reports. The family office interacted directly with the legal counsel and financial institutions used by the Wyly family. In 1995, the Wyly family office began working with the newly-formed Irish Trust Company to handle Wyly-related offshore transactions. The Irish Trust Company was characterized by Ms. Robertson as the "offshore family office."<sup>482</sup> From its inception to the present, the Irish Trust Company has been headed by Michelle Boucher.<sup>483</sup> At first Ms. Boucher reported to Ms. Robertson.<sup>484</sup> When Ms. Hennington became head of the Wyly family office, Ms. Hennington and Ms. Boucher worked together to track and manage Wyly assets in the United States and offshore.<sup>485</sup>

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<sup>480</sup> Subcommittee interview of Ms. Robertson (3/9/06).

<sup>481</sup> *Id.* Ms. Robertson told the Subcommittee that she worked for the Wyly family from 1979 to 1998 or 1999, keeping the books for individual family members, among other duties. In the mid-1980s, she became head of the Wyly family office. In 1993, she began working part-time for Maverick. In 1998 or 1999, she ended her employment with the Wyly family office and became a full-time Maverick employee and continues to work there full time as the Chief Financial Officer.

<sup>482</sup> 8/7/98 fax from Ms. Robertson to Sam and Charles Wyly and others (PSI\_ED00073787-93, at 90).

<sup>483</sup> Ms. Boucher is a Chartered Accountant and has held the titles of Chief Financial Officer and Money Laundering Reporting Officer at the Irish Trust Company since its inception. 11/5/04 letter from Ms. Boucher to Bank of America (BA148314-15).

<sup>484</sup> *Id.*; Subcommittee interview of Ms. Robertson (3/9/06).

<sup>485</sup> Subcommittee interviews of Ms. Robertson (3/9/06) and Ms. Hennington (4/26/06) .

## (2) Offshore Facilitators

**Offshore Service Providers.** Offshore service providers in the Isle of Man (IOM) and the Cayman Islands provided key services to the Wyly-related offshore entities. The IOM offshore service providers established the 19 Wyly-related trusts and the 39 IOM corporations they owned; provided trustees for the IOM trusts; provided nominee directors and officers for the IOM corporations; administered the paperwork required by IOM law; and supplied the documentation and authorizations needed for particular transactions undertaken by specific offshore entities. These IOM service providers were the lynchpin in the Wyly offshore structure, since they administered the key offshore entities and were instrumental in representing that the offshore trusts and corporations were independent of Wyly control, while at the same time implementing Wyly decisions on trust assets and investment activities.

During the 13-year period examined in this Report, eight IOM offshore service providers helped administer one or more of the Wyly-related IOM entities.<sup>486</sup> The most active were IFG International, Inc. (IFG),<sup>487</sup> Lorne House Trust Company Ltd. (Lorne House), Trident Trust Company (IOM) Ltd. (Trident), and Wychwood Trust Ltd. (Wychwood). The documents reviewed by the Subcommittee show that these offshore service providers interacted primarily with four persons representing Wyly interests, Ms. Boucher, Mr. French, Ms. Hennington, and Ms. Robertson. Several also, on occasion, communicated directly with Wyly family members, including Sam and Charles Wyly.

**Irish Trust Company.** The key offshore service provider in the Cayman Islands was the Irish Trust Company, which has been referred to as the “offshore family office.”<sup>488</sup> Unlike the IOM offshore service providers, whose ownership was completely independent of the Wyllys, the Irish Trust Company was wholly owned by Irish Holdings Ltd., which in turn was owned by the Bessie and Tyler Trusts, two Wyly-related trusts.<sup>489</sup>

Established in 1995, Irish Trust Company handled a variety of offshore tasks for the Wyly-related offshore entities. For example, it handled paperwork and administrative tasks for the Wyly-related offshore entities, six Cayman limited liability corporations (LLCs) associated

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<sup>486</sup> For a complete list, see Appendix 2.

<sup>487</sup> IFG owned a subsidiary called Aundyr Trust Company Ltd., which often appears in the documentation. See, e.g., 12/12/95 fax from Aundyr to Lehman Brothers (CC020030) (“Aundyr Trust Company Limited is a wholly owned subsidiary of IFG International Limited.”).

<sup>488</sup> Both Irish Trust Company and Ms. Boucher declined the Subcommittee’s request for an interview and provided no information to the Subcommittee. Information about them is, thus, taken from documents produced by others to the Subcommittee and from interviews provided by other persons.

<sup>489</sup> See “The Irish Trust Company (Cayman) Ltd. Application for a Restricted Trust License” (PSI00120946-52). This application states that the company was also owned by the South Madison Trust, an Isle of Man trust benefitting Mr. French. Mr. French, however, told the Subcommittee that he did not believe this trust ever had any ownership interest in the Irish Trust Company. Subcommittee interview of Mr. French (4/21/06).

with Sam Wyly's six children, and the two Wyly-related hedge funds, Maverick and Ranger, that had offshore components. It kept detailed financial records for the Wyly-related offshore entities, tracking their expenditures, securities transactions, bank transactions, assets, and liabilities, and producing financial reports both for the entities and the Wyly family office. It also became the key liaison between the offshore entities and the Wyly family office in the United States, relaying information, advancing paperwork, and often offering suggestions on how offshore transactions should be structured, which offshore account should supply needed funds, and when offshore dollars were available to be sent to the United States.

The head of the Irish Trust Company from its inception to the present day has been Michelle L. Boucher, a Canadian citizen and Cayman resident.<sup>490</sup> Ms. Boucher is a chartered accountant. The documents obtained by the Subcommittee show that, since her employment in 1995, Ms. Boucher was in frequent contact with the Wyly representatives in Dallas and with the broker, Mr. Schaufele, who handled securities transactions for the offshore entities.<sup>491</sup> She helped design and execute numerous financial transactions involving Wyly-related offshore assets, directed the movement of millions of offshore dollars to Wyly-related accounts in the United States, and helped produce numerous financial statements tracking Wyly offshore assets. Beginning in 2001, Ms. Boucher became a trust protector for all the Wyly-related offshore trusts, replacing Mr. French and assuming this responsibility at the same time Ms. Robertson was reducing her day-to-day interactions with the offshore entities. After Ms. Robertson resigned from her trust protector positions in 2004, Ms. Boucher became and remains today the sole trust protector of all of the Wyly-related offshore trusts.

In addition to her posts as head of Irish Trust Company and trust protector, Ms. Boucher has served as the Money Laundering Reporting Official, a position required under Cayman law, for the Maverick and Ranger hedge funds organized in that country.<sup>492</sup> For a five-month period from 1998 to 1999, she also served as the chief financial officer of Scottish Annuity & Life Holdings, Ltd.<sup>493</sup>

**Offshore Financial Institutions.** Another key set of offshore facilitators were the financial institutions that opened accounts for the Wyly-related offshore entities.

One of the most important was Queensgate Bank & Trust Company Ltd. (Queensgate Bank), a small offshore bank organized in the Cayman Islands. It apparently began operations in

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<sup>490</sup> 11/5/04 letter from Ms. Boucher to Bank of America (BA148314-15)(hereinafter "Boucher letter"). Ms. Boucher is also the Money Laundering Reporting Officer for the Irish Trust Company, a post required under Cayman law. Id.

<sup>491</sup> Id. ("I personally have had a 10 year relationship with Mr. Lou Schaufele and enjoy working with him and his team immensely.").

<sup>492</sup> Id.; information provided to the Subcommittee by Maverick and Ranger.

<sup>493</sup> See 11/5/04 Boucher letter; 4/18/00 "Scottish Re: Presentation to the Permanent Subcommittee on Investigations" at 48, 55.

1990, and is licensed by the Cayman Islands to form trusts and corporations.<sup>494</sup> Although this bank refused to cooperate with the Subcommittee investigation, information obtained from other sources indicate that it has between 10 and 24 employees, and operates out of the Uglund House, a building that apparently is the official address for thousands of Cayman companies.<sup>495</sup> The majority owners of Queensgate Bank are apparently members of the Uglund family.<sup>496</sup> The managing director of Queensgate Bank is John Dennis Hunter, a British national and Cayman resident who has apparently held this position since 1993; the vice chairman of the board is Francis O. Flannigan, an Irish national.<sup>497</sup>

Queensgate Bank opened accounts for a number of Wyly-related offshore entities, including Irish Holdings, Irish Trust Company, Scottish Holdings, Scottish Annuity Company, the Maverick and Ranger offshore funds, the six Cayman LLCs associated with Sam Wyly's six children, First Dallas International Ltd., and many of the Isle of Man trusts and corporations examined in this Report. Queensgate Bank also established and administered a special purpose vehicle, Security Capital Ltd., that transferred millions of offshore dollars into the United States using pass-through loans.<sup>498</sup> At least four Queensgate employees, Mr. Hunter, Karla Bodden, Blair Gauld, and Jane Fleming, served as nominee directors of Security Capital. Mr. Hunter, Mr. Flannigan, and Ms. Bodden have also served as nominee directors of other Wyly-related offshore entities.<sup>499</sup>

Queensgate Bank was able to transfer funds into the United States using correspondent accounts it had opened at Webster Bank in Connecticut, and IBJ Whitehall Bank & Trust

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<sup>494</sup> See 6/15/90 Queensgate Bank memorandum and articles of incorporation (W000666-96); 9/25/90 Queensgate offshore banking license (W000662). Queensgate Bank declined the Subcommittee's request for an interview.

<sup>495</sup> See, e.g., 9/26/02 Webster Bank account application completed by Queensgate Bank (W000001-3)(stating Queensgate has 10-24 employees, and providing Uglund House address); "The Irish Trust Company (Cayman) Ltd. Application for a Restricted Trust License," (PSI00120946-52)(stating Queensgate Bank has offices at Uglund House); Congressional Record, 109th Cong., 2nd sess., (2/1/06) at S408 (Senator Dorgan speaking)("According to Bloomberg News, [Uglund House] is the official address of 12,748 companies.").

<sup>496</sup> See 2/3/05 Webster Bank form, "Certification regarding correspondent accounts for foreign banks," completed by Queensgate Bank (W000707-12)(listing bank's owners as Queensgate Group Ltd., Andreas Uglund and Sons Ltd., Andreas Uglund, and Knut Axel Uglund). The Uglund family is based in Norway.

<sup>497</sup> See Bankers Almanac entry for Queensgate; PSI\_ED00010432; 12/12/95 fax from Ms. Boucher to Mr. Buchanan (PSI00118184); "The Irish Trust Company (Cayman) Ltd. Application for a Restricted Trust License," at 2 (PSI00120947).

<sup>498</sup> For more information about Security Capital, see Report section on Bringing Offshore Dollars Back with Pass-Through Loans, below.

<sup>499</sup> Ms. Bodden, for example, has served as a director of the Edinburgh Fund (PSI00103836), and Irish Trust Company (BA055846), while Mr. Hunter has served as a director of EB&M Holdings (BA060745), the Edinburgh Fund (PSI00103836), Irish Trust Company (BA055846), Maverick Fund (PSI00118184), Ranger Fund Ltd. and Ranger Fund LLC (PSI\_ED00010432), and Scottish Annuity (PSI00118184).

Company in New York.<sup>500</sup> Queensgate Bank even subleased office space to Irish Trust Company in the Uglund House, becoming not only the company's bank, but also its landlord.<sup>501</sup>

Another key financial institution was Bank of Bermuda (IOM) Ltd., a bank and trust company that opened accounts and transferred funds across international lines for multiple Wyly-related offshore entities. This bank was affiliated with a number of other Bank of Bermuda entities operating in other countries, including the Cayman Islands and the United States.<sup>502</sup> The Bank of Bermuda apparently continues to administer accounts for the Wyly-related offshore entities today.

**Offshore Legal Counsel.** Another offshore facilitator that advanced Wyly-related offshore interests was Maples & Calder, one of the largest law firms in the Cayman Islands and a specialist in offshore legal issues. Like Queensgate Bank, it has offices in the Uglund House. The managing partner is Gus Pope, and one key law partner who handled Wyly-related matters is Henry Smith. Maples & Calder helped draft paperwork and provided legal advice to establish a host of Wyly-related Cayman entities, including Irish Holdings, Irish Trust Company, Scottish Holdings, Scottish Annuity Company, Maverick and Ranger's offshore funds, First Dallas International, Michelangelo Investors, and Edinburgh Fund Ltd.<sup>503</sup> It has also provided legal advice to Queensgate Bank.<sup>504</sup>

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<sup>500</sup> IBJ Whitehall Bank & Trust Company was purchased, in 2002, by Mizuho Bank, which produced the documents related to Queensgate Bank's correspondent account. Mizuho Bank recently sold a part of the IBJ portfolio of accounts, including the Queensgate Bank account, to Webster Bank. Webster Bank told the Subcommittee that it closed the Queensgate Bank correspondent account in November 2005.

<sup>501</sup> See "The Irish Trust Company (Cayman) Ltd. Application for a Restricted Trust License," at 1, 3 (PSI00120946, 48); 7/24/96 email from Ms. Boucher to Amber Gibson (PSI00101306) ("Dinner – Edouardo's Restaurant ... we are taking out Dennis Hunter and Karla Bodden of Queensgate Bank & Trust (our offshore directors and landlords!)").

<sup>502</sup> According to its website, in February 2004, Bank of Bermuda joined the HSBC Group, a global bank currently operating in 77 countries. See [www.bankofbermuda.com](http://www.bankofbermuda.com). See also Bankers Almanac entries for Bank of Bermuda (IOM) Ltd., Bank of Bermuda Ltd., Bank of Bermuda (Cayman) Ltd., and Bank of Bermuda (New York) Ltd.

<sup>503</sup> See, e.g., documents related to Irish Trust (PSI\_ED00065884-89, PSI00117419; PSI00120948), Maverick (PSI00119286, PSI00120570-74, PSI00136390); 12/02 Ranger Investments Private Placement Memorandum for Ranger Hedged Equity (offshore), Ltd. (PSI\_ED00039145-205, at 152); Scottish Annuity & Life Holdings (SCREPSI014197-99, SCREPSI014238); Scottish Life Holdings (SCREPSI011573-77); Scottish Annuity Company (Caymans)(SCREPSI011573); First Dallas International (PSI00110281); Michelangelo Investors (Subcommittee interview of Maples & Calder, 7/12/06); and Edinburgh Fund Ltd. (PSI00103848).

<sup>504</sup> 3/23/06 letter from Maples & Calder to the Subcommittee.

## F. Overview of Wyly Offshore Operations

The Wyly offshore operations grew in size and complexity over time, eventually encompassing 58 offshore trusts and corporations. Key developments, many of which are discussed in more detail in Report sections below, can be summarized as follows.

**Initial Move Offshore in 1992.** In March 1992, following a plan devised by legal counsel, the Wyls established their first set of offshore trusts, called the Bulldog, Pitkin, and Tallulah International Trusts.<sup>505</sup> Using an Isle of Man service provider, Lorne House, Sam Wyly settled the Bulldog Trust and the Tallulah International Trust as two irrevocable trusts. The beneficiaries of these trusts were two foreign charities, the British Red Cross and the Community Chest of Hong Kong, as well as Sam Wyly's children. Charles Wyly settled the Pitkin Trust, an irrevocable trust whose beneficiaries were the same two foreign charities as well as his children.<sup>506</sup> All three trust agreements had virtually identical terms.

In December 1992, three more trusts were established, the Castle Creek, Delhi, and Lake Providence International Trusts. These trusts differed from the earlier trusts, but were virtually identical to each other. Again, two were settled by Sam Wyly and one by Charles Wyly. The beneficiaries of both the Delhi and Lake Providence International Trusts were the same two foreign charities and Sam Wyly's children. The beneficiaries of the Castle Creek International Trust were the same two foreign charities and Charles Wyly's children.

All but one of the 1992 trusts formed wholly-owned IOM corporations. Many of these offshore entities opened bank accounts at Queensgate Bank or Bank of Bermuda (IOM); some also opened U.S. securities accounts at CSFB.<sup>507</sup> As explained more fully below, the Wyls used a series of stock option-annuity swaps to transfer nearly 3 million Michaels and Sterling Software stock options and warrants to ten of the trust-owned corporations. Over time, the offshore corporations exercised these stock options, obtained shares, transferred some of the shares to other Wyly-related entities, used some to obtain loans or engage in securities transactions, and sold still others on the public market to generate cash.

**Second Set of Offshore Transfers in 1994-95.** In 1994 and 1995, five more IOM trusts were established. In contrast to the 1992 trusts, none of these trusts was settled by Sam or Charles Wyly. Instead, on the advice of counsel to obtain more favorable tax treatment, all were

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<sup>505</sup> A complete list of the offshore trusts, the corporations they owned, and the offshore service providers that administered them are included in Appendices 1-3 to this report.

<sup>506</sup> The trust agreements made the Wyly children ineligible for any trust benefit "[u]ntil the second anniversary of the death of the Settlor," apparently in an effort to prevent the trust from being considered a U.S. grantor trust with U.S. beneficiaries. See, e.g., Bulldog Trust Agreement (PSI00007383) and Pitkin Trust Agreement (PSI00009208).

<sup>507</sup> See CSFB list of accounts (CSFB0015938-41).

settled by non-U.S. persons and characterized as “foreign grantor trusts.”<sup>508</sup> These trusts were settled by either Keith L. King or Shaun F. Cairns, both of whom are non-U.S. citizens and were then IOM residents. Mr. King was then a director of Lorne House,<sup>509</sup> while Mr. Cairns was a director of Wychwood.<sup>510</sup>

In February 1994, acting through Lorne House, Mr. King established two of the foreign grantor trusts, the Bessie and Tyler Trusts, with virtually identical terms. One benefitted Sam Wyly’s family, and the other benefitted the family of Charles Wyly. The Bessie Trust’s named beneficiaries were Mr. King, Sam Wyly, and Sam Wyly’s wife and children; while the Tyler Trust’s named beneficiaries were Mr. King, Charles Wyly, and Charles’ wife and children.<sup>511</sup>

In 1995, acting through Wychwood, Mr. Cairns established three more foreign grantor trusts, the Plaquemines, LaFourche, and Red Mountain Trusts. The Plaquemines Trust was formed in February 1995. Unique among the Wyly-related offshore trusts, it was settled by another trust, the 1992 Bulldog Trust. Its named beneficiaries were the same two foreign charities specified in the December 1992 trusts and Sam Wyly’s children. Soon after, the Bulldog Trust transferred two of the corporations it owned to the Plaquemines Trust. A few months later, in July 1995, Mr. Cairns acted as grantor to form the LaFourche Trust, whose beneficiaries were Sam Wyly and his wife and children; and the Red Mountain Trust, whose beneficiaries were Charles Wyly and his wife and his children. Each of the 1994 and 1995 trusts formed one or more wholly-owned IOM corporations. Some of the trusts and their corporations opened accounts at Queensgate Bank or Bank of Bermuda. A few opened accounts at CSFB.

In 1996, relying on advice from legal counsel, the Wylys engaged in a second round of stock option-annuity swaps, involving Michaels, Sterling Software, and Sterling Commerce shares. To carry out these transactions, six additional IOM trusts were briefly established in late 1995 or early 1996, all of which were settled by either Sam or Charles Wyly. Three of the new trusts, Arlington Trust, Crazy Horse Trust, and Sitting Bull Trust, and the pre-existing Tallulah International Trust, took possession of stock options originally granted to Sam Wyly. Three of the new trusts, the Lincoln Creek, Maroon Creek, and Woody International Trusts, took possession of stock options originally granted to Charles Wyly. As explained more fully below, the trusts transferred the stock options to ten other Wyly-related offshore corporations in

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<sup>508</sup> Foreign grantor trusts are trusts whose settlors are non-U.S. persons. See 26 U.S.C. §§ 671-679 of the Internal Revenue Code (“IRC”)(addressing foreign trusts).

<sup>509</sup> “The Irish Trust Company (Cayman) Ltd. Application for a Restricted Trust License,” at 3 (PSI00120948); Subcommittee interview of Ms. Robertson (3/9/06). In 1995, Mr. King was the subject of disciplinary proceedings and banned from practice in the Isle of Man. See, e.g., 12/5/95 letter from Isle of Man Financial Supervision Commission to Mr. Keith Leslie King (00148-55).

<sup>510</sup> Subcommittee interview of Ms. Robertson (3/9/06).

<sup>511</sup> Also in 1994, Mr. King established a foreign grantor trust for Michael French, called the South Madison Trust, whose beneficiaries were Mr. King, Mr. French, and Mr. French’s wife and children. See trust agreement (2/2/94)(F000130-85).

exchange for annuity agreements. By the end of 1996, all of the trusts that had participated in the 1996 stock option-annuity swaps were terminated. They distributed their assets, including the annuity agreements, to either Sam or Charles Wyly. As before, over time, the offshore corporations exercised some of the stock options, obtained company shares, transferred some shares to other Wyly-related entities, engaged in various securities transactions, and sold some shares on the public market to generate cash.

In addition, in 1996, five Wyly-related offshore corporations bought Michaels stock in private transactions with Michaels Stores. The first of these private stock sales took place in April 1996, when three of the offshore corporations purchased a total of 2 million Michaels shares for \$25 million.<sup>512</sup> In December 1996, the two other corporations purchased options to buy another 2 million shares, and in February 1997, exercised those options and bought the shares for a total of \$20 million.<sup>513</sup> These private stock sales injected a total of \$45 million in offshore dollars into Michaels Stores at a time when the stock price was low and financial analysts were criticizing the company for insufficient capital.<sup>514</sup>

**Offshore Support of Wyly Interests.** Beginning in 1993, the Wyly-related offshore entities began spending offshore dollars to advance Wyly-related business and personal interests. For example, several offshore entities deposited millions of dollars in the Maverick offshore funds that opened for business in 1993. In 1994, two of the trusts, the Lake Providence and Castle Creek International Trusts, purchased annuity policies from Scottish Annuity (Cayman) Ltd. and provided millions of dollars in annuity assets, which Scottish deposited in Maverick offshore funds for further investment. In 1995, the Bessie and Tyler trusts formed Irish Holdings, and the Wyly offshore entities began using Irish Trust Company's administrative services, as did the Maverick offshore funds. In 1997, several offshore entities began investing funds in Green Mountain, an energy company acquired by the Wyllys that year.

In 1998, Queensgate Bank established a Cayman offshore corporation, Security Capital Ltd., to facilitate pass-through loan transactions between Wyly-related persons and entities. In essence, a Wyly-related offshore corporation loaned funds or other financial assets to Security Capital which loaned the same amount of funds or assets to a Wyly-related person or entity, usually in the United States. Over a five-year period, from 1998 to 2003, Security Capital participated in at least ten of these pass-through loans, providing about \$140 million in cash and other financial assets to advance Sam and Charles Wyly's personal and business interests. Also in 1998, the Wyly-related offshore insurance company went public as Scottish Annuity & Life Holdings Ltd. In 1999, as explained in more detail later, due to defects in the trust agreement,

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<sup>512</sup> See Michaels Stores Inc. 10-K filing (5/2/97); 3/29/96 stock purchase agreement between Michaels and Locke (PSI00062993-3010); 3/29/96 stock purchase agreement between Michaels and Quayle (PSI00063011-28).

<sup>513</sup> See Michaels Stores Inc. 10-K filing (5/2/97); 12/23/96 option agreement between Michaels and Devotion (PSI00062959-74); 12/23/96 option agreement between Michaels and Elegance (PSI00085007-22).

<sup>514</sup> See, e.g., "Michaels Stores Turns To Chairman Again for Infusion of Cash," Wall Street Journal (1/7/97).

the trustees of the Plaquemines Trust voided the trust and reappointed its assets to its grantor, the Bulldog Trust.

In 2000, Charles Wyly established a private investment fund called First Dallas, with an offshore component, First Dallas International. In 2001, Sam Wyly established another hedge fund, Ranger, in addition to Maverick. The Wyly-related offshore entities promptly transferred millions of offshore dollars to both First Dallas and Ranger.

**Third Set of Offshore Transfers.** Beginning in 1999, a third set of Wyly stock options were transferred offshore. In the summer of 1999, Sam and Charles Wyly decided to sell Sterling Software and Sterling Commerce. In September 1999, Sam and Charles transferred substantial Sterling Software and Sterling Commerce stock options to five Wyly-related offshore corporations in exchange for cash totaling about \$27 million. In March 2000, both Sterling Software and Sterling Commerce were sold in separate \$4 billion transactions. SBC Communications, the company that bought Sterling Commerce, paid cash for all outstanding stock options, including \$74 million for the stock options held by the Wyly-related offshore corporations. Computer Associates, the company that bought Sterling Software, exchanged outstanding Sterling Software stock options for a smaller number of Computer Associates options. In July 2002, Sam and Charles Wyly transferred a substantial number of Computer Associates stock options (equivalent to about 1.5 million Sterling Software stock options) to two more of the offshore corporations they controlled in exchange for cash totaling about \$4 million.

**Two More Trusts.** In October 2000, two more Wyly-related offshore trusts were established, although both trusts were later voided. The first, Bulldog II Trust, was settled by Sam Wyly, and the original Bulldog Trust was immediately merged into it. Two more trusts, the Delhi and Lake Providence International Trusts, were merged into the Bulldog II Trust in 2001. Three years later, in 2004, the trustees determined that the Bulldog II Trust may have created unintended U.S. tax liabilities, voided it, and purported to reconstitute the original Bulldog, Delhi and Lake Providence Trusts as if the mergers had never taken place. A similar set of events befell the Pitkin Trust II. This new trust was established in 2000, with Charles Wyly as the grantor, and the original Pitkin Trust was immediately merged into it. In 2001, the Castle Creek International Trust was also merged into it. In 2004, the Pitkin Trust II was voided by the trustees who purported to reconstitute the original Pitkin and Castle Creek trusts as if they had never been merged.

**Sub Funds.** In 2001, with the advice of counsel, Sam Wyly decided to create “sub funds” within the Bessie Trust, so that each of his six children would have an individual “sub fund” of designated assets within this trust. To carry out this decision, the Bessie Trust formed six Cayman limited liability corporations (LLCs), each of which was associated with one of Sam Wyly’s children and each of which was intended to hold the assets designated for that child. Ms. Boucher, working with counsel, devised a detailed plan to assign assets to the six sub funds, to be held in the name of the corresponding Cayman LLCs. Following this plan, in June 2001, several of the Wyly-related corporations owned by Bulldog Trust loaned the specified assets to Greenbriar Ltd., owned by the Delhi International Trust, which then loaned those and additional assets of its own to Security Capital in exchange for a \$56 million promissory note. Security

Capital, in turn, loaned the assets to the Cayman LLCs in exchange for promissory notes from each LLC that added up to the same amount. The end result was that the specified assets had moved from the IOM corporations and the Bulldog and Delhi trusts to the six Cayman LLCs and the Bessie Trust.

**Real Estate, Furnishings, Artwork, and Jewelry.** From 1999 to 2004, about \$85 million in offshore dollars was transferred to accounts in the United States and used to purchase U.S. real estate, construct houses for the personal use of Wyly family members, and operate those properties, known as Rosemary's Circle R Ranch, LL Ranch, Cottonwood Galleries, Stargate Horse Farm, and 36 Malibu Colony. In addition, nearly \$30 million in offshore dollars were transferred to purchase furnishings, artwork, and jewelry used by members of the Wyly family. The real estate transactions were accomplished through the establishment of additional offshore and domestic entities that added further layers of complexity to the Wyly offshore structure.

**Annuity Payments.** The first payment under the 1992 and 1996 annuity agreements was made in 2003, more than ten years after the Wylys first moved their stock option compensation offshore. To date, about \$35 million in annuity payments have been made to Sam Wyly, Charles Wyly, and Charles Wyly's wife. In November 2005, an annuity payment was missed. One of the offshore corporations, Roaring Creek Ltd., which is owned by Pitkin Trust, was supposed to pay about \$1.1 million to Charles Wyly. To date, this payment has not been made.

By the end of 2005, 58 Wyly-related offshore entities had been created, including 19 offshore trusts and 39 offshore corporations. Over 17 million stock options and warrants representing at least \$190 million in compensation provided to Sam and Charles Wyly had been moved offshore. Over the following years, about \$140 million in loans and more than \$600 million in untaxed offshore dollars were spent to advance Wyly-related personal and business interests, primarily in the United States. About \$124 million in stock option compensation remains offshore and untaxed. Additional untaxed capital gains also remain offshore.<sup>515</sup>

## **G. Detailed Examination of Wyly Offshore Operations**

The following Report sections provide an indepth examination of the functioning of the Wyly offshore structure.

### **(1) Directing Trust Assets**

Sam and Charles Wyly sent their stock options and warrants offshore to an array of offshore trusts and corporations that grew in number and complexity over time. The evidence

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<sup>515</sup> For more information on how the \$190 million was calculated, see the Report section on Transferring Assets Offshore, footnote 746. For more information on how the \$600 million was calculated, see the Report sections on Supplying Offshore Dollars to Wyly Business Ventures (about \$500 million), Funneling Offshore Dollars Through Real Estate (about \$85 million), and Spending Offshore Dollars on Artwork, Furnishings, and Jewelry (about \$30 million).

shows that, in doing so, the Wyly brothers did not simply hand over the securities and cede direction over them to the offshore trustees. Instead, over the years, they continued to make decisions about how and when the stock options and warrants should be exercised, how and when the resulting shares should be sold or used in other securities transactions, and what should be done with the investment gains. The Wyls and their representatives typically conveyed decisions about the trust assets to individuals named in the trust agreements as “trust protectors,” whom the Wyls had selected. The trust protectors then typically conveyed these decisions, worded as “recommendations,” to the offshore trustees who, in form under Isle of Man law retained final decisionmaking authority over the trust assets, but in practice simply carried out the directions they received.

Over the thirteen years examined by the Subcommittee, the offshore trustees rarely questioned any “recommendation” made by a Wyly trust protector and typically implemented a recommendation within days of receiving it.<sup>516</sup> The Subcommittee saw no evidence that the offshore trustees initiated or implemented financial transactions or investments on their own involving assets from a Wyly-related offshore trust. Instead, the offshore trustees appear to have functioned as mere administrative cogs carrying out decisions made by the Wyls and their representatives regarding trust assets and investment activities. At the same time, the offshore trustees continued to represent that the offshore trusts and the corporations they owned were independent entities free of Wyly control.

#### **(a) Background on Trusts**

Trusts are established for a variety of reasons, including by persons seeking to provide for the economic security of family members, manage their estates, or fund charitable works to benefit the public. A trust is created when one person, called the grantor or settlor, conveys a property interest to another person, called the trustee, to be held for the benefit of a party called the beneficiary.<sup>517</sup> The grantor is the person who establishes the trust and typically contributes the trust assets. The trustee typically takes title to the assets and assumes a fiduciary obligation to exercise reasonable care over the property and to act solely in the interest of the beneficiary. The beneficiary can be a named individual, a charity, or a class of persons such as the grantor’s children. The grantor, in some circumstances, can also serve as the trustee or as one of the beneficiaries. The grantor can create a trust that is revocable or irrevocable. To establish the trust, the grantor, with the assistance of legal counsel, typically executes a written trust agreement identifying the trustee, the beneficiaries, the initial trust assets, and the terms of the trust.

Under U.S. trust law, grantors can retain significant control over assets conveyed to a trust. For example, the trust agreement can authorize the grantor to manage the trust assets or

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<sup>516</sup> Because none of the offshore service providers supplied documentation or interviews to the Subcommittee, this analysis is necessarily based on information provided by other parties.

<sup>517</sup> For more information, see, e.g., G. Bogert, The Law of Trusts and Trustees, (Thomson/West Group, 3<sup>rd</sup> ed., 2005), Chapter 1.

direct the trustee's performance of certain duties, or require the trustee to obtain the grantor's written consent prior to taking certain actions.<sup>518</sup> Grantors can spend trust funds, replace the trustee, and reserve the right to revoke the trust altogether. Foreign jurisdictions afford grantors similar authority over trust assets. The Isle of Man, for example, which plays a key role in the Wyly case history, allows grantors to establish trusts giving the trustee wide discretion to invest and distribute trust assets. The grantor may then converse directly with the trustee or provide a "letter of wishes" with specific recommendations on how to administer the trust assets.

A trust agreement can also establish a "trust protector," a person selected by the grantor with authority to oversee the trust assets and often with the power to replace the trustee. The Isle of Man permits trust protectors to interact with trustees on a daily basis, conveying information and recommendations from the grantor about how the trust assets should be handled, and to replace the trustees at will, including, for example, if a trustee declines to follow the protector's recommendations.<sup>519</sup> At the same time, trust law typically assigns final decisionmaking authority over trust assets to the trustee, requiring the trustee to act with due care and in the sole interest of the trust beneficiaries.

U.S. tax treatment of trust property depends upon the amount of control the grantor retains over the trust. If the grantor places property in an irrevocable trust and gives up all control over the property and the trust, the trust is generally treated as a separate taxpayer and pays tax on the income from the property.<sup>520</sup> When the trust distributes the income to the beneficiaries, it gets a deduction for the amount distributed, but the beneficiaries have to pay tax on the income, so that the income is taxed only once.<sup>521</sup> On the other hand, if the grantor directly or indirectly keeps the power to revoke the trust or retains significant control over the trust or trust assets, the trust is considered a "grantor trust" and its income is generally attributed to the grantor for tax purposes.<sup>522</sup> In some cases where a grantor has supposedly established an

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<sup>518</sup> *Id.* at Chapter 6, Section 104, "Reservation by Settlor of Powers of Management."

<sup>519</sup> IOM trust law does not explicitly address the position of trust protector or define its authority, but trust protectors are in common use within the jurisdiction and are accepted as valid trust participants by the IOM Financial Supervision Commission that oversees trust operations. In the United States, trust protectors are not common. See, e.g., 9/22/00 email from Ms. Hennington to Evan Wyly (PSI\_ED00005014-15) ("There is really no such thing as a protector in the domestic world."). In recent years, however, a handful of states have enacted legislation that authorizes trust protectors to participate in U.S. trusts. See Alaska Stat. § 13.36.370 (2006); Idaho Code § 15-7-501 (2006); N.C. Gen. Stat. § 36C-8-808 (2006); S.C. Code Ann. § 62-7-808 (2005); S.D. Codified Laws § 55-1B-1 (2006); Tenn. Code Ann. § 35-15-808 (2005).

<sup>520</sup> 26 U.S.C. §§ 641(a) and (b).

<sup>521</sup> 26 U.S.C. §§ 651, 652, 661 and 662. If a trust distributes a portion of the original trust assets, sometimes referred to as the trust principal, those distributions are not taxed.

<sup>522</sup> 26 U.S.C. §§ 671-678. See also *Holdeen v. United States*, 297 F.2d 886 (2d Cir. 1961) (use of trust assets to benefit of the grantor); *Wiles v. Commissioner*, 59 T.C. 289 (1972), *aff'd*, 491 F.2d 1406 (5th Cir. 1974) (trust's payment of the grantor's debts); *Bixby v. Commissioner*, 58 T.C. 757 (1972) (ability to replace trustee and control of investments through a related "advisory committee"). These provisions of the tax code apply both to

irrevocable, independent trust, but secretly retained control over the trusts assets, courts have ruled that the trust was a sham and attributed the trust assets and income to the grantor for tax purposes.<sup>523</sup>

Trusts formed in foreign jurisdictions originally operated under a different set of tax rules. Generally, foreign trusts were seen as foreign entities outside the normal reach of U.S. tax law, and foreign trust distributions to U.S. persons were generally untaxed. Over the years, some U.S. citizens began to take advantage of the tax status of these foreign trusts. For example, some U.S. persons formed foreign trusts in tax havens, named themselves as the grantor, named U.S. beneficiaries, and placed U.S. assets in those trusts. They claimed that the foreign trusts could then distribute the trust income to the U.S. beneficiaries tax free, and the trusts could accumulate capital gains tax free, unless and until any appreciated assets were brought back into the United States. Congress and the IRS responded with a series of laws and regulations designed to stop what were seen as tax dodges unintended by the tax code. In 1976, for example, Congress declared that a foreign trust that was funded by a U.S. person and had U.S. beneficiaries was considered a U.S. grantor trust whose income had to be attributed to the U.S. person who transferred the assets.<sup>524</sup>

Some U.S. persons responded to these new limitations on foreign trusts by convincing a foreign person (rather than a U.S. person) to act as the grantor of the foreign trust and name U.S. beneficiaries. The U.S. person then transferred assets to this “foreign grantor trust” for later distribution to the U.S. beneficiaries tax free. In 1996, in effort to end this practice, Congress enacted legislation essentially requiring the U.S. beneficiaries to pay tax on any distributions from a foreign trust that was not already taxable to a U.S. grantor.<sup>525</sup> In passing this law,

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the grantor and other persons who may be deemed an “owner” of trust assets because, for example, they contributed the trust assets and exercised control over them. See, e.g., 26 U.S.C. § 678.

<sup>523</sup> See, e.g., Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984); Dahlstrom v. Commissioner, T.C. Memo. 1991-264; Markosian v. Commissioner, 73 T.C. 1235 (1980); Muhich v. Commissioner, T.C. Memo. 1999-192.

<sup>524</sup> See the Tax Reform Act of 1976, 26 U.S.C. § 679(a). The U.S. Senate Finance Committee stated in its report on the new legislation that, under the then existing law, foreign trusts “generally pay no income tax anywhere in the world,” that allowing “tax-free accumulation of income” in foreign trusts was “inappropriate,” and that such practices provided an “unwarranted advantage” to foreign trusts over domestic trusts. The Committee saw the problem as compounded where U.S. persons funded a foreign trust with appreciated property using transactions that purported to avoid the payment of any capital gains tax on the appreciated assets transferred to the foreign trust. Section 679 of the tax code, enacted as part of the 1976 Act, provided generally that where a U.S. person directly or indirectly transferred property to a foreign trust, without reporting gain on the transfer, the income of the foreign trust was taxable to the transferor if the trust had any U.S. beneficiary. This provision essentially treated the trust as a grantor trust whether or not the transferor retained any power or interest over the trust. S. Rept. No. 94-938, “Tax Reform Act of 1976,” pp. 216-219 (6/10/76). In addition, the 1976 Act tightened the rules designed to prevent U.S. taxpayers from using foreign trusts to escape capital gains tax on appreciated assets, by increasing the excise tax on assets transferred to a foreign trust and extending that excise tax to reach virtually all untaxed assets transferred by any means. 26 U.S.C. § 1491.

<sup>525</sup> This provision was included in the Small Business Job Protection Act of 1996. 26 U.S.C. § 672(f).

however, Congress applied it only to assets transferred to foreign trusts after February 6, 1995; foreign trusts funded with assets prior to that date were allowed to continue operating under earlier rules permitting tax-free distributions to U.S. beneficiaries.<sup>526</sup>

The Wyly case history, which spans a thirteen-year period from 1992 to 2005, reflects this legal tug of war over foreign trusts. The Wyls created and funded some foreign trusts with U.S. grantors, such as the Bulldog and Pitkin Trusts, and other foreign trusts with foreign grantors, such as the Bessie and Tyler Trusts.<sup>527</sup> Some of the Wyly-related offshore trust agreements appear to have been written with the express goal of avoiding U.S. tax rules applicable to foreign trusts with U.S. beneficiaries by naming, for example, only foreign charities as the immediate trust beneficiaries and barring any “U.S. person” from receiving trust assets until two years after the death of the grantor, Sam or Charles Wyly.<sup>528</sup> The Wyly case history also illustrates the tensions between trust law, which often allows significant grantor control of trust assets, and U.S. tax and securities obligations which often turn on control issues. It illustrates further the tensions created by offshore secrecy laws that make it difficult to determine who really controls an offshore entity.

### **(b) Wyly Trust Agreements**

The trust agreements that established the 19 Wyly-related offshore trusts were documents intended to be interpreted using Isle of Man (IOM) law. Fourteen of the trusts identified Sam or Charles Wyly as the grantor; four identified a foreign individual, Keith King or Shaun Cairns, as the grantor; and one identified another trust as the grantor.<sup>529</sup> Each of the trust agreements named an IOM offshore service provider as the trustee, such as Lorne House, IFG, or Wychwood. Each of the agreements conferred upon the trustee broad discretion to manage and distribute the trust assets, indemnifying the trustee against any investment loss.<sup>530</sup> In some cases, the named beneficiaries were Wyly family members; in other cases, the named trust

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<sup>526</sup> The 1996 law also tightened the rules for taxing assets transferred to foreign trusts. In 1997, Congress enacted even tougher rules on transfers to foreign trusts, replacing an excise tax on assets transferred to foreign trusts with a rule requiring the immediate taxation of all appreciated assets transferred to a foreign trust. 26 U.S.C. § 684. The new law taxed the appreciated asset whether the transfer was direct, indirect, or constructive, and even in cases where no consideration was received.

<sup>527</sup> See Appendix 1, listing the offshore trusts, their grantors, and their beneficiaries.

<sup>528</sup> See, e.g., 1992 Castle Creek International Trust Agreement at 8 (PSI00009023)(“Until the second anniversary of the death of the Settlor no part of the Trust Fund, including the corpus or income comprising the Trust Fund may during any Taxable Year be paid to or accumulated for the benefit of any United States Person.”) and parallel provisions in the 1992 Bulldog Trust agreement (PSI00007383), 1992 Delhi International Trust agreement (PSI00009100), and 1992 Pitkin Trust agreement (PSI00009208).

<sup>529</sup> See Appendix 1.

<sup>530</sup> See, e.g., 1992 Bulldog Non-Grantor Trust Agreement at 8, 11-14 (PSI00007383, 86-89)(giving Trustee “sole and absolute discretion” regarding trust distributions and full discretionary authority to exercise a long list of powers); parallel provisions in the 1992 Pitkin Non-Grantor Trust Agreement (PSI00009208, 11-14).

beneficiaries were foreign charities and persons named in an attached schedule. The persons named in the schedule were usually Wyly family members. Several of the trust agreements authorized the trustees to name additional beneficiaries, with the consent of the trust protectors.<sup>531</sup>

All of the trust agreements provided for the appointment of one or more “trust protectors.” Two types of provisions were used. In 1992, the trust agreements that formed the first two Wyly-related offshore trusts used identical provisions to establish a “Committee of Trust Protectors” with authority to appoint, remove, and replace the trustee, inspect trust records, and advise the trustee on any matter.<sup>532</sup> Other trust agreements contained similar provisions. The foreign grantor trusts established in 1994 and 1995, however, instead of establishing a Committee, simply named specific individuals as the trust protectors. These individuals were given essentially the same authority as the Committee to replace the trustee, but the agreements did not otherwise describe their authority.<sup>533</sup>

### **(c) Wyly Trust Protectors**

During the thirteen years examined by this Report, three individuals, Michael French, Sharyl Robertson, and Michelle Boucher, served as the protectors overseeing the Wyly-related offshore trusts. During his tenure as trust protector, Mr. French also served as legal counsel to the Wyly family and acquired ownership interests in the Maverick hedge fund and Scottish Re insurance venture. Ms. Robertson simultaneously served as head of the Wyly family office and later as chief financial officer of Maverick. Ms. Boucher simultaneously served as the head of the Irish Trust Company that handled administrative matters and recordkeeping for the Wyly-related offshore entities. The Irish Trust Company is owned by the Bessie and Tyler Trusts associated with Sam and Charles Wyly. All three of the trust protectors were selected by the Wylys. All three were trusted individuals in constant contact with Wyly family office personnel.

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<sup>531</sup> See, e.g., 1994 Bessie Trust Agreement, at Section 3 (PSI00008908-10)(“The Trustees shall have power at any time and from time to time with the prior written consent of the Protector by revocable or irrevocable instrument in writing executed within the Trust Period to appoint and direct that any person or class of persons not already included in the class of Beneficiaries shall thenceforth be included in such class ....”), and parallel provisions in the LaFourche Trust Agreement (PSI0009134-35), Maroon Creek Trust Agreement (PSI00009893-94), Red Mountain Trust Agreement (PSI00009239-40), and Tyler Trust Agreement (PSI00006997-99).

<sup>532</sup> 1992 Bulldog Non-Grantor Trust Agreement at 17-18 (PSI00007392-93) and 1992 Pitkin Non-Grantor Trust Agreement at 17-18 (PSI00009217-18)(“A Committee of Trust Protectors is hereby constituted to provide advice to the Trustee.”). Under the terms of these agreements, the Committee had to have at least one and not more than five members.

<sup>533</sup> The offshore trust agreements that created a Committee of Trust Protectors include those establishing the Castle Creek International, Delhi International, Lake Providence International, Plaquemines, and Tallulah International Trusts. Trust agreements that named individual protectors include those establishing the Bessie, LaFourche, Red Mountain, and Tyler Trusts.

For the first nine years, from early 1992 until late 2000, Mr. French and Ms. Robertson served as the trust protectors for all of the Wyly-related offshore trusts. After Mr. French severed his relationship with the Wyly family in December 2000, he resigned from the protector positions, and was replaced in each instance by Ms. Boucher.<sup>534</sup> After Ms. Boucher's appointment, Ms. Robertson became less active, but did not formally resign from the protector positions until 2004.<sup>535</sup> Currently, Ms. Boucher is the sole protector overseeing the Wyly-related offshore trusts, having held that position for more than five years.

A document prepared by Ms. Boucher describes what the Wyllys were looking for in a trust protector. The document states: "Protectors should be individuals who: are familiar with the Wyly activities[;] have knowledge and expertise in structuring transactions and investing in the types of assets required[;] are familiar with and comfortable to interact with trustees, attorneys, brokers and other financial intermediaries to co-ordinate and ensure proper execution of trust activities[; and] ... are likely to be involved with Wyly activities on [a] continuing and long term basis."<sup>536</sup> This description shows that the Wyllys were not looking for individuals who would merely safeguard trust assets; they were looking for persons who would help structure transactions, invest the trust assets, and coordinate with Wyly advisers.<sup>537</sup>

In the years reviewed by the Subcommittee, the trust protectors played a central role in the day-to-day functioning of the offshore trusts and corporations. The general pattern was for Sam or Charles Wyly, or one of their representatives, to communicate a decision about a trust asset or investment activity to one of the trust protectors who, in turn, conveyed that decision to one or more of the offshore trustees, who routinely complied. In separate interviews, Mr. French and Ms. Robertson told the Subcommittee that they did not independently determine what to

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<sup>534</sup> See, e.g., 12/21/00 letter signed by Mr. French resigning from one of the trusts (PSI00059833); 12/26/00 email from Ms. Robertson to Ms. Boucher (PSI\_ED00072149)(stating that "Mike signed a document last week resigning as Protector of all Trusts" and asking Ms. Boucher to do the paperwork necessary to take his place). Earlier, Ms. Robertson had told Ms. Boucher that legal counsel had been advising her and Mr. French to step down as trust protectors and for the family to use non-U.S. citizens instead, due to "new trust regulations and ugly case law." 8/19/99 email from Ms. Robertson to Ms. Boucher (PSI\_WYBR00529).

<sup>535</sup> See, e.g., 2/6/04 and 11/25/04 letters signed by Ms. Robertson resigning from various trusts (PSI\_ED00072699-705, SR0000682, 84, 86-89, 726, 862, 1052, 1054, 1056).

<sup>536</sup> 10/31/00 email from Ms. Boucher to Charles Wyly (PSI00106558-59). See also 8/7/98 fax from Ms. Robertson to Sam, Charles, and other Wyly family members describing, among other matters, the functions of a protector (PSI\_ED00073787-93).

<sup>537</sup> At times, the Wyllys considered establishing a "Protector Company" staffed with outside lawyers and trust experts, but never did so. Instead throughout the period examined in this Report, they relied on three individuals, Mr. French, Ms. Robertson, and Ms. Boucher, to carry out their directives relative to the offshore assets. Subcommittee interviews of Ms. Hennington (4/21/06) and Ms. Robertson (3/9/06). See also, e.g., 10/31/00 email from Ms. Boucher to Charles Wyly (PSI00106558-59)(discussing possible protector company and upcoming meeting to analyze issues); December 2000 emails discussing possible company names (PSI\_ED00007717, 44511-12, 47822, 24); other documents discussing possible protector company (PSI0010232; PSI\_ED00009789-90, 10104-05).

communicate to the trustees regarding the trust assets. Each told the Subcommittee that they conveyed information only after receiving instructions or guidance from Sam or Charles Wyly or one of their representatives.<sup>538</sup> They also told the Subcommittee that, in their experience, the offshore trustees did not initiate investment activity or commit trust assets on their own. In addition, neither could identify any occasion during the thirteen years examined by the Report in which an offshore trustee declined to make an investment recommended by the protectors.<sup>539</sup>

The trust protectors and other Wyly representatives generally worded decisions relating to trust assets as “recommendations” to the offshore trustees to maintain the fiction that the offshore trustees were exercising independent judgment over the trusts’ assets and investment

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<sup>538</sup> Subcommittee interviews of Mr. French (4/21/06 and 6/30/06) and Ms. Robertson (3/9/06). For examples of communications showing Sam or Charles Wyly providing guidance on offshore assets, see, e.g., 3/10/00 memorandum from Charles Wyly to Ms. Boucher (PSI00035085)(“Sam and I recommend to our protectors that all the Sterling Software options be converted to CA options.”); April 2000 emails from Ms. Boucher to Sam Wyly and others (PSI\_ED00070335)(seeking direction on offshore sales of Michaels stock); 4/26/00 email from Evan Wyly to Ms. Boucher (PSI\_ED00043559)(“Sam recommends that the trustees exercise and sell the remainder of the Michaels options that expire this summer. Sell at \$40 or better.”); 9/15/00 email from Ms. Boucher to Ms. Robertson (MAV010831)(“I spoke to Sam today, he wants to proceed with selling 200,000 Michaels Stores shares from offshore”); 2/28/01 email from Ms. Hennington to Ms. Boucher (PSI\_ED00005370)(“I was talking to Charles yesterday and he was kind of thinking out loud on some stuff. He was talking about use of off-shore cash and was using the following for planning ...”); 3/27/01 agenda for “Irish Trust Group Meeting with Trust Protectors & Family Members” (PSI00110232-33)(listing topics to be discussed including, for example, trust investments in Precept and Ranger Capital, “possible loan arrangements” via Security Capital, management of Soulieana’s art collection, and trust holdings in Scottish Annuity); 5/23/01 email from Ms. Boucher to Sam Wyly and others (PSI00088927)(alerting them to planned stock sales by the offshore entities); 7/13/00 email from Ms. Hennington to Evan Wyly (PSI\_ED00004735)(informing him of a planned real estate purchase using primarily offshore funds: “Of the total cost, 98% will be funded from offshore.”); 1/31/02 email from Ms. Boucher to Charles Wyly and others (PSI00039590-92)(Ms. Boucher wrote: “I have estimated that the protectors should recommend an additional investment of \$3Million dollars into First Dallas International.” Mr. Wyly wrote: “Yes.”); 1/31/03 email from Ms. Hennington to Mr. Schaufele (BA082027)(“I have been with Charles for the last 1½ hours ... Moberly is going to make a paid in capital contribution to the company of cash.”); 5/21/03 email from Ms. Hennington to Ms. Boucher (PSI\_ED00012130) (forwarding a financial analysis of Wyly “familyperformance” which Ms. Hennington “did for Sam yesterday – he is calling about every hour with some new project”); 9/2/03 email from Ms. Boucher to Kristin Yeary (PSI\_ED00003204)(“I was speaking with Sam & Evan today, and we would like to get an idea of budget going forward at the Ranch” in order to arrange for offshore funding); and 5/3/99 email from the then head of the Wyly family office, Elaine Spang, to Ms. Hennington (HST\_PSI005574)(“Sam signed a letter authorizing Green Funding I to loan greenmountain.com \$22,000,000 under a non-recourse loan.... [A]n offshore entity will loan the funds to Green Funding I under a similar non-recourse loan, and GFI will turn the funds around to gm.com.”). See also memoranda, from 1995 to 1998, from Ms. Robertson to Sam and Charles Wyly and others seeking guidance on compensation issues, including for Irish Trust employees (SR0001019, 1021, 1026, 1037-39, 1072); 10/13/99 email from Ms. Hennington to Ms. Boucher (PSI\_ED00000267)(asking “[d]o you think we should sit down with Charles again and make sure he wants to go forward” with certain real estate transactions intended to be funded with offshore funds). See also documents cited in this and subsequent sections of this Report.

<sup>539</sup> Subcommittee interviews of Mr. French (4/21/06 and 6/30/06) and Ms. Robertson (3/9/06). Mr. French and Ms. Robertson each recalled a few times when offshore trustees raised questions about recommended investments, mentioning in particular investments in Green Mountain and Global Audio, two Wyly-related business ventures that consistently lost money. However, even then, neither trust protector could recall an occasion in which an offshore trustee actually declined to make a recommended investment.

activities. On occasion, however, a Wyly representative would slip and simply direct a trust to take an action. For example, on one occasion in 2000, after Ms. Boucher had sent Evan Wyly an email about a possible action to be taken by an offshore trust and he responded, “OK to proceed as described,” Ms. Robertson intervened with this warning:

“Remember that it is critical from a U.S. tax standpoint that there is no appearance that the Wyly’s are in control of the trusts or the protectors. You tried to word carefully, but I would recommend that you ‘inform’ of the intended recommendation and suggest they inform you if the[y] are aware of any different issues to be considered. In effect Evan approved this txn [transaction], you don’t want that.”

Evan agreed, writing to Ms. Boucher: “probably both of us need to be more careful with our wording since I’m not in control or approving; I’m just making recommendations.”<sup>540</sup> On another occasion in 2001, Ms. Hennington, then head of the Wyly family office, bypassed both the trust protectors and the offshore trustees, and directed a brokerage firm to sell 100,000 shares belonging to Quayle, an offshore corporation. After communicating with Ms. Boucher about her action, Ms. Hennington wrote: “I am so sorry about calling over there, I just did not know what problems it would cause.”<sup>541</sup>

**Tracking Assets.** In addition to conveying Wyly decisions to the offshore trustees, two of the trust protectors undertook a number of activities to track and manage the growing body of assets held in the names of offshore entities. Ms. Robertson and Ms. Boucher, for example, prepared numerous financial reports identifying the assets held by particular offshore trusts and their corporations, and routinely provided these reports to Sam and Charles Wyly.<sup>542</sup> Ms.

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<sup>540</sup> 11/2 and 11/3/00 emails among Ms. Boucher, Evan Wyly, Ms. Robertson, and Sam Wyly (MAV010859-60).

<sup>541</sup> October 2001 emails exchanged among Ms. Hennington, Ms. Boucher, and Mr. Schaufele (PSI\_ED00000649, 654-55).

<sup>542</sup> See, e.g., 8/31/95 “Foreign Systems” (PSI\_ED00042175-86)(assets of ten offshore trusts associated with Sam or Charles Wyly); 8/7/98 fax from Ms. Robertson to Sam, Charles, and other Wyly family members (PSI\_ED00073789-90)(listing stock options held by offshore trusts); 10/31/99 “Foreign Systems” (PSI00109903)(assets of six offshore trusts associated with Sam Wyly) and (PSI00109912)(assets of four offshore trusts associated with Charles Wyly); 9/30/00 “Foreign Systems” (PSI00071741-46)(assets of five offshore trusts associated with Sam Wyly) and (PSI00071748-51)(assets of four offshore trusts associated with Charles Wyly); 9/30/00 “Offshore Stock Analysis” (PSI00071735)(listing stock holdings of nine offshore trusts); 10/31/01 “Sam Wyly Combined Cash Flow Analysis” (PSI\_ED00008514)(listing cash assets of 21 offshore corporations); 12/31/01 “Foreign Systems (SW Total Family)” (PSI00078956-72); 2/28/02 “Foreign Systems (SW including Sub Funds)” (PSI0071753-60); 10/31/02 “Foreign Systems (CW Total Family)” and “Foreign Systems (CW)” (PSI00078298-301); 2002 “Summary of Income at the Corporate level Bulldog Trust” (PSI00078315); 9/23/03 “Cash Analysis By Company” (PSI00040534, 36-38)(cash report on multiple offshore entities); 12/31/04 “Foreign Systems (SW including Sub Funds)” (PSI\_ED00095238-93); 12/31/04 “Foreign Systems (CW)” (HST\_PSI006919-24); undated “Offshore Stock Analysis” (PSI00109932)(listing stock holdings of ten offshore trusts); undated charts (PSI00071736-39, PSI00109933-36)(listing value of assets at multiple offshore trusts and their subsidiaries). See also 4/12/96 memorandum from Ms. Robertson to Sam and Charles Wyly (SR0001018-20)(“I am spending at least

Robertson and Ms. Boucher also prepared financial reports identifying both the offshore and onshore assets associated with a particular family, such as the Sam Wyly family, so that both sets of assets could be considered as a whole. These reports typically included, for example, columns entitled, “Sam Wyly Offshore,” “Sam Wyly Onshore,” and “Sam Family Combined.”<sup>543</sup> The protectors also met in person with each of the offshore trustees, in the Isle of Man, on at least an annual basis.<sup>544</sup> Some of the IOM trustees also met with the protectors in the United States, and occasionally with Wyly family members.<sup>545</sup> In these meetings, the protectors discussed such issues as the offshore trust investments, planned asset transfers, acquisition of real estate, artwork and jewelry using offshore dollars, and more.<sup>546</sup> All of these activities presumably contributed to the ability of the Wyllys and their representatives to formulate and communicate decisions regarding the offshore assets.

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50% of my time on the Family Office. Until the last few weeks, this has been predominantly offshore with Michelle Boucher.”).

<sup>543</sup> See, e.g., 6/30/99 “Wyly Family (Global)” (PSI00109923-26); 6/30/99 “Stock Status Report” (PSI00109927)(listing stock holdings under columns entitled: “Onshore,” “Offshore,” and “Combined”); 9/30/99 “Wyly Family (Offshore)” (PSI00109868-70); 9/30/00 “Wyly Family (Global)” (PSI00071729-32); 9/30/00 “Stock Status Report” (PSI00071733); 9/30/00 “Wyly Family (Offshore)” (PSI00071734, 40); 9/30/01 “Total SW family Offshore Balance sheet” (PSI\_ED00006863-64); 10/31/01 “Sam Wyly Combined Cash Flow Analysis” (PSI\_ED00008514-15); 12/19/01 “Charles Wyly Family - Combined” (PSI\_ED00006856-59); 12/31/01 “Global SW Family” (PSI00078955); 2/21/02 “Global SW Family” (PSI00110067); 4/11/02 “Sam Wyly Combined Cash Flow Analysis” (PSI\_ED00019840); 6/6/02 “Sam Wyly Combined Cash Flow Analysis” (PSI\_ED00019820); 9/30/03 “Sam Wyly Combined Cash Flow Analysis” (PSI00040535); 9/30/03 “Charles Wyly Combined Cash Flow Analysis” (PSI00040533); 12/31/04 “Global SW Family” (PSI\_ED00095232-33); 12/31/04 “Global CW Family” (HST\_PSI006887); 12/31/04 “Family Offshore” (PSI\_ED00095234-35); and 12/31/04 “Foreign Systems (SW Total Family)” (HST\_PSI006890); 12/31/04 “Foreign Systems (CW Total Family)” (HST\_PSI006891). See also 8/7/98 fax from Ms. Robertson to Sam, Charles, and other Wyly family members (PSI\_ED00073790-91)(explaining how the internal Wyly financial reporting system worked).

<sup>544</sup> Subcommittee interview of Ms. Robertson (3/9/06). See also, e.g., materials related to an IOM trip in September 1995 (PSI00117613); November 1997 (SR0000001; PSI00131375-76); November 1999 (PSI\_ED00043811, 65855, 68667); May 2000 (MAV008060-63); Geneva trip to meet with IOM trustees in November 2000 (PSI\_ED00044334, 44455, 44463, 44964, 46461); IOM trip in March 2001 (PSI00064918-29, 110224-31; PSI\_ED00044939); IOM trip in May 2002 (PSI\_ED00009685, 9787-92); March 2003 (PSI\_ED00011813, 13743-44.); and July 2004 (PSI\_ED00012773-75).

<sup>545</sup> Subcommittee interview of Ms. Robertson (3/9/06). See also, e.g., July 2003 emails discussing Trident visit to Dallas (PSI\_ED00002708-09); trip by Close trustee to Dallas in October 2002 (PSI\_ED00013426); trip by Inter-continental in January 2001, October 2002 and May 2004 (PSI\_ED00044503, 14421,14352, 13458, 13318, 13334-35); trip by IFG to Dallas in January 2000 (PSI\_ED00070074); and 10/12/92 letter from Lorne House discussing meeting in Dallas in October 1992 (PSI00128344).

<sup>546</sup> See, e.g., issues identified for November 1999 meetings (PSI\_ED00043836); summary of meetings in May 2000 (MAV008060-63); issues identified for November 2000 meetings (PSI\_ED00044334, 44455, 46460-61); and agendas for May 2002 meetings (PSI\_ED00009787-92).

**(d) Communicating Wyly Decisions on Trust Assets**

To understand how the Wyly-related offshore trusts functioned, the Subcommittee reviewed communications between the trust protectors and the offshore service providers who served as the trustees of the offshore trusts and supplied nominee directors and officers for the offshore corporations.<sup>547</sup> The Subcommittee also examined communications between the trust protectors and the Wyls and their representatives. These communications not only show that the Wyls and their representatives were initiating and directing trust investment activities, they also raise questions about some of the activities undertaken by some of the offshore trustees.

**Specific Communications.** The communications reviewed by the Subcommittee show that, on a few occasions, the trust protectors conveyed general information to the offshore trustees on how the Wyls would like trust assets to be handled, such as when the protectors delivered to six trustees so-called “letters of wishes” from Sam Wyly describing how he would like trust assets to be distributed at his death.<sup>548</sup> Most of time, however, the protectors communicated with the offshore trustees by telephone and through a steady stream of correspondence, faxes, and electronic communications conveying very specific information about how to handle a wide range of trust matters, including the acquisition of new assets, the timing and terms of asset sales and transfers, and the allocation of assets among the offshore entities.

The protectors typically communicated with the offshore service provider serving as the trustee of the affected trust, providing detailed information about how a matter should be handled. For example, a 1992 letter from the Committee of Trust Protectors to the Bulldog Trustee recommended that the Bulldog Trust sell a specified number of Michaels stock options held by specified offshore corporations at or above a specified price.<sup>549</sup> The letter even recommended how the stock options should be exercised, indicating that the offshore corporations should use a cashless exercise through First Boston Corporation, using Louis Schaufele as the broker. Within two days, the Bulldog Trustee exercised the stock options exactly as recommended.<sup>550</sup> A 1998 fax from the protectors presented a similarly detailed recommendation to the LaFourche Trustee, specifying that certain corporate subsidiaries redeem a specified number of shares in an investment fund called Edinburgh, and sell a specified

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<sup>547</sup> The Subcommittee was generally limited to reviewing communications that included at least one U.S. person, such as a U.S.-based trust protector, and were retained by a U.S. person or entity, such as the Wyly family office. Because IOM and Cayman persons and entities generally refused to provide requested documents, the Subcommittee did not gain access to many communications that involved solely offshore personnel.

<sup>548</sup> See, e.g., six letters of wishes signed by Sam Wyly, addressed to six different offshore trusts, transmitted to the trustees by Ms. Robertson in August 1997 (SR0000838-45, 967-68).

<sup>549</sup> See 4/20/92 letter from the Committee of Trust Protectors to Lorne House Trust Company Ltd. (PSI00081463-64).

<sup>550</sup> See, e.g., PSI00081460-62 (letters from Lorne House to Michaels Stores exercising stock options as recommended by the protectors).

number of Maverick shares to a named Wyly-related corporation.<sup>551</sup> In 1997, the protectors sent the Tyler Trustee invoices listing specific “collectibles and art work,” and recommended the purchase of the specified items at a total cost of \$450,278. (PSI00078516) The trust paid the invoices five days later. (PSI00078556) In 2000, the protectors recommended that the LaFourche Trust provide \$500,000 in offshore funds to purchase “transfer development rights” for certain real estate in Colorado.<sup>552</sup> Three days later, the trust wired the funds to Colorado. (CC011870; PSI00037113)

In addition to sending communications to individual trusts, the protectors sent communications to multiple trusts regarding the transfer of specified assets from one offshore trust to another. For example, in 2001, in consultation with legal counsel, Ms. Boucher designed and the protectors recommended a complex set of transactions in which certain corporations owned by the Bulldog Trust would transfer specified assets to a corporation owned by the Delhi International Trust which, in turn, would transfer those and other specified assets, with a collective value of about \$56 million, to Security Capital.<sup>553</sup> Security Capital would then transfer them to certain Cayman limited liability corporations (LLCs) owned by the Bessie Trust. The trusts complied with the recommendation and, at the conclusion of the transactions, the specified assets were held by six Cayman LLCs associated with Sam Wyly’s six children. On another occasion in 2002, Ms. Boucher coordinated the same-day transfer of \$15 million across three offshore trusts. Wire transfers moved the funds from Devotion, owned by the LaFourche Trust; to Sarnia Investments, owned by the Lake Providence International Trust; to Greenbriar, owned by the Delhi International Trust; and finally to Security Capital.<sup>554</sup> The next day, Security Capital wired the \$15 million to Sam Wyly.

Still another example of cross-trust transfers coordinated by the protectors involves real estate. In 2000, the protectors recommended and the LaFourche Trust purchased a 244-ranch in Colorado for about \$11 million. Soon after, the protectors decided that the ranch should instead be owned by the Bessie Trust, and recommended that the LaFourche Trust, through its wholly owned corporation, Devotion, sell the property to the Bessie Trust. At first, the expectation was that the Bessie Trust would pay Devotion the purchase price plus additional costs, totaling about \$12.2 million.<sup>555</sup> But Ms. Boucher discovered that the LaFourche Trustee, then Trident, had not

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<sup>551</sup> See 10/30/98 fax from Ms. Boucher and Mr. French to Trident (PSI\_ED00070495).

<sup>552</sup> 3/3/00 email from Ms. Boucher to Trident, then LaFourche Trustee (PSI\_ED00047857).

<sup>553</sup> For more information on this 2001 transaction, see Report section on Bringing Offshore Dollars Back with Pass-Through Loans, below.

<sup>554</sup> See, e.g., 1/29/02 emails from Ms. Boucher to Lehman Brothers explaining proposed wire transfers of \$15 million to take place that day (CC012690-91). For more information on this \$15 million transaction, see Report section on Bringing Offshore Dollars Back with Pass-Through Loans, below.

<sup>555</sup> See, e.g., 3/28/00 email from Ms. Boucher to Ms. Robertson on “Little Woody Creek Ranch Limited” (PSI\_ED00047995). For more information on this real estate transaction, see Report section on Funneling Offshore Dollars Through Real Estate, below.

yet booked the real estate purchase, and was willing to re-book the transaction. Ms. Boucher recommended, and the two trusts implemented, a two-step process. First, instead of selling the real estate itself to the Bessie Trust, Devotion sold the shell corporation, called Little Woody Creek Road Ltd. (LWCRL), that was the owner of record for the property. Devotion sold this shell corporation, LWCRL, to the Bessie Trust for a nominal amount, just \$1.65. Another corporation owned by the Bessie Trust, Yurta Faf, then loaned \$12.2 million to LWCRL which, in turn, paid the funds to Devotion in satisfaction of the costs associated with buying the ranch.<sup>556</sup> This complex set of transactions was possible only because compliant trustees were willing to produce the bookkeeping favored by the protectors.

The sheer number and specificity of the protectors' recommendations indicate that these recommendations were intended to be treated by the trustees, not as suggestions or general guidance, but as specific directives for action. Through the issuance of these recommendations, the protectors effectively managed the portfolio of assets held by the Wyly-related offshore trusts, determining the types and mix of investments, which assets were held by which entities, and what use should be made of the assets so acquired.

**Specifying Offshore Entities.** The protectors made specific recommendations not only about buying, selling, and transferring trust assets, but also about which offshore entity should supply funds for a specific project.

For example, in 1995, Ms. Boucher wrote the following to Lorne House, then trustee for several offshore trusts: "Please arrange for the following amounts to be wired to Scottish Holdings on behalf of Bessie & Tyler [Trusts]. I suggest you use funds from Bulldog and Pitkin entities, preferably Morehouse and Roaring Fork."<sup>557</sup> In 2000, Ms. Boucher wrote to Ms. Robertson: "I spoke to Sam today, he wants to proceed with selling 200,000 Michaels Stores shares from offshore.... I would like to recommend selling 175,000 held by East Carroll, and 25,000 of the shares held by East Baton Rouge."<sup>558</sup> On another occasion in 2001, Ms. Boucher wrote: "We are buying \$2.5M worth of \$35 CA calls.... I've picked Sarnia for the transaction and sent everything to IFG."<sup>559</sup> IFG was then trustee of the offshore trust that owned Sarnia Investments. These trust protector recommendations indicate that the trust protectors were

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<sup>556</sup> See, e.g., 3/29/00 email from Ms. Boucher to Ms. Robertson on "Little Woody Creek Ranch sale to Bessie" (PSI\_ED00047999)("Good news (!) is that Francis hadn't finalized the 'restructuring' of the transaction so from a corporate records perspective Devotion has \$1.65 invested in LWCRL's capital stock and a loan to them for \$12,193,000. I'll have Bessie buy LWCRL for \$1.65 and have Yurta Faf advance LWCRL \$12,193,000 and have LWCRL repay Devotion. Ken is moving funds around to get money available in Yurta Faf. I expect the sale etc. ... will happen Monday."). "Francis" refers to Francis Webb, an employee of Trident, which was then the LaFourche Trustee. "Ken" refers to Ken Jones of IFG, then the Bessie Trustee.

<sup>557</sup> 12/14/95 fax from Ms. Boucher to Lorne House (PSI00118176).

<sup>558</sup> 9/15/00 email from Ms. Boucher to Ms. Robertson (MAV010831).

<sup>559</sup> 6/15/01 email from Ms. Boucher to Ms. Hennington (PSI\_ED00013896).

directing not only the assets of individual trusts, but were managing the assets of multiple trusts in a coordinated fashion.

**Demands for Quick Action.** In addition to specific communications regarding the disposition of trust assets and which offshore entities should supply funds, the protectors often pressed the trustees to act quickly to implement the recommended actions, even when substantial sums were at stake.

For example, the protectors routinely presented the Tyler Trust with invoices for hundreds of thousands of dollars to purchase specified works of art and furnishings, and asked that the “funds be wired as soon as possible” since the vendors were awaiting payment.<sup>560</sup> In 2000, Ms. Boucher sent this email to IFG, then the Bessie Trustee: “The protector committee is recommending the acquisition of various pieces of art from Computer Associates. The total acquisition price will be \$669,735. I hope to have the invoice shortly, and expect that payment will be required early next week.”<sup>561</sup>

Prompt action was also expected in real estate deals. On one occasion in 1999, the protectors pushed the LaFourche Trust to provide \$11 million in offshore funds to purchase a 244-acre ranch near Aspen, Colorado. In a subsequent email, Ms. Boucher wrote to Ms. Robertson: “Francis [Webb of Trident, then the LaFourche Trustee] commented after the fact on being very rushed on moving forward with the Woody Creek Ranch closing. Which he was, but that’s life.”<sup>562</sup> In 2001, on a Thursday, Ms. Boucher indicated to the Wyly family office in Dallas that she had requested that the trustees provide \$3.6 million in operating funds for one piece of property, and \$1.5 million for another, and “I expect the trustees will have it to move to you Tuesday or Wednesday next week.”<sup>563</sup>

Stock recommendations were also expected to be carried out promptly. In 2001, for example, Ms. Boucher wrote to Sam and Evan Wyly that a “protector recommendation will go out overnight” recommending that certain offshore entities sell a total of 270,000 shares of

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<sup>560</sup> See, e.g., 2/12/97 fax from Ms. Robertson to Lorne House presenting 23 invoices itemizing “collectibles and art work” and recommending that the Tyler Trust, through Soulieana, purchase all of the specified items at a total cost of \$450,278 (PSI00078516). The trust paid the invoices five days later (PSI00078556). See also 4/21/99 fax from Ms. Robertson to the Tyler Trust presenting 16 invoices (PSI00078481-97)(“As in the past, the protectorate committee recommends that Tyler Trust (Soulieana Limited) consider the purchase of collectibles and artwork. I am attaching invoices ... totalling \$224,298.26. ... If possible, could these funds be wired **AS SOON AS POSSIBLE** since vendors need to be paid immediately.”)(emphasis in original). For more information, see Report section on Spending Offshore Dollars on Artwork, Furnishings, and Jewelry, below.

<sup>561</sup> 11/17/00 email from Ms. Boucher to IFG (PSI\_ED00044504).

<sup>562</sup> 11/4/99 email from Ms. Boucher to Ms. Robertson on “items for trustees” (PSI\_ED00043836-37).

<sup>563</sup> 9/6/01 email from Ms. Boucher to Wyly family office employees (PSI\_ED00014220). See also, e.g., 9/6/01 letter from Lake Providence International Trust’s subsidiary Sarnia Investments (CC027321)(requesting \$1.5 million wire transfer on the same day that Ms. Boucher had recommended it).

Scottish Annuities & Life Holdings Inc. using stockbroker Lou Schaufele to “move the stock out in the market, at his discretion but at no less than \$15 per share.” She stated that “trading should commence tomorrow.”<sup>564</sup>

The protectors’ expectation that trustees would quickly implement their recommendations is additional indication that the recommendations were intended, not as suggestions, but as detailed instructions for action.

### **(e) Trustee Compliance with Wyly Decisions**

The documents reviewed by the Subcommittee also contain numerous examples of instances in which the offshore trustees complied with decisions made by the Wyllys or their representatives, further illustrating their influence over the offshore assets.<sup>565</sup>

**Pass-Through Lender.** One example of Wyly influence over the offshore assets involves Security Capital, a shell corporation established in the Cayman Islands by Queensgate Bank & Trust Co. Ltd. (Queensgate Bank) to participate in pass-through loan transactions with Wyly interests.<sup>566</sup>

According to the Wyllys’ legal counsel, Queensgate Bank formed both Security Capital Trust and Security Capital Ltd. in August 1998. According to counsel, Security Capital Trust is a Cayman charitable trust whose grantor and trustee is Queensgate Bank, and Security Capital Ltd. is a Cayman corporation wholly-owned by the Trust. The directors of the corporation are four Queensgate employees as well as the managing director of IFG, and the managing director of Trident.<sup>567</sup> IFG and Trident were then and remain today trustees of Wyly-related offshore trusts that own the offshore corporations that loaned funds and other financial assets to Security Capital.<sup>568</sup>

Security Capital Ltd. is a shell corporation with no assets, office or employees of its own. Nevertheless, on ten occasions, various Wyly-related offshore corporations loaned millions of dollars in cash or other financial assets to Security Capital Ltd. which loaned the same amount of cash or assets to a Wyly-related person or entity. Nine out of ten of the loan recipients were located in the United States, including Sam and Charles Wyly who personally received more

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<sup>564</sup> 5/23/01 email from Ms. Boucher to Sam and Evan Wyly (PSI00088927).

<sup>565</sup> See also other sections of this Report.

<sup>566</sup> For more information about Security Capital, see Report section on Bringing Offshore Dollars Back with Pass-Through Loans, below.

<sup>567</sup> According to the Wyllys’ legal counsel, Security Capital Ltd.’s directors are: John Dennis Hunter, Karla Bodden, Blair Gauld, and Jane Fleming of Queensgate Bank; David Harris of IFG; and David Bester of Trident.

<sup>568</sup> From at least 1998 until 2004, IFG was the trustee of the Bessie, Bulldog, and Delhi International Trusts, while Trident was trustee of the Pitkin and Tyler Trusts, among others.

than \$60 million in offshore cash from Security Capital pass-through loans. Altogether, Security Capital served as an intermediary for nearly \$140 million in offshore funds and financial assets that were passed from one set of Wyly-related interests to another.

In their dual roles as trustees of the offshore trusts and directors of Security Capital, the IFG and Trident managing directors presumably participated in approving both the loans by Wyly-related offshore corporations to Security Capital and the Security Capital loans to Wyly-related interests.<sup>569</sup> Documents show instances in which IFG and Trident communicated with the Wyly trust protectors and received trust protector recommendations on transferring offshore dollars or other financial assets to Security Capital;<sup>570</sup> on occasion, IFG and Wyly representatives also discussed Security Capital's loaning funds to the Wyllys.<sup>571</sup> It appears that the IFG and Trident directors facilitated these transfers, allowing the offshore corporations to lend millions of dollars to Security Capital despite its being a shell operation, and allowing Security Capital to function as a pass-through to loan offshore dollars and other financial assets to Wyly-related interests.

**Buying Assets.** On several occasions, the offshore trustees used trust funds to purchase assets recommended by the Wyllys or their representatives, despite trustee concerns about the cost or value of those assets. Three examples illustrate this point.

On one occasion in 1992, the trust protectors recommended that the Bulldog and Pitkin Trusts purchase from Sam Wyly a specified number of shares of a privately-held company, Photomatrix Corporation, at 12 cents per share.<sup>572</sup> Mr. Buchanan of Lorne House, then Trustee of the Bulldog and Pitkin Trusts, wrote to the protectors as follows:

“While we have the greatest admiration for the Protectors’ advice, an additional burden of responsibility is thrown upon us when the suggestion is made that we should buy securities from the Settlers. We cannot find a market quotation for Photomatrix. While we do not wish to suggest that 12 cents is a wrong price, we do need something for our records to show that it was a fair one. We would also like to know the registered address of Photomatrix, in case – having bought stock

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<sup>569</sup> Neither IFG nor Trident agreed to provide an interview to the Subcommittee to discuss their roles in Security Capital.

<sup>570</sup> See, e.g., 6/13/01 email from Ms. Boucher to David Harris at IFG and Ms. Hennington (PSI\_ED00006047)(transmitting lengthy document entitled, “Summary of Proposed transactions,” describing transfer of financial assets from offshore entities to Security Capital) and 6/3/02 letter signed by IFG employees on behalf of Locke to Bank of America (BA003936)(authorizing a \$5 million wire transfer to Security Capital).

<sup>571</sup> See, e.g., July 2003 emails involving David Harris of IFG, Ms. Hennington, and Ms. Boucher (PSI00040540-42)(discussing Security Capital line of credit for Sam Wyly).

<sup>572</sup> 10/9/92 letter from Ms. Robertson to Lorne House, with a copy to Mr. French (PSI00118984-85).

– we do not receive information to which we would be entitled as shareholders.”<sup>573</sup>

The protectors were recommending that the Trusts buy, not only an illiquid security in an unknown company, but also that they purchase the shares at a specified price from a particular seller, Sam Wyly, the grantor of one of the Trusts. Despite expressing concern about the value of the stock and the underlying company, the Trustee carried out the requested purchase, using Bulldog and Pitkin funds to buy more than 410,000 shares from Sam and Charles Wyly at the requested price.<sup>574</sup>

In 1996, the protectors recommended that the Bessie Trust direct its wholly owned corporation, Audubon Assets Ltd., to sell certain Treasury bills and use the proceeds to purchase a painting called Noon Day Rest for £155,000 or about \$240,000.<sup>575</sup> This painting had been selected by Sam Wyly’s wife, and the Wyllys wanted the trust to pay the cost. Mr. Buchanan of Lorne House, then the Bessie Trustee, expressed concern that the painting was overpriced, would not increase in value as quickly as Treasury bills, and would be difficult to sell at short notice. Mr. French, the trust protector, insisted that the trust pay the bill. Audubon Assets purchased the painting, which was shipped to Dallas.

On another occasion in 1999, one of the trust protectors wrote that the managing director of IFG, then trustee for several of the offshore trusts, “has been raising hell about the money going into Green Mountain,”<sup>576</sup> an energy business acquired by the Wyllys in 1997. Although Green Mountain had lost money since its acquisition in 1997, wire transfer records reviewed by the Subcommittee show that the offshore trusts repeatedly transferred millions of dollars to the company. These funds totaled over \$50 million by early 1999, with the bulk provided by trusts administered by IFG.<sup>577</sup> In response to the trust protector’s communication regarding IFG’s concern about investing in Green Mountain, Sam and Evan Wyly apparently spoke personally with the managing director of IFG.<sup>578</sup> Over the next four years, from 1999 until 2003, the

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<sup>573</sup> 10/12/92 letter from Mr. Buchanan to Mr. French (PSI00128344).

<sup>574</sup> See, e.g., 1/15/93 listing of Bulldog assets (PSI00029079)(showing Bulldog has over 238,000 Photomatrix shares) and 5/31/93 listing of Pitkin assets (PSI00127231)(showing Pitkin has over 179,000 Photomatrix shares).

<sup>575</sup> For more information about the purchase of this painting, see Report section on Spending Offshore Dollars on Artwork, Furnishings, and Jewelry, below.

<sup>576</sup> 8/19/99 email from Ms. Robertson to Ms. Boucher (PSI-WYBR00529).

<sup>577</sup> For more information about Green Mountain, see the discussion of this company in Report section on Supplying Offshore Dollars to Wyly Business Ventures, below.

<sup>578</sup> See, e.g., 1/4/00 email from Evan Wyly to Ms. Robertson (PSI\_ED0070074)(stating that Sam and Evan Wyly would like to meet with David Harris of IFG about Green Mountain when Harris was in Dallas the following week); 4/25/00 email from Evan Wyly to IFG (PSI\_ED00048130-32)(showing Evan Wyly answering IFG questions about Green Mountain); 4/10/03 emails among Evan Wyly, David Harris, and Ms. Boucher (PSI\_ED00011922-

offshore trusts administered by IFG continued to send money to the company, providing Green Mountain with another \$74 million.<sup>579</sup>

These incidents, and others cited in the Report sections that follow, show that the Wyllys and their representatives, rather than the offshore trustees, initiated the decisions to acquire trust assets and invest trust funds. These incidents also show that, even when the offshore trustees had qualms about the cost or value of an investment identified by the Wyllys, the trustees adopted the investment recommendations they were given.

**Giving Up Trust Assets.** The trusts also, on occasion, gave up trust assets, because they were asked to do so by the Wyllys or their representatives. In some cases, the assets were moved from one trust to another; in other cases, the assets were simply surrendered. In 2001, for example, the Bulldog and Delhi International Trusts complied with a trust protector recommendation to transfer specified assets valued at more than \$56 million to Security Capital in exchange for promissory notes.<sup>580</sup> The assets ended up in the possession of six Cayman limited liability corporations owned by the Bessie Trust.

In another example in 1998, the trust protectors recommended that the Bessie and Tyler Trusts approve a restructuring of Scottish Holdings, Ltd., then part of an offshore insurance venture founded by the Wyllys and Mr. French.<sup>581</sup> The proposed restructuring required the trusts to give up part of their ownership interests to enlarge the ownership interest held by the South Madison Trust, an offshore trust benefitting Mr. French. Because Lorne House, then the Trustee of the Bessie and Tyler Trusts, expressed concern about surrendering the Trusts' ownership interests, Charles Wyly and Ms. Robertson provided a letter on behalf of Tyler Trust indemnifying the Trustee for "any costs of any nature" that might result from approving the restructuring. The letter stated:

"We understand that you are concerned that the following documents which we are asking you to sign as Trustees of the Tyler Trust appear to be more favourable to the beneficiaries of the South Madison Trust than to the beneficiaries of the Tyler Trust. It is nevertheless our wish that you should sign them on behalf of the Tyler Trust and we hereby indemnify you against any costs of any nature and to

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26)(showing Evan Wyly answering IFG questions about Green Mountain).

<sup>579</sup> Altogether, according to the wire transfers traced by the Subcommittee, from 1997 to 2003, the offshore trusts administered by IFG invested about \$119 million in Green Mountain, which represents the bulk of offshore funds sent to the company.

<sup>580</sup> For more information on this 2001 transaction, see Report section on Bringing Offshore Dollars Back with Pass-Through Loans, below.

<sup>581</sup> For more information about this restructuring, see section on Scottish Re Group, below.

hold you harmless with respect to any consequences of your signing the documents.”<sup>582</sup>

The letter was signed by Charles Wyly as settlor of the Tyler Trust, even though he was not, in fact, the settlor; and by Ms. Robertson as a “Disinterested Member, Committee of Protectors.”<sup>583</sup> Sam Wyly provided a similar letter, signing it as “settlor” of the Bessie Trust, even though he was not, in fact, the settlor.<sup>584</sup> Neither letter was signed by Mr. French who was a South Madison Trust beneficiary and stood to profit from the proposed restructuring. One month later, in February 1998, the Bessie and Tyler Trusts consented to the restructuring even though it diminished the trusts’ assets.<sup>585</sup>

Two months later, in April 1998, the protectors removed Lorne House as Trustee of the Tyler and Bessie Trusts.<sup>586</sup> Ms. Robertson told the Subcommittee that the decision was made because Lorne House was too small and too old-fashioned for them to rely on.<sup>587</sup> Lorne House, however, offered another explanation several years later in the minutes of a meeting discussing a matter involving the Bessie Trust: “We were asked to resign as trustees after we had queried the benefits that the Wyly brothers’ in-house lawyer, who was not an appointed beneficiary, sought for himself.”<sup>588</sup>

Another remark made by Lorne House in connection with the same offshore insurance venture is also revealing about the amount of influence being exercised over the trusts. In 1995, Mr. Buchanan complained to Mr. French about the failure of Scottish Re to supply financial information needed to monitor trust investments in the company. Mr. Buchanan commented: “Lorne House Trust, as a trustee, is fighting the IRS in Northern California where the IRS is contending that a corporation owned by the (foreign) trust is the mere ‘alter ego’ of the Settlor, even though I can assure you that the settlor in question has been far more willing to leave us in

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<sup>582</sup> 1/5/98 letter from Charles Wyly and Ms. Robertson to Lorne House (PSI00131346).

<sup>583</sup> The Tyler Trust was, in fact, settled by Keith King as a foreign grantor trust benefitting Charles Wyly and his family.

<sup>584</sup> 1/15/98 letter from Sam Wyly and Ms. Robertson to Lorne House (PSI00117555). The Bessie Trust had been settled by Keith King as a foreign grantor trust benefitting Sam Wyly and his family.

<sup>585</sup> For more information about this matter and Scottish Re, see Report section on Supplying Offshore Dollars to Wyly Business Ventures, below.

<sup>586</sup> 4/23/98 letter from the Committee of Trust Protectors to Lorne House (PSI00131353)(replacing Lorne House as trustee of the Bessie and Tyler Trusts); 5/11/98 Deed of Retirement and Appointment of New Trustees for the Bessie Trust (CC015786-87).

<sup>587</sup> Subcommittee interview of Ms. Robertson (3/9/06).

<sup>588</sup> 5/7/02 minutes of Lorne House Trust Committee discussing the Bessie Trust (PSI00117525).

genuine control – a fact which promises to win us the case – than S. appears to be.”<sup>589</sup> Apparently, with respect to Scottish Re, Mr. Buchanan felt that Lorne House had less than “genuine control.”

**Circumventing SEC Reporting.** In some cases, the offshore trustees complied with trust protector recommendations, even when they knew the objective of the recommendations was to circumvent SEC reporting requirements. One such example involves the creation and dissolution of the Plaquemines Trust. From 1992 until 1995, Lorne House had on file with the SEC a disclosure form known as a Schedule 13D reporting that, as trustee of the Bulldog and Pitkin Trusts, it exercised beneficial ownership over 18 percent of the outstanding shares of Sterling Software.<sup>590</sup> Under U.S. securities law, a 13D filing must be submitted by all shareholders who own more than five percent of the stock of a U.S. publicly traded corporation. In early 1995, however, apparently to circumvent this filing requirement, the trust protectors recommended that Bulldog transfer a sufficient number of the Sterling Software shares to another offshore trust with a different trustee, so that Lorne House would fall below the five percent reporting threshold. This decision was made even though SEC Rule 13D states explicitly that a trust may not be created or used to evade the reporting requirement.

In March 1995, Lorne House, then the Bulldog Trustee, discussed with one of the trust protectors, Mr. French, a plan to transfer two of Bulldog’s corporations, East Carroll and East Baton Rouge, each of which owned a significant number of Sterling Software shares, to a new IOM trust that was to be called the Plaquemines Trust. On March 6, 1995, a Lorne House employee wrote to Mr. French about the plan as follows:

“Thank you for your fax dated March 3<sup>rd</sup>. We intend to transfer East Carroll Limited and East Baton Rouge Limited from Bulldog to Plaquemines, this would mean that Plaquemines would hold 350,000 shares and Bulldog would hold 644,725 shares of Sterling Software.”<sup>591</sup>

The Lorne House managing director, Ronald Buchanan, sent Mr. French another fax the next day:

“Bulldog will settle Plaquemines, in the words which you suggested. Since the purpose of the exercise, as I understand it, is to divide the ownership of Sterling

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<sup>589</sup> 3/1/95 letter from Mr. Buchanan of Lorne House to Mr. French (PSI00120863-64). “S.” is believed to be a reference to Sam Wylly.

<sup>590</sup> For more information about Schedule 13D, the Lorne House filings, and the circumstances surrounding its decision to stop filing this report, see Report section on Converting U.S. Securities into Offshore Cash, below.

<sup>591</sup> 3/6/95 fax from Barbara Rhodes of Lorne House to Mr. French (PSI00120860).

Software we need to split ownership of the underlying companies which own SS between the two trusts. That was the purpose of Barbara's fax of yesterday."<sup>592</sup>

The Plaquemines Trust agreement states that the trust was established on February 28, 1995, even though these Lorne House communications indicate that, as of March 7, the wording of the trust agreement had not yet been finalized.<sup>593</sup> This timing suggests that the trust agreement may have been backdated. The trust agreement indicates that the grantor was the Bulldog Trust, and the trustee was Wychwood. On March 19, 1995, Lorne House amended its Schedule 13D for Sterling Software, reporting that on March 6, 1995, it transferred 350,000 shares "for no consideration, to another trust with a separate and independent trustee."<sup>594</sup> Lorne House reported that, as a result of this transfer, it possessed just 4.6 percent of the outstanding shares, which meant that it was no longer obligated to file. Although Lorne House reported transferring the shares in March, corporate resolutions for the Bulldog Trust show that it actually transferred East Carroll and East Baton Rouge to the Plaquemines Trust a month later, on April 5, 1995.<sup>595</sup>

About five months later, on August 15, 1995, Ms. Robertson sent a fax to Wychwood recommending that Wychwood resign as trustee of the Plaquemines Trust.<sup>596</sup> A fax dated the following day from Lorne House to Mr. Cairns, the managing director of Wychwood, and others explained that Ms. Robertson and Mr. French, the two trust protectors, wanted quickly to purchase certain Sterling Software call options on the public market using the Plaquemines Trust, among others, to make the purchase.<sup>597</sup> The fax explained further: "Wychwood must not be trustee of two sets of trusts which are buying options simultaneously since the amount involved would trigger a reporting requirement. We have been asked, therefore, to transfer the trusteeship of the Plaquemines and Delhi Trusts from Wychwood to a temporary trustee." Janek Basnet, an Isle of Man resident, replaced Wychwood as the trustee of the Plaquemines and Delhi

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<sup>592</sup> 3/7/95 fax from Mr. Buchanan of Lorne House to Mr. French (PSI00120859).

<sup>593</sup> See 2/28/95 Plaquemines Trust Agreement (PSI00064668-99).

<sup>594</sup> 3/10/95 Schedule 13D filed by Lorne House regarding Sterling Software, at 5.

<sup>595</sup> 4/5/95 Resolutions of the Trust Committee of Lorne House (PSI00122306-07). See also 4/4/95 letter from Lorne House to Ms. Robertson (PSI00120767-68)(discussing Sterling Software shares held by Bulldog, Pitkin and Plaquemines trusts).

<sup>596</sup> 8/15/95 fax from Ms. Robertson to Mr. Cairns (PSI00124623).

<sup>597</sup> 8/16/95 fax from Mr. Buchanan of Lorne House to Shaun Cairns, Janek Basnet, and others (PSI00118019). See also 7/10/95 fax from Mr. French to Mr. Buchanan (PSI00136718).

International Trusts that same day.<sup>598</sup> Three months later, in November 1995, Mr. Basnet was replaced by IFG as the Plaquemines Trustee.<sup>599</sup>

Three years later, in June 1998, in response to a request, legal counsel for IFG provided a five-page letter identifying serious defects in how the Plaquemines Trust had been established.<sup>600</sup> Among other problems, the letter noted that the Plaquemines Trust agreement violated a doctrine known as the Rule Against Perpetuities which bans trusts of overly long duration, and that the agreement incorrectly named as beneficiaries the “issue” of the Bulldog Trust instead of the issue of Sam Wyly, thereby apparently omitting Sam Wyly’s children from the trust beneficiaries. Five months later, in November 1998, the same law firm recommended voiding the trust.<sup>601</sup> Despite this letter, no action was taken on the trust for another year. In August 1999, IFG informed the trust protectors of its intention to void the Plaquemines Trust and “appoint” its assets to its grantor, the Bulldog Trust.<sup>602</sup> IFG stated in part: “You will recall our previous discussions in relation to ... our great concerns that the original appointment from the Bulldog Trust into Plaquemines Trust was invalid. Local Counsel agree with our concerns and we have now finalised our position on the matter.” In December 1999, IFG deemed the Plaquemines Trust “void” and transferred all of its assets back to its grantor, the Bulldog Trust.<sup>603</sup> There is no public filing showing that an Isle of Man court validated this process.

This short history of the Plaquemines Trust indicates that it was used for an improper purpose, to circumvent SEC disclosure requirements, and was possibly backdated. In its first year of operation, it had three different trustees. On the mistaken theory that U.S. shares did not have to be disclosed to the SEC if they were held by different trusts with different trustees, the trustees apparently agreed to juggle their trustee posts and trust holdings in an effort to stay under the reporting threshold. Once a Plaquemines Trustee was finally settled on, it was discovered that the trust agreement itself was defective. Although the defects were spelled out in a five-page letter in mid-1998, the offshore trustee did not take action to correct the defects for more than a year. In December 1999, IFG voided the trust and returned its assets to the Bulldog Trust, describing the Plaquemines Trusts as “void *ab initio*” and characterizing it as if it had never existed for four years. Another problem, however, was that the Bulldog Trust itself had

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<sup>598</sup> See, e.g., 11/22/95 Deed of Retirement and Appointment of New Trustees for the Plaquemines Trust (CC020119-22)(providing a short history of key dates for the Plaquemines Trust).

<sup>599</sup> *Id.* The document names Aundyr Trust Company Ltd. which is an IFG subsidiary.

<sup>600</sup> 6/5/98 letter from Mann & Partners, an IOM law firm, to David Harris, managing director of IFG (PSI-WYBR00470-75).

<sup>601</sup> 11/5/98 letter from Mann & Partners to IFG (PSI-WYBR00479-80).

<sup>602</sup> 7/29/99 fax from IFG’s subsidiary Aundyr Trust Company to the “Protectorate Committee” of the “Bulldog/Plaquemines Trust” (PSI-WYBR00523-25).

<sup>603</sup> 12/30/99 minutes of a meeting of the Ayundr Trust Company directors (PSI00135539; PSI-WYBR00526-27).

also been identified as defective, as discussed below.<sup>604</sup> Together, these facts paint a picture of offshore trustees willing to help frustrate U.S. securities disclosure requirements, juggle trusteeships and trust assets, and allow the continued operation of a trust known to be defective.

**Dummy Foreign Grantors.** Additional evidence of Wyly influence over the offshore trusts involves the four foreign grantor trusts established in 1994 and 1995, the Bessie, Tyler, LaFourche, and Red Mountain Trusts, to benefit the Wyly family.

Mr. French told the Subcommittee that, in 1994, he asked Keith King, a non-U.S. citizen and then a director of Lorne House, if he would be willing to establish a foreign grantor trust benefitting the Wyly family.<sup>605</sup> At that time, foreign grantor trusts were allowed to distribute trust funds to U.S. beneficiaries tax free, and the purpose of the request was to obtain those tax benefits for Wyly family members. In response to Mr. French's request, Mr. King established the Bessie Trust whose beneficiaries were Mr. King, Sam Wyly, and his family; and the Tyler Trust whose beneficiaries were Mr. King, Charles Wyly, and his family.<sup>606</sup> Each trust agreement stated that Mr. King, as grantor, had contributed the initial trust assets of \$25,000 cash.

In 1995, Shaun Cairns, managing director of Wychwood, established two more foreign grantor trusts: the LaFourche Trust, whose beneficiaries were Sam Wyly and his family, and the Red Mountain Trust, whose beneficiaries were Charles Wyly and his family. Each trust agreement stated that, Mr. Cairns, as grantor, had contributed initial trust assets of \$25,000 in cash.<sup>607</sup> These two trusts were established on short notice as part of an effort, described later, to buy Sterling Software call options without triggering SEC reporting requirements.<sup>608</sup>

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<sup>604</sup> See, e.g., 5/12/98 letter from Mann & Partners to IFG (PSI-WYBR00371-73).

<sup>605</sup> Subcommittee interview of Mr. French (4/21/06).

<sup>606</sup> See Appendix 1 for more information about the four foreign grantor trusts.

<sup>607</sup> Some documents suggest that Mr. Cairns and Mr. King may have been reimbursed for the funds they contributed to the four trusts as initial trust assets. See, e.g., 10/17/95 fax from Mr. Cairns to Mr. French (PSI-WYBR00308) ("I have had a chat to Ronnie [Buchanan] regarding the reimbursement of the \$50,000 and he has asked me to refer the matter directly to you."); 11/26/95 fax from Mr. Buchanan of Lorne House to Mr. French (PSI00118234) ("Loan notes for the \$24,999s follow. Please fax the Protectors' authorisation to forgive the notes, as of today."); 12/31/95 balance sheets for the Bessie Trust and Tyler Trust (PSI-WYBR00310-11) (each showing a \$24,999 loan to "Berkshire Trust" which may have provided the initial funding). See also 1/19/96 note from "RB," presumably Ronald Buchanan, to "JKB," presumably Janek Basnet, and others (PSI00137842) ("It has been decided, belatedly, to give Shari [Robertson] a trust. MF [Michael French] will ask KLK [Keith L. King] to fund it: Bulldog & Pitkin are to repay him.").

<sup>608</sup> See, e.g., 7/10/95 fax from Mr. French to Mr. Buchanan (PSI00136718); 7/10/95 fax from Mr. French to Mr. Cairns (PSI00136721); 7/12/95 fax from Susan Sims, who worked with Mr. French, to Mr. Cairns (PSI00136720); 8/16/95 fax from Mr. Buchanan of Lorne House to Shaun Cairns, Janek Basnet, and others (PSI00118019); undated "Note to file" on the 8/16/95 fax by Mr. Buchanan (PSI00124625). For more information about the formation of these trusts, see Report section on Converting U.S. Securities into Offshore Cash, below.

The LaFourche and Red Mountain Trusts were established in July 1995. In October 1995, Mr. French identified numerous clerical and substantive errors in the trust agreements. Wychwood agreed to make the requested changes in the text, and apparently backdated the corrected trust agreements to July, the original trust date.<sup>609</sup>

At the time the four foreign grantor trusts were created, an IRS Revenue Ruling held that a foreign trust “owned” by a foreign grantor could distribute its income during the lifetime of the grantor to U.S. beneficiaries tax free.<sup>610</sup> In light of this Revenue Ruling, a U.S. law firm, Morgan, Lewis, & Bockius, had issued a legal opinion holding that an Isle of Man grantor trust, with a non-U.S. grantor, could issue tax-free distributions to U.S. beneficiaries during the grantor’s lifetime.<sup>611</sup> The problem, however, was that the Revenue Ruling also stated that the test for whether a foreign grantor “owned” a foreign trust was whether the foreign grantor exercised “dominion and control over the income and corpus of the trust” and “absolute power to dispose of the beneficial enjoyment of both the income and the corpus of the trust.”<sup>612</sup>

With respect to the Isle of Man trusts, the Morgan Lewis opinion did not describe facts that established control by the foreign grantor; instead the letter stated that the trustee of the foreign trust would operate “subject, in most cases, to the consent of a protector.”<sup>613</sup> The four Wyly-related foreign grantor trusts used the same protectors as the other Wyly-related offshore trusts, Mr. French and Ms. Robertson, who told the Subcommittee that their practice was to convey decisions made by the Wyls and their representatives to the trustees.

Other information in this Report provides examples of how the Wyls and their representatives exercised direction over the assets and income of the four trusts. In August 1995, for example, soon after the LaFourche and Red Mountain Trusts were established, the trust protectors directed and the Wychwood trustee caused the two corporations owned by the two

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<sup>609</sup> See 10/3/95 fax from Mr. French to Mr. Cairns (PSI-WYBR00296)(Mr. French wrote: “Shari Robertson and I have reviewed the copies of the two trusts you faxed to us. There are some clerical errors that must be remedied. I assume the documents can be redone to reflect these corrections. ... Please see to it these corrections are effected as soon as possible.”); 10/17/95 email from Mr. Cairns to Mr. French (PSI\_WYBR00308)(Mr. Cairns wrote: “Sorry for the delay in sending you the attached. We have made additional changes to the 4<sup>th</sup> Schedule of Lafourche .... Could you please let me have your views before I have them signed up and dated. (Back dated.)”).

<sup>610</sup> Rev. Rul. 69-70, 1969-1 C.B. 182. This revenue ruling was invalidated on a prospective basis by legislation enacted in 1996, as described earlier.

<sup>611</sup> 2/15/94 memorandum by Charles G. Lubar of Morgan, Lewis, & Bockius, to Mr. French (PSI-WYBR00285-89).

<sup>612</sup> Rev. Rul. 69-70; 1969-1 C.B. 182.

<sup>613</sup> 2/15/94 memorandum from Charles G. Lubar of Morgan, Lewis, & Bockius, to Mr. French (PSI-WYBR00285-89).

new trusts to buy 500,000 Sterling Software call options.<sup>614</sup> In 2000, the protectors recommended and the LaFourche Trust purchased a 244-ranch in Colorado for about \$11 million. A few months later, the protectors decided that the ranch should instead be owned by the Bessie Trust, and the LaFourche Trust sold the property to the Bessie Trust.<sup>615</sup> In 2001, the Wyllys and their representatives devised a plan to create subfunds for the Bessie Trust, directed the Bessie Trust to establish six Cayman limited liability corporations, and directed that \$56 million worth of financial assets be transferred from other Wyly-related trusts to the Cayman LLCs.<sup>616</sup>

These and other incidents indicate that Mr. King and Mr. Cairns may have been acting as so-called “strawmen” for the Wyllys who were the true grantors of the four trusts. Indeed, at one point, both Sam and Charles Wyly signed letters as grantors of the Bessie and Tyler Trusts, and no one involved with the trusts contradicted them.<sup>617</sup>

**Bulldog II and Pitkin II.** In 2000, two more IOM trusts were created, referred to as the Bulldog II and Pitkin II trusts. Four years later, both were voided by their trustees. The legal contortions used to create and void these trusts for tax purposes are still more evidence of the offshore trustees’ readiness to advance and protect Wyly interests.

In May 1998, legal counsel advised IFG, then trustee of the Bulldog and Pitkin Trusts, that both the Bulldog and Pitkin Trusts violated the Rule Against Perpetuities barring trusts of overly long duration.<sup>618</sup> The letter referenced “previous advisers” who had also identified this problem. The letter proposed a possible solution that would involve setting a termination date for the trust. Apparently, no action was taken for another two years.

In May 2000, a memorandum prepared by one of the trust protectors, Ms. Robertson, for Sam and Charles Wyly and others indicated that a decision had been made to establish two replacement trusts, the Bulldog II and Pitkin II trusts, and to merge the old Bulldog and Pitkin trusts into them to resolve the perpetuity problem.<sup>619</sup> The memorandum stated that three other Wyly-related offshore trusts, the Castle Creek, Delhi, and Lake Providence International Trusts,

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<sup>614</sup> 8/15/95 fax from Ms. Robertson to Mr. Cairns (PSI00124623). For more information about these 500,000 call options, see Report section on Converting U.S. Securities into Offshore Cash, below.

<sup>615</sup> See discussion of these transactions, above.

<sup>616</sup> For more information about this \$56 million transaction, see Report section on Bringing Offshore Dollars Back with Pass-Through Loans, below.

<sup>617</sup> 1/5/98 letter from Charles Wyly and Ms. Robertson to Lorne House (PSI00131346); 1/15/98 letter from Sam Wyly and Ms. Robertson to Lorne House (PSI00117555).

<sup>618</sup> 5/12/98 letter from Mann & Partners to IFG (PSI-WYBR00371-73).

<sup>619</sup> 5/12/00 memorandum from Ms. Robertson to Sam, Charles, and Evan Wyly and Donald Miller summarizing her recent trip to the Isle of Man (MAV008060).

would also be merged into the new trusts to reduce the overall number of offshore trusts. In October 2000, the new trusts were established and the Bulldog and Pitkin Trusts were merged into them. (PSI00135560-63; MAV008252) A few months later, in March 2001, the Delhi and Lake Providence International Trusts were merged into Bulldog II (PSI00135564-67), while the Castle Creek International Trust was merged into Pitkin II (PSI00059880-81).

Two years later, in 2003, IFG, then the Bulldog II Trustee, identified tax problems with the Bulldog II trust. IFG wrote:

“The Bulldog Trust was created by a trust agreement dated 11 March 1992 between Sam Wyly, a wealthy US person, and Lorne House Trust Company Limited. The current trustee of the trust is IFG .... The reason for creating the trust was tax driven. Its purpose was to take the assets held/to become held within the trust and various Isle of Man companies owned by it outside of the settlor’s estate for US gifts and estate tax purposes and at the same time to create a fund the income and gains of which were not attributable to any of the settlor or his family. The assets within the trust are now very substantial.

“During 1998 and 1999 the trustees, together with the settlor’s advisers, considered a number of possible amendments to the trust so as to create a structure that would be even more ‘efficient’ for tax purposes. ... Ultimately the revised tax planning arrangements were not proceeded with. However ... the trustees declare[d] a new trust, Bulldog II Trust, and ... merge[d] the original Bulldog Trust into Bulldog II Trust. ...

“In the light of various amendments to US tax legislation since 1992 the settlor has, with his advisers, been reconsidering his income tax position and the trustee is now advised that the merging of the original Bulldog Trust into Bulldog II Trust may have caused the trust to become a grantor trust for US income tax purposes. Clause 5.9 of the original Bulldog Trust contains a specific provision that ‘the trustee shall not at any time prior to the termination of this trust take any action or do any act which may cause this trust to become a grantor trust for United States income tax purposes.’

“In light of the preceding paragraph it is the trustee’s view that the purported merger of Bulldog Trust into Bulldog II Trust was void ab initio.”<sup>620</sup>

This document portrays the offshore trustees as willing participants in “tax driven” transactions to structure the IOM trusts to be immune to U.S. taxation. It also shows that, when an effort to improve a trust’s tax “efficiency” by merging it into another trust failed, the trustee was ready to declare that the merger never took effect, but was “void ab initio.”

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<sup>620</sup> 10/6/03 document entitled, “Bulldog Trust” prepared by David Harris, managing partner of IFG (PSI00135569-70).

In March 2004, an IOM law firm confirmed the problems identified by IFG, and IFG asked Meadows Owens to review a proposal to unwind Bulldog II and reconstitute the original Bulldog Trust. (PSI-WYBR00679). Apparently the same problems were identified for the Pitkin II Trust. In September 2004, the Pitkin II Trust was voided by its trustee and unwound, and the original Pitkin Trust was purportedly reconstituted as if its assets had never been moved into a new trust. (PSI-WYBR00679). The same was done by the trustees of the Castle Creek International Trust, which was purportedly reconstituted as if it had never been merged into Pitkin II. (PSI00059906; PSI00135542-51). In October, the same procedure was followed for the Bulldog II Trust. The trustees voided the Bulldog II Trust and then purported to reconstitute the original Bulldog Trust, Lake Providence International, and Delhi International Trusts as if they had never disappeared four years earlier. (PSI-WYBR00718-20).

By the end of 2004, all of the assets that had been removed from the Bulldog and Pitkin Trusts in 2000, were allegedly restored to the trusts that had originally transferred them. At the same time, the Rule Against Perpetuity defect identified in 1998, which applied to both the Bulldog and Pitkin Trusts, remained unaddressed. It is unclear what steps, if any, have since been taken to resolve this defect in the 1992 Bulldog and Pitkin trusts.

The steps taken by the offshore trustees to create, merge, void, and reconstitute trusts related to the Wyllys raise numerous legal issues. U.S. taxpayers who set up transactions in one way, and discover later that another way would have reduced their taxes, are not usually permitted by the tax code to reconstruct their past actions. In the Isle of Man, however, the offshore trustees appeared to have been attempting to achieve just that result.<sup>621</sup>

**Affiliate and Beneficial Ownership Issues.** Still another example of offshore trustee deference to the Wyllys and their representatives is the conduct of the offshore trustees when confronted with questions regarding compliance with U.S. law. As explained in later Report sections, in 2001, Lehman Brothers began to question whether one of the offshore corporations, Devotion, should be treated as a corporate affiliate of Michaels Stores due to the involvement of Sam Wyly with both companies.<sup>622</sup> Devotion took the position that it was not an affiliate subject to trading restrictions under U.S. securities law, even though the Wyllys and their representatives were directing Devotion's securities transactions. The offshore service providers, through their nominee directors and officers, presumably authorized Devotion to take that position and to use a law firm, Meadows Owens, to represent its position in discussions with Lehman's legal counsel. After Lehman tentatively reached the judgement that Devotion was an affiliate of Michaels Stores, Devotion switched its account to Bank of America, again at the direction of the Wyllys.<sup>623</sup>

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<sup>621</sup> As mentioned earlier, none of the Isle of Man offshore service providers would agree to be interviewed by the Subcommittee, so that the Subcommittee was unable to obtain their explanations for these actions.

<sup>622</sup> See Report section on Converting U.S. Securities into Offshore Cash, below.

<sup>623</sup> For more information about how the offshore entities moved their accounts from Lehman to Bank of America, see Report section on Converting U.S. Securities into Offshore Cash, below.

In 2003, a clearing broker for Bank of America began raising questions about transactions engaged in by the Wyly-related offshore entities and asked for the names of the beneficial owners behind the offshore corporations.<sup>624</sup> For more than a year, the offshore trustees refused to provide the information, even though Bank of America was required to obtain it under U.S. anti-money laundering law. Their refusal was apparently a result of the Wyllys' reluctance to document the family's specific connections to the offshore corporations.

**Fleeing the Jurisdiction.** One last example. In 2000, after attending a series of meetings with the IOM trustees, Ms. Robertson sent the following message to Sam and Charles Wyly:

“Seems to be concern expressed by the trustees that within a matter of years that there will be further regulation, which might requir[e] submission of audited financials and access to trust documents. Bester's (Trident) solution was to hire a 'lawyer' custodian to hold the trust deeds, which disclose beneficial ownership. The lawyer would be instructed by the protectors and the trustee not to release the trust deeds to anyone without joint consent. This would slow the process of delivery of the trust deeds down, giving the ability to flee the jurisdiction if it was deemed necessary.”<sup>625</sup>

According to this document, one of the offshore trustees, Trident, proposed a plan to delay responding to a potential document request by IOM law enforcement and expressed confidence that IOM professionals would be willing to carry it out, in order to give the client an opportunity to “flee the jurisdiction.” This document suggests the offshore trustees went beyond implementing trust protector recommendations and proposed means to conceal the beneficial ownership of the trusts and corporations.

#### **(f) Analysis of Issues**

The fiction maintained by the Wyly-related offshore trusts was that they functioned as independent legal entities exercising independent control over the trust assets. In fact, the trust protectors selected by the Wyllys continually conveyed specific decisions made by the Wyllys and their representatives about how trust assets should be handled, and the offshore trustees consistently did what the trust protectors asked them to do. Based on the documents and other information it obtained, the Subcommittee saw no evidence, in thirteen years, that the offshore trustees initiated investment decisions or committed trust assets on their own.

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<sup>624</sup> See Report section on Hiding Beneficial Ownership, below.

<sup>625</sup> 5/12/00 memorandum from Ms. Robertson to Sam and Charles Wyly and others on “Isle of Man Trip” (MAV008060-63).

Some of the conduct engaged in by the offshore service providers raise legal and ethical issues. Some of the offshore service providers, for example, became directors of a shell lender that issued pass-through loans to and from Wyly interests, created trusts to circumvent SEC reporting requirements, set up “strawman” foreign grantor trusts, permitted defective trusts to continue operating for years, apparently backdated trust agreements or altered them without disclosing that the alterations had been made, and refused to disclose to U.S. securities firms the names of the beneficial owners behind the offshore trusts and corporations, despite legal requirements for disclosure. These and other activities offer additional evidence that the offshore service providers were willing to and did cede direction of the offshore trust assets to the Wyllys and their representatives, and took a wide range of actions to assist them.

## **(2) Transferring Assets Offshore**

Assets can be transferred offshore in a number of ways. In this case history, the Wyly assets were transferred offshore in three groups of transactions, several years apart. The first group took place in 1992, when the initial offshore trusts were established. The second group took place in 1996, after the foreign grantor trusts were established. The third group took place in 1999 and 2002, surrounding the 2000 sales of Sterling Software and Sterling Commerce. On the first two occasions, the primary mechanism used to move assets offshore were stock option-annuity swaps, in which millions of stock options and warrants were transferred to 20 offshore corporations in exchange for 20 annuity agreements promising to make payments to the Wyllys years later. In the third instance, Sam and Charles Wyly transferred millions of stock options directly to several offshore corporations in return for cash. Altogether, from 1992 to 2002, about 17 million stock options and warrants, representing at least \$190 million in compensation, were transferred offshore.

All 17 million stock options and warrants transferred offshore had been provided to Sam and Charles Wyly by Michaels, Sterling Software, or Sterling Commerce as compensation for services performed. Wyly legal counsel took the position that the Wyllys did not have to pay any income tax on most of this compensation at the time it was sent offshore, because the Wyllys had exchanged most of the stock options and warrants for annuity agreements of equivalent value. Wyly legal counsel advised further that the securities had been transferred to independent third parties, even though the corporations who received the securities were owned by trusts established by or for the benefit of the Wyllys and allowed the Wyllys and their representatives to direct how the securities should be handled. Wyly legal counsel also advised that when the offshore corporations exercised the stock options, the stock option gains did not have to be reported as Wyly income, despite a long-standing IRS requirement that when stock options are transferred to a related party, any stock option gains must be attributed to the original stock option holders as compensation income. Instead, Wyly legal counsel advised that the Wyllys were liable for taxes only if and when they actually received annuity payments from the offshore corporations years later. In the meantime, legal counsel advised that the Wyllys could transfer their stock option compensation offshore tax-free. This untaxed compensation provided the seed money that enabled the Wyly-related offshore entities to initiate an extensive investment effort.

The stock option-annuity swaps used in this case history sought to manipulate the unusual tax status of stock options, which are virtually the only type of compensation that is not routinely taxed during the year when received, but is usually taxed during the year in which the stock options are exercised, often years after receipt. The swaps attempted to take advantage of this delay in taxation by transferring the stock options offshore to purportedly independent entities; the Wyllys and their representatives then convinced the corporations that originally issued the options not to report any compensation when those offshore entities exercised the options. A number of U.S. executives attempted to defer taxation on their stock option compensation by transferring their options to other persons and entities in various types of transactions. In 2003, the IRS announced that it considered some of these stock option transactions to be potentially abusive tax shelters and offered to settle the tax liability of persons who participated in them with reduced penalties. The Wyllys chose not to participate in this settlement initiative.

#### **(a) Stock Options in General**

In the United States, over the past ten years, stock options have commonly provided 50 percent or more of the compensation awarded to chief executive officers of publicly traded companies.<sup>626</sup> They are also commonly used to compensate the directors of a public company.

Stock options give the stock option holder the contractual right to purchase company stock at a fixed price, called the “strike price,” for a designated period of time. Frequently, the strike price equals the price that the stock is trading on a public stock exchange on the day the stock option is granted. The stock option typically guarantees that the stock option holder can buy the company stock at the designated strike price for a period of years. The expectation is that the executive will then work to increase the company stock price, not only to build a stronger company, but also to increase the value of the executive’s personal stock option holdings.

Some stock options do not permit the stock option holder to immediately purchase the company stock. Instead, they require the stock option holder to remain with the company for a designated period of time, such as two or three years, before the stock option “vests” and the executive can “exercise” it to buy the company stock. This vesting period is used to encourage the executive to remain with the company.

In some cases, stock options lose value, because the company stock price falls below the strike price. In such cases, some companies “reprice” the stock options, lowering the strike price so that the executive can profitably purchase the company stock, even though the public stock

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<sup>626</sup> See, e.g., “Special Report: Executive Pay,” Business Week (4/15/02); “Special Report: Executive Pay,” Business Week (4/19/99)(“Long-term compensation – mostly from exercised options – made up 80% of the average CEO's pay package, up from 72% in 1997.”).

price has decreased. The SEC discourages such “repricing,” since it rewards corporate executives at the expense of investors left holding the higher priced shares.<sup>627</sup>

Historically, compensatory stock options were typically nontransferable, meaning the executive given the stock option was not permitted to transfer it to a third party.<sup>628</sup> The purpose of this restriction is to preserve the incentives for the executive to remain with the company during the stock option’s vesting period and work to increase the company stock price; both employee incentives are reduced if the stock option were transferred to an outside party. Despite this general practice, some companies have allowed stock options to be transferred with the permission of the company’s board of directors; a few have allowed executives to transfer their stock options at will with notice to the company. In addition, in 1996, the SEC relaxed provisions that had made stock option transfers subject to Rule 16 insider trading restrictions; the new rules exempted from Rule 16 all securities provided by an issuer to an officer or director if certain conditions were met, including requiring any stock options to be held for at least six months from the time of award.<sup>629</sup>

Compensatory stock options are taxed under Section 83 of the Internal Revenue Code. This section, which codified a longstanding IRS position, provides that stock options are generally not taxed when granted, but are instead taxed when exercised.<sup>630</sup> When exercised, the difference between the strike price paid by the option holder for the stock and the market price of the stock on the day of the exercise is taxable as ordinary income to the stock option holder. In addition, under Section 83(h), the corporation that granted the stock option is allowed to take a “mirror” deduction for the compensation included by the executive in his or her gross income at the time of exercise.

Treasury regulations in effect since 1978 provide that, if a compensatory stock option were sold to a third party in an arm’s-length transaction, the stock option holder must treat the

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<sup>627</sup> See 17 C.F.R. §229.402(I) (SEC rule requiring any company that reprices an option during the fiscal year to include a chart in its proxy statement showing all option repricings for the prior 10 years).

<sup>628</sup> See, e.g., “Transferable Stock Options: A Complex but Valuable Estate Planning Opportunity,” Edward E. Bintz, 11 No. 8 Insights 15 (August 1997)(“Historically, most stock options granted to executives of publicly traded corporations have been nontransferable, generally in order to comply with requirements of Rule 16b(3)” of the Securities Exchange Act of 1934).

<sup>629</sup> 17 C.F.R. § 240.16b-3. This rule change was proposed in 1994, modified in 1995, and finalized in 1996. SEC Release No. 34-34514 (August 10, 1994), 59 F.R. 42449; SEC Release No. 34-36356 (October 11, 1995), 60 F.R. 53832; SEC Release No. 34-37260 (May 31, 1996), 61 F.R. 30376. Creating a Rule 16 exemption for employee stock options was part of an over-all relaxation of SEC rules related to stock options. The SEC explained the changes in part by saying that compensation transactions between a corporation and its officers and directors did not involve the kind of market risks that Section 16b was intended to discourage.

<sup>630</sup> Treas. Reg § 1.83-7. See generally, Commissioner v. LoBue, 351 U.S. 243 (1956). Special taxation rules apply to certain “statutory” stock options, that meet specific tax code requirements, but these types of options were not used in this case history. See 26 U.S.C. § 421.

amount received for the options at that time as taxable compensation income.<sup>631</sup> If the sale were to a related party, however, the transfer would not be considered a taxable event; instead, when the stock options were later exercised by the related party, any profit between the option's strike price and the stock's market price at the time of exercise would be attributed as compensation to the person who was originally awarded the stock option and who would then be required to pay tax on that income.<sup>632</sup> The purpose of this requirement is to prevent sham stock option sales to related parties for less than fair value.

Beginning in the 1990s, some accounting firms began selling a tax shelter to U.S. corporate executives to delay or eliminate the payment of tax on stock option compensation.<sup>633</sup> In this tax shelter, an executive typically transferred compensatory stock options to a related person, such as a family member or an entity controlled by family members such as a family-related partnership or corporation. In exchange, the related person typically promised to pay the executive an amount equal to the stock option's value, using a long-term, unsecured promissory note or some other unsecured, deferred payment plan promising future payments, often 20 or 30 years in the future. Often the related person had few, if any, assets other than the transferred stock options. The tax shelter promoters claimed that, because no payment was made on the transfer date to the executive, the stock option transfer was not a taxable event, and no tax was due until actual payment of the promised sums in the future. In the meantime, the related person could exercise the stock options, buy and sell the company stock, and, if the related person were located in an offshore tax haven, invest the cash tax-free.

For the tax shelter to work, however, the corporation that provided the stock option to the U.S. executive had to assist the transaction. For example, the corporation had to allow normally nontransferable stock options to be transferred by the executive to the related person. The corporation also had to allow the related person to exercise the options and take ownership of the company stock. In addition, the corporation had to agree not to issue a Form 1099 or W-2 reporting compensation to the executive from the stock option exercise, and give up the corporate deduction available to it for the stock option compensation on the date of exercise. These actions typically represented an economic hardship to the corporation since it had to forego a valuable tax deduction for the stock option compensation. Nevertheless, many corporate executives were able to convince their corporations to go along.

In 2003, the IRS concluded that this executive stock option transaction had no economic substance apart from tax avoidance, and announced that it considered it a potentially abusive tax

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<sup>631</sup> Treas Reg. § 1.83-7(a), T.D. 7554 (7/24/78).

<sup>632</sup> *Id.* See also private letter rulings, PLR 9349004 (6/8/93); and PLR 9722022 (2/27/97).

<sup>633</sup> See IRS Notice 2003-47, "Transfers of Compensatory Stock Options to Related Persons."

shelter.<sup>634</sup> In 2005, over 100 executives and corporations accepted an offer by the IRS to settle possible tax liability and penalties related to the executive stock option tax shelter by agreeing to pay back taxes on the stock option compensation, interest, and a reduced amount of penalties.<sup>635</sup> The IRS calculated that U.S. corporate executives had used the stock option tax shelter to avoid reporting nearly \$1 billion in taxable income.<sup>636</sup>

Sam and Charles Wyly used transactions similar to those described in the IRS notice to move their assets offshore. Each brother had millions of compensatory stock options that had been granted to him by the three publicly traded companies they founded or expanded, Michaels Stores, Sterling Software, and Sterling Commerce, for which, at various times, the brothers served as directors, officers, or large shareholders.<sup>637</sup> In 1992 and 1996, with the assistance of legal counsel, the Wyly brothers arranged for the transfer of many of these stock options to the offshore entities examined in this Report. In return, they accepted, not promissory notes, but private annuities.

### **(b) Private Annuities in General**

Annuities are, in essence, a contract. The party buying the annuity provides cash or property in exchange for a contractual promise that the party providing the annuity will make

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<sup>634</sup> *Id.* The Notice deemed these types of stock option transfers to related persons to be a “listed transaction” under IRS Section 6011 and IRS Tax Regulation 1.6011. The IRS also issued temporary and proposed regulations requiring such stock option compensation to be reported as taxable income to the original stock option holder. These regulations were finalized in 2004. See 2004-2 C.B. 460.

<sup>635</sup> See 2/22/05 IRS Announcement 2005-19, “Executive Stock Options Settlement Initiative.” This settlement, which was offered to both individual and corporate taxpayers who participated in the executive stock option tax shelter, required executives to include 100 percent of their stock option compensation in income, and pay back income and employment taxes, plus interest and a 10 percent penalty. The IRS later reported that it had identified 114 executives and 42 companies who participated in the abusive tax shelter, of which 95 individuals and 33 companies chose to participate in the settlement or resolved their tax liability through the audit process. 7/11/05 IRS press release, “Robust Response of Executive Stock Option Initiative.”

<sup>636</sup> 7/11/05 IRS press release, “Robust Response of Executive Stock Option Initiative.”

<sup>637</sup> At Michaels, Sam and Charles Wyly have been directors of the company from 1984 to the present time, including periods as Chairman and Vice Chairman of the Board. The Wyly Group was a large shareholder (holding five percent or more of the company stock) from 1984 until 2001, if only domestic stock holdings are counted, and through at least 2005, if offshore holdings are also counted. Sam Wyly served as Chief Executive Officer of Michaels Stores until April 1996. See 4/7/05 amended Schedules 13D filed by the Wyls regarding Michaels Stores. At Sterling Software, Sam and Charles Wyly were directors of the company from its inception in 1981, until its sale in 2000, including periods as Chairman and Vice Chairman, and the Wyly Group was a large shareholder from 1992, until the company’s sale in 2000. See Schedule 13Ds filed by the Wyls regarding Sterling Software. At Sterling Commerce, Sam and Charles Wyly were directors of the company from its inception in 1995, until its sale in 2000. Because no amended 13D filings have been filed with respect to Sterling Commerce securities held by the Wyly Group and the Wyly-related offshore entities, it is difficult to calculate their ownership over time. An S-3/A Form filed by Sterling Commerce, however, reports that as of 10/31/96, Sam and Charles Wyly and the Little Woody International and Crazy Horse Trusts collectively owned nearly 9 million shares and options, or nearly 12 percent of the total shares outstanding. See 11/1/96 S-3/A Form filed by Sterling Commerce at 4.

payments to a named “annuitant” over a designated period of time. In most cases, the cash or property provided for the annuity is invested, and the expected investment return on those assets is intended both to fund the annuity payments and generate a profit for the party providing the annuity.

Annuities are flexible and can be designed to fulfill particular needs. For example, the annuitant may or may not be the same person who contributes the annuity assets. The promised annuity payments can be for a fixed term of years or for a term measured by the life of the annuitant. The payments can commence immediately or on a future date. The payments can be a fixed amount or an amount tied to the expected or actual investment return on the annuity assets. The annuity can be obtained from a commercial insurance company that sells annuity policies, or from someone that is not in the business of selling such policies, in which case it is often deemed a “private annuity.”

Annuities are taxed under Section 72(a) of the Internal Revenue Code. A primary tax benefit associated with annuities is that capital gains on annuity assets are not taxed until the annuity payments are due. At that time, annuity payments are generally included in the recipient’s income as they are received, but not all of the annuity payment is taxable. Because some of each payment represents a return of part of the assets originally provided for the annuity, the recipient does not have to pay tax on that part. Instead, the recipient pays tax only on the increase in value.

A special rule applies to annuities purchased with appreciated assets, such as stock or real estate, instead of cash. Normally, when an appreciated asset is exchanged for something of value, the seller has to pay tax on any gain attached to that asset at the time of the exchange. But in the case of appreciated assets exchanged in an arm’s-length transaction for a deferred private annuity that is measured by the life of a person, the IRS generally allows the seller of the appreciated assets, under Code provisions dealing with the sale or exchange of capital assets, to avoid reporting a taxable gain at the time of exchange, on the theory that it is impossible to accurately determine the value of the annuity at that time.<sup>638</sup> The reporting of the gain is instead deferred until the annuity payments begin.<sup>639</sup>

The tax code limits the tax benefits provided by annuities to only those taxpayers who are natural persons. Under Section 72(u), an entity that is not a natural person, such as a corporation

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<sup>638</sup> This deferral is available only when the payment of the annuity is unsecured. A secured annuity has a more predictable value, so the gain would be immediately reportable at the time of the exchange.

<sup>639</sup> The IRS has interpreted Section 72 to permit a part of the income portion of each payment to be taxed at capital gain rates, under a formula that estimates the portion of income that represents the capital gain on the property and the portion that represents ordinary income. Rev. Rul. 69-74, 1969-1 C.B. 43. The result is that each annuity payment under an annuity bought with appreciated property is allocated three ways: one portion represents the recovery of the original investment which is non-taxable, another portion represents the profit on the appreciated property which is taxed at capital gains rates, and the remainder represents the gain from the investment of the assets which is taxed as ordinary income.

or trust, cannot defer tax on any annuity it holds, unless it is holding the annuity as an agent for a natural person.<sup>640</sup>

Annuities are no stranger to tax fraud. One common tactic has been for the person who purchased the annuity and supplied the annuity assets to immediately regain control of the assets by “borrowing” them back from the party providing the annuity. The tax code views such loan arrangements as evidence that the annuity itself was a sham to obtain a tax deferral on the investment assets. To prevent this type of sham as well as to prevent the diminishing of assets set aside for retirement income, Section 72(e) deems any “loan” that uses annuity assets as immediately taxable ordinary income. These loans may also be considered by the IRS as evidence that the annuities were themselves shams that should be disregarded for tax purposes.

In the Wyly case history, about 11 million stock options were exchanged for private annuities provided by offshore corporations owned by the Wyly-related offshore trusts.

### **(c) 1992 Stock Option-Annuity Swaps**

The first transfer of Wyly-related assets offshore took place in 1992. Nearly 3 million stock options and warrants, valued on paper by the parties at about \$41.8 million, were transferred to ten newly-established, offshore corporations. An elaborate transfer strategy had been developed by David Tedder and Michael Chatzky, the attorneys who first advised the Wylys to move assets offshore.<sup>641</sup> Essentially, the strategy had four parts: (1) establishing ten Isle of Man (IOM) corporations and ten Nevada corporations, all of which were shell operations that had no employees or offices of their own; (2) transferring the nearly 3 million stock options and warrants from Sam and Charles Wyly to the Nevada corporations in exchange for private annuity agreements; (3) assigning the securities and annuity agreements from the Nevada corporations to the IOM corporations; and (4) terminating the Nevada corporations. The end result was that the ten offshore corporations took possession of the nearly 3 million stock options and warrants.

**Shell Corporations.** The first step in the Tedder-Chatzky plan was the creation of shell corporations both offshore and in the United States. In March 1992, the first set of Wyly-related offshore trusts and their subsidiaries were established.<sup>642</sup> The Bulldog Trust, whose grantor was Sam Wyly, formed multiple IOM corporations, six of which were used in the 1992 stock option-

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<sup>640</sup> A corporation or trust that is not acting as an agent for a natural person must pay tax on the full cash surrender value of the annuity contract as of the end of the year, plus any distributions it received during the year.

<sup>641</sup> Subcommittee interviews of Ms. Robertson (3/9/06) and Mr. French (4/21/06). See also written legal opinions cited below.

<sup>642</sup> For more detail, see Overview of Wyly Offshore Operations, above.

annuity swaps.<sup>643</sup> The Pitkin Trust, whose grantor was Charles Wyly, also formed multiple IOM corporations, four of which were used in the 1992 stock option-annuity swaps.<sup>644</sup>

During March and April 1992, Ms. Robertson worked with a U.S. company formation agent to establish ten Nevada corporations, each of which had an identical name to one of the ten IOM corporations.<sup>645</sup> Ms. Robertson served as the sole director as well as the president, secretary, and treasurer for all ten Nevada corporations.<sup>646</sup> Each of the corporations was owned by the foreign corporation bearing the same name.<sup>647</sup> When asked why the Nevada and IOM corporations shared names, Ms. Robertson indicated that she thought legal counsel had designed it as a device intended to guide the flow of assets from the U.S. entities to the offshore entities and to avoid any commingling or mixup over ownership of particular stock options and warrants.<sup>648</sup>

**Initial Asset Transfers to Nevada.** In April 1992, in ten separate transactions, Sam and Charles Wyly transferred to the ten Nevada corporations a total of one million options and 983,589 warrants to buy Sterling Software stock, as well as 865,000 options and 100,000 warrants to buy Michaels stock.<sup>649</sup> In exchange, the ten Nevada corporations provided ten

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<sup>643</sup> The six IOM corporations were East Baton Rouge Ltd., East Carroll Ltd., Morehouse Ltd., Richland Ltd., Tensas Ltd., and West Carroll Ltd.

<sup>644</sup> The four IOM corporations were Little Woody Ltd., Maroon (later renamed Rugosa) Ltd., Roaring Creek Ltd., and Roaring Fork Ltd.

<sup>645</sup> The ten Nevada corporations were named: East Baton Rouge Ltd., East Carroll Ltd., Morehouse Ltd., Richland Ltd., Tensas Ltd., West Carroll Ltd., Little Woody Ltd., Maroon Ltd., Roaring Creek Ltd., and Roaring Fork Ltd.

<sup>646</sup> See, e.g., 3/27/92 Articles of Incorporation of Little Woody Limited filed with the State of Nevada (PSI00059447-50); 3/31/1992 Written Consent of Sole Director of Little Woody Limited (PSI00094344-45); 4/15/1992 Written Consent of Directors of Little Woody Limited (PSI00094347).

<sup>647</sup> See, e.g., 4/22/92 "Receipt" showing each IOM corporation paid \$10 cash to purchase 1,000 shares of the corresponding Nevada corporation (PSI00093483); 2/28/92 letter from Pratter, Tedder & Graves to Sam Wyly describing the 1992 transfers at 3 (PSI-WYBR00219-43, at 221) ("It is our further understanding that the domestic corporation intending to purchase the Securities in exchange for the issuance of the private annuity is wholly owned by a foreign corporation which is wholly-owned by a foreign nongrantor trust.").

<sup>648</sup> Subcommittee interview of Ms. Robertson (3/9/06). The matching names are also evidence of a strategy to move the stock options and warrants through U.S. intermediaries to offshore entities.

<sup>649</sup> See chart entitled, "Transferring Assets Offshore," prepared by the Subcommittee Minority Staff, summarizing the offshore transfers of Wyly assets. Sterling Commerce was not incorporated until 1995, and played no role in the 1992 transactions.

private annuity agreements which pledged to begin making annuity payments to Sam, Charles, or Charles Wyly's wife in the year in which each turned 65 years of age.<sup>650</sup>

To transfer the stock options and warrants to the Nevada corporations, the Wyllys obtained the cooperation of both Sterling Software and Michaels, which controlled the ownership records for these securities. Prior to 1992, the Sterling Software and Michaels stock option plans and individualized stock option agreements with Sam and Charles Wyly had made the stock options awarded under them nontransferable to any person, except through the option holder's estate.<sup>651</sup> Despite these provisions, in connection with the 1992 stock option-annuity swaps, Sterling Software and Michaels issued formal consent documents which stated that, "notwithstanding such restriction on transfer" in the original stock option agreements, the companies consented to the Wyllys transferring their options to the offshore entities.<sup>652</sup> Beginning in 1992 and in the years afterward, the Sterling Software, Michaels, and Sterling Commerce stock option agreements with the Wyllys replaced the nontransferability provision with a clause giving the option holder unilateral authority to transfer the stock options to a third party, with five days notice to the company.<sup>653</sup> Upon receiving such notice, the companies

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<sup>650</sup> See Private Annuity Agreements involving East Baton Rouge (PSI00086096-106); East Carroll (PSI00132954-64); Morehouse (PSI00133169-85); Richland (PSI00133232-48); Tensas (PSI00009472-88); West Carroll (PSI0133535-51); Little Woody (PSI00133007-17); Maroon (PSI00009427-37); Roaring Creek (PSI00133289-305); and Roaring Fork (PSI00133370-84).

<sup>651</sup> See, e.g., "Sterling Software Inc. Non-Statutory Stock Option Plan," Section 10 (PSI00099859-62); "Michaels Stores Inc. Non-Statutory Stock Option Plan," Section 13 (PSI00083962-64); 9/16/86 Sterling Software "Non-Statutory Stock Option Agreement" with Charles Wyly, Section 6 "Non-Transferability of Options" (PSI00086021-24 at 22) ("This Option is not assignable or transferable ... otherwise than by will or the laws of descent and distribution and during the lifetime of the Participant may only be exercised by him."); and with Sam Wyly (HST\_PSI037049-52); 8/22/90 Michaels "Non-Statutory Stock Option Agreement" with Sam Wyly, Section 6 "Non-Transferability of Option" (PSI00132916-19).

<sup>652</sup> See, e.g., 4/17/92 Sterling Software "Consent to Transfer of Non-Statutory Stock Option" with Charles Wyly (PSI00133019); 4/14/92 Michaels "Consent to Transfer of Non-Statutory Stock Option" with Sam Wyly (PSI00132913-14). Michaels general counsel told the Subcommittee that Mr. French had orally informed him in 1992, that the Michaels Board of Directors had approved the 1992 stock option transfers to the offshore entities. Subcommittee interview of Mark Beasley (6/7/05). Mr. Beasley noted that the Board never placed this approval in writing or mentioned it in the Board minutes. Mr. French told the Subcommittee that he could not recall whether or not he had conveyed this information to Mr. Beasley in 1992. Subcommittee interview of Mr. French (4/21/06). See also, e.g., 4/20/92 letter from Jackson & Walker to Ms. Robertson (MSNY025211-12) (enclosing multiple documents in which Sterling Software and Michaels consented to stock option transfers from the Wyllys to the Nevada corporations, and stating "[a]fter we sign up the assignments from the Nevada corporation[s] to the Isle of Man corporations on Wednesday, we can coordinate having new Sterling Series B warrants and Michaels warrants executed in the name of the appropriate Isle of Man corporations").

<sup>653</sup> See, e.g., 11/23/94 Sterling Software "1992 Non-Statutory Employee Stock Option Agreement" with Sam Wyly, Section 6 (HST\_PSI004827-30); 8/19/92 "Michaels Stores, Inc. Non-Statutory Stock Option Agreement" with Charles Wyly, Section 6 (MSNY015795-99, at 97); 2/12/96 "Sterling Commerce, Inc. 1996 Stock Option Plan Stock Option Agreement" with Sam Wyly, Section 6 (PSI00085949-52).

typically issued a formal document amending the relevant stock option agreements to reflect the new ownership; on occasion, the companies even waived the five-day notice requirement.<sup>654</sup>

**1992 Annuity Agreements.** All ten of the 1992 annuity agreements used the same format and contained the same provisions with numerous identical passages. Their key provisions can be summarized as follows. Each agreement identified the number of stock options and warrants being contributed by the annuitant and specified a present fair market value for them.<sup>655</sup> Each agreement promised the annuitant would receive annuity payments equal to the fair market value of the securities plus an 8.4 percent per annum interest rate, compounded each year from the date the securities were contributed until the date of the first payment.<sup>656</sup> Each agreement stated that the annuity payments would begin on the date the annuitant reached the age of 65, would continue for the life of the annuitant, and would be paid once per year. In addition, each agreement required the annuitant to give up all ownership interest in the contributed securities, acknowledge that no collateral secured the annuity payments, and accept the “risks attendant with respect to the acquisition of an unsecured high risk private annuity.”<sup>657</sup>

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<sup>654</sup> See, e.g., 12/21/95 Sterling Software “Amendment to Non-Statutory Stock Option Agreement” (PSI00029394-95)(transferring stock option ownership from Sam Wyly to Crazy Horse Trust); 12/30/95 Sterling Software “Amendment to Non-Statutory Stock Option Agreement” (PSI00132065-66)(transferring ownership from Charles Wyly to Woody International Trust); 9/13/96 Sterling Commerce “Third Amendment to Stock Option Agreement” (PSI00085953-55)(showing transfer of ownership from Sam Wyly to the Crazy Horse Trust and then to Moberly); 12/29/95 Michaels “Amendment to Non-Statutory Stock Option Agreement” (PSI00063573-74)(transferring ownership from Charles Wyly to Maroon Creek Trust); 7/23/02 Computer Associates “Agreement to Transfer Stock Options and Amend Stock Option Agreement” (transferring stock option ownership from Charles Wyly to Quayle and waiving five-day notice period), exhibit to 7/26/05 deposition of Sam Wyly, Sam Wyly and Ranger Governance, Ltd. v. Computer Associates International Inc. And Sterling Software, Inc., Civil Action No. 3:04-CV-1984-B (N.D. Texas).

<sup>655</sup> See, e.g., 4/13/92 Private Annuity Agreement involving East Baton Rouge Ltd. (Nevada) (PSI00086096-106), at Schedule A (listing contributed assets as 375,000 options to buy Michaels stock) and Section 2.1 (“Agreement as to Value” indicating that the parties agreed that the value of the 375,000 stock options was \$6,609,375).

<sup>656</sup> Id. at Section 2.4(a) and (b). This interest rate matched the rate then recommended by the IRS. Each month, the IRS publishes recommended interest rates for use in annuities to establish arm’s-length transactions; the recommended rate for April 1992 was 8.4 percent. Rev. Rul. 92-23, 1992-1 Cum. Bull. 292. See also five letters, dated 4/30/92, from a Texas actuarial and consulting firm, Milliman & Robertson, Inc., to either Sam or Charles Wyly (PSI00040155-56, 69-70, 77-78, 81-82, 85647-48), explaining how the annual payment amount was calculated for five of the 1992 annuities. Each of these letters, using the same format and virtually identical passages, identified the particular factors and IRS-recommended valuation tables and interest rates used to calculate the annual payment amount that would have to be made under each annuity. The letter on the East Baton Rouge annuity, for example, determined that the annual annuity payment would be in the amount of \$1,536,342.

<sup>657</sup> Id. at Sections 1.1(d) and 3.1. Each private annuity agreement refers to itself as “high risk,” presumably because the annuity payments are unsecured, no payments would be provided if the annuitant died before the payment due date, and, at the time the agreement was signed, the offshore corporation possessed no assets other than the stock options provided by the Wyls.

Each agreement required the corporation providing the annuity to make the promised annuity payments whether or not the contributed securities produced sufficient earnings.<sup>658</sup>

The collective dollar value of the stock options provided in exchange for the private annuities, according to the fair market value specified in each of the ten annuity agreements, totaled about \$41.8 million.

**From Nevada to the Isle of Man.** Within a week of executing the annuity agreement – often on the same day – each of the Nevada corporations assigned both the private annuity agreement and the contributed assets to its corresponding IOM corporation, bearing the same corporate name.<sup>659</sup> So, for example, East Baton Rouge Ltd. in Nevada transferred its annuity agreement and assets to East Baton Rouge Ltd. in the Isle of Man.<sup>660</sup> By the end of April 1992, nearly 3 million stock options and warrants had moved offshore in exchange for private annuity agreements payable to the Wyls.

When asked why the Wyls entered into annuity agreements with the Nevada corporations instead of the IOM corporations that ultimately held the agreements, none of the persons interviewed by the Subcommittee could explain the reasoning other than to say they were following the instructions of legal counsel, David Tedder and Michael Chatzky.<sup>661</sup> In any event, the Nevada corporations appear to have served as convenient, U.S.-based intermediaries.

**1992 Legal Opinions.** On February 28, 1992, a California law firm associated with Mr. Tedder, called Pratter, Tedder & Graves, issued three almost identical legal opinion letters to Sam, Charles, and Charles Wyly's wife opining that they could defer any payment of tax on the stock option compensation that was exchanged for private annuities.<sup>662</sup> On April 2, 1992, the firm issued ten legal opinion letters, almost identical to each other, to the ten Nevada corporations concluding that their transfers of the annuity agreements and stock options offshore were also nontaxable events.<sup>663</sup>

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<sup>658</sup> *Id.* at Section 6.1.

<sup>659</sup> See, e.g., 4/13/92 "Assignment and Assumption Agreement" between Roaring Fork Ltd. (Nevada) and Roaring Fork Ltd. (IOM) (PSI00128830-32); 4/15/92 "Assignment and Assumption Agreement" between Tensas Ltd. (Nevada) and Tensas Ltd. (IOM) (PSI00130828-30).

<sup>660</sup> See, e.g., 4/15/92 "Assignment and Assumption Agreement" between East Baton Rouge Ltd. (Nevada) and East Baton Rouge Ltd. (IOM) (MSNY010493-95).

<sup>661</sup> Both Ms. Robertson and Mr. French, for example, told the Subcommittee that they did not know why the Nevada corporations were used.

<sup>662</sup> 2/28/92 letters from Pratter, Tedder & Graves, signed by David Tedder, addressed to Sam, Charles and Caroline D. Wyly (PSI-WYBR00191-269). Mr. French told the Subcommittee that Mr. Chatzky was involved with the drafting of these letters. Subcommittee interview of Mr. French (4/21/06 and 6/30/06).

<sup>663</sup> 4/2/92 letters from Pratter, Tedder & Graves, signed by David Tedder, addressed to the ten Nevada corporations (PSI-WYBR00028-190), except that one signature block for the East Carroll letter is unsigned.

Each of the legal opinion letters addressed to the Wyls advised that they could defer the payment of any tax on the \$41.8 million in stock option compensation sent offshore in exchange for the private annuities. The letters reasoned that a promise to make lifetime annuity payments had no immediately determinable value, an unfunded and unsecured promise to pay money in the future did not qualify as taxable property, and the stock options themselves had no readily ascertainable fair market value under Section 83 of the tax code, so none of the transactions resulted in an immediate tax liability to the Wyls. The letters also reasoned that, because the value of the private annuity being provided equaled the fair market value of the stock options being contributed in exchange for the annuity, no gift tax would apply. The letters asserted further that the exercise of the stock options would not result in taxable compensation to the original stock option holders, because the stock options had been disposed of in arm's-length transactions.

The legal opinion letters failed to acknowledge or analyze the key issue of whether the stock option transfers were transfers between related parties and, thus, under Section 83 of the tax code, had to attribute any stock option exercise gains as taxable income to the original stock holders, Sam and Charles Wyly. Instead, each letter simply asserted without explanation that the stock options were transferred in arm's-length transactions.

Counsel forwarded copies of the letters addressed to the Wyls to Michaels and Sterling Software, presumably to aid both corporations in reaching a decision not to report any stock option compensation for the Wyls either at the time the Wyls initially transferred the stock options to the Nevada corporations or later when the offshore corporations exercised those stock options.<sup>664</sup> The evidence indicates that neither Michaels nor Sterling Software, in fact, issued a W-2 or 1099 form reporting the Wyly stock option compensation, either in 1992 or later.<sup>665</sup> Apparently both corporations determined that the stock option-annuity swaps, as represented to them, meant that neither Sam nor Charles Wyly would receive any taxable income from their stock options until the annuity payments began years later.

**Dissolution of Nevada Corporations.** After the annuities were assigned from the Nevada to the IOM corporations, Sam and Charles Wyly transferred their interests in the private

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<sup>664</sup> See, e.g., 4/9/92 letters from Pratter, Tedder & Graves forwarding the opinions to Michaels and Sterling Software (PSI\_WYBR00191-92; 217-18; 244-45).

<sup>665</sup> Michaels told the Subcommittee that it did not take a tax deduction related to any of the Wyly stock options transferred offshore, foregoing millions of dollars in tax deductions related to this stock option compensation. See also 5/6/05 Notice of Election by Corporation to Participate in Announcement 2005-19 Settlement Initiative, Form 13657, filed by Michaels Stores, Inc. with the IRS (MSNY028653-58). Documents provided by Sterling Software's successor corporation, CA, Inc. (CA), indicate that Sterling Software also did not take a tax deduction for the Wyly stock option transferred offshore. See information provided to the Subcommittee by Sterling Software's successor corporation, CA (7/20/06). See also Treasury Regulation Section 1.83-6(a)(2), which states that a corporation may take a deduction for stock option compensation under Section 83 only if the option holder has included the stock option gains in income, unless the corporation issues a W-2 or 1099 form reporting the compensation to the IRS. Venture Funding Limited v. Commissioner, 110 T.C. 236 (1998), affd, 198 F.3d 248 (6<sup>th</sup> Cir. 1999).

annuities to Texas partnerships that each controlled. Sam Wyly transferred his interest to Tallulah Ltd., while Charles Wyly transferred his interest to Stargate Ltd.<sup>666</sup> Several years later, in 1996, the ten Nevada corporations were dissolved.<sup>667</sup>

Together, the evidence shows that the 1992 stock option-annuity swaps were orchestrated by U.S. legal counsel and facilitated by two publicly traded corporations. The swaps began with the Wyllys transferring nearly 3 million stock options and warrants with an ascribed value of \$41.8 million to ten newly created corporations in Nevada with no employees, offices, or other assets. In return for these valuable securities, the Nevada corporations provided unsecured annuity agreements promising to make payments years later. The Nevada corporations then assigned both the securities and annuity agreements to shell IOM corporations with no other assets. Exchanging valuable stock options and warrants in return for unsecured promises by shell corporations to make payments beginning years in the future makes no economic sense, absent the tax considerations. The opinion letters issued at the time suggest that the primary motivation for these transactions was the deferral of U.S. tax on nearly \$42 million in compensation.

#### **(d) 1996 Stock Option-Annuity Swaps**

The second set of offshore transfers of Wyly assets took place in 1996. Again designed by legal counsel, this time Chatzky and Associates, the transfer strategy consisted of essentially three steps: (1) 8.6 million stock options were transferred by Sam and Charles Wyly to seven grantor trusts in the Isle of Man; (2) the seven IOM grantor trusts then transferred the stock options to ten Wyly-related IOM corporations in exchange for private annuities payable to Sam or Charles Wyly; and (3) the IOM grantor trusts were terminated and distributed the annuity agreements to Sam and Charles Wyly. The end result was that the ten IOM offshore corporations took possession of 8.6 million stock options worth at least \$118.4 million. As in 1992, the Wyllys took the position, on advice of counsel, that they did not have to pay taxes on any of more than \$118 million in stock option compensation, either at the time of the transfer or when the stock options were later exercised, but only if and when they received the promised annuity payments years later.

**Initial Asset Transfers to Offshore Trusts.** Seven IOM trusts participated in the 1996 stock option-annuity swaps. One of these trusts had previously existed but was newly amended;

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<sup>666</sup> See, e.g., series of letters dated 8/31/92, addressed to Sam Wyly from six IOM corporations, East Baton Rouge, East Carroll, Morehouse, Richland, Tensas, and West Carroll (PSI00092593-98) (consenting to his assigning his private annuity interests to Tallulah Ltd.); 7/23/02 letter from Computer Associates to Sam and Charles Wyly (PSI00059890-92) (stating that stock options awarded to Charles Wyly were contributed to Stargate Ltd. which later sold them to Elegance and Quayle).

<sup>667</sup> See, e.g., documents related to the dissolution of Morehouse Ltd. (Nevada) (PSI00093352-61) and Roaring Creek Ltd. (Nevada) (PSI00093401-10).

the other six were newly created in December 1995 or January 1996.<sup>668</sup> Sam and Charles Wyly were the grantors of all seven.<sup>669</sup> In February and March 1996, in ten separate transactions, Sam and Charles Wyly transferred millions of stock options to the seven IOM grantor trusts, including 2.65 million options to buy Sterling Software stock; 1.35 million options to buy Michaels stock; and 4.6 million options to buy Sterling Commerce stock.<sup>670</sup>

**From One IOM Entity to Another.** Once the seven IOM grantor trusts acquired the 8.6 million stock options, they immediately transferred them to ten IOM corporations, all of which were owned by other Wyly-related offshore trusts. In exchange, the ten offshore corporations entered into private annuity agreements with the IOM grantor trusts.<sup>671</sup> Each of these annuity agreements named either Sam or Charles Wyly as the annuitant and specified that the offshore grantor trust was holding the annuity as an agent for that person.

When asked why the Wylys had transferred their stock options to the IOM grantor trusts instead of transferring them directly to the IOM corporations in exchange for the private annuities, no one interviewed by the Subcommittee could explain the reasoning other than to say they were following the instructions of legal counsel.

As in the case of the 1992 stock option-annuity swaps, the publicly traded corporations that had issued the compensatory stock options to Sam and Charles Wyly facilitated the 1996 transactions. Among other actions, Michaels, Sterling Software, and Sterling Commerce acknowledged the offshore transfers and amended their records to reflect the new ownership of

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<sup>668</sup> The pre-existing IOM trust was the Tallulah International Trust, which was originally established in 1992, and amended and restated in December 1995. (PSI00009785-817) The six newly created IOM trusts were the Arlington Trust, Crazy Horse Trust, Lincoln Creek Trust, Maroon Creek Trust, Sitting Bull Trust, and Woody International Trust. For more information on these trusts, see Appendix 1.

<sup>669</sup> See, e.g., 2/22/96 Private Annuity Agreement involving the Arlington Trust (PSI00093214-28) at §12.1 (“[The Arlington Trust] hereby warrants that it is presently a grantor trust for United States income tax purposes.”). See also IRC 671-79 (grantor trust rules).

<sup>670</sup> See chart entitled, “Transferring Assets Offshore,” prepared by the Subcommittee Minority Staff, summarizing the offshore transfers of Wyly assets. Sterling Commerce was established as a separate corporation in December 1995, and held its initial public offering in March 1996. It issued stock options to its officers and directors, including Sam and Charles Wyly, in February 1996. See Sterling Commerce 3/13/96 10-K filing at Exhibit 10(m) at 1. See also documents related to Sterling Commerce stock option-annuity swaps (PSI00137770)(2/21/96 recommendation by Mr. French to Lorne House for two offshore trusts to establish new offshore corporations to participate in annuity assignments “which we would like to finalize by tomorrow”) and (PSI00138087-88)(3/7/96 fax forwarding documents to be signed and returned the same day).

<sup>671</sup> See Private Annuity Agreements between the Arlington Trust and Sarnia Investments Ltd. (PSI00093214-28); between the Crazy Horse Trust and Audubon Assets Ltd. (PSI00093176-90); between the Crazy Horse Trust and Locke Ltd. (PSI00093153-67); between the Crazy Horse Trust and Moberly Ltd. (PSI00042655-69); between the Lincoln Creek Trust and Elegance Ltd. (PSI00084937-51); between the Maroon Creek Trust and Quayle Ltd. (PSI00009370-84); between the Sitting Bull Trust and Devotion Ltd. (PSI00085252-66); between the Tallulah International Trust and Yurta Faf Ltd. (PSI00009502-16); between the Woody International Trust and Elysium Ltd. (PSI00132363-77); and between the Woody International Trust and Soulieana Ltd. (PSI00009453-67).

the stock options by the offshore corporations.<sup>672</sup> As before, it appears that none of the corporations sent the IRS a 1099 or W-2 filing reporting Wyly stock option compensation either at the time of the 1996 transfers or when the stock options were later exercised.<sup>673</sup> Apparently, none of the corporations took a corporate deduction for any of the \$116 million in Wyly stock option compensation.<sup>674</sup>

**Michaels Stock Option Repricing.** In addition to facilitating the offshore transfers, Michaels also increased the value of the stock options held by the offshore corporations. On February 22, 1996, Sam and Charles Wyly transferred 1.35 million Michaels options to several offshore trusts. Ten days later, on March 4, 1996, the Michaels board of directors decided to reprice all of its outstanding stock options, lowering the strike price nearly 30 percent, from \$17 to \$12.50.<sup>675</sup> The company justified this repricing as necessary to retain and motivate its executives, but also applied the new strike price to the stock options which, by then, were held by the Wyly-related offshore corporations. These corporations, which were supposedly independent entities, had no need to be retained, motivated, or otherwise rewarded by Michaels. Michaels nevertheless applied the lower strike price to all of the Michaels stock options held offshore, substantially increasing their value.<sup>676</sup>

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<sup>672</sup> See, e.g., December 1995 Sterling Software “Amendment to Non-Statutory Stock Option Agreement” involving the Arlington Trust (PSI00092917-18), Crazy Horse Trust (PSI00029394-95), and Woody International Trust (PSI00132065-66); February 1996 Michaels “Second Amendment to Employee Stock Option Agreement” and December 1995 “Amendment to Non-Statutory Stock Option Agreement” involving the Maroon Creek Trust and Quayle (MSNY015790-94), the Woody International Trust and Soulieana (MSNY015807-11, PSI000132015-16), and the Tallulah International Trust (PSI00063618-19, 26156-57); 3/7/96 Sterling Commerce “Second Amendment to Stock Option Agreement” involving the Crazy Horse Trust and Moberly (PSI00085964-65), and the Woody International Trust and Elysium (PSI00124554-55).

<sup>673</sup> Information provided to the Subcommittee by Michaels, Sterling Software’s successor corporation CA, Inc., and Sterling Commerce’s successor corporation, SBC Communications.

<sup>674</sup> Michaels later calculated that, by not taking deductions for the Wyly compensation represented by the 1992 and 1996 stock options sent offshore, it gave up deductions exceeding \$20 million. See undated document prepared by Michaels entitled, “Loss of Tax Deductions: Wyly’s Foreign Trusts” (MSNY020284)(showing stock option exercises by Wyly-related offshore entities from February 1997 through August 2000, producing stock option profits exceeding \$50 million).

<sup>675</sup> This action was the second time within six months the Michaels board had repriced the company’s stock options. Throughout 1994 and 1995, Michaels’ stock price had steadily fallen. Its outstanding stock options had accordingly lost value, and by mid-1995, many had strike prices that exceeded the prevailing market price. In response, on 9/28/95, Michaels lowered the strike price on all of its outstanding stock options, replacing strike prices ranging from \$39 to \$20 with a new strike price of \$17. See, e.g., 10/23/96 DEF 14A proxy statement filing by Michaels, at 11. The lower \$17 strike price was applied not only to stock options held by the company’s employees, but also to the stock options held by the Wyly-related offshore entities. On 3/4/96, Michaels lowered the strike prices still further. See, e.g., 4/30/97 DEF 14A proxy statement filing by Michaels, at 19.

<sup>676</sup> See, e.g., 7/18/97 document listing repriced options related to Wyly family members (MSNY016018-23).

**1996 Annuity Agreements.** The annuity agreements used in the 1996 stock option-annuity swaps closely paralleled the 1992 annuity agreements. They had the same format, almost all of the same provisions, and numerous identical passages.<sup>677</sup> Like the 1992 agreements, the 1996 agreements identified the stock options contributed by the annuitant and provided a fair market value for them. Each used IRS annuity valuation tables and recommended interest rates to calculate the overall value of the annuity and the amount of an annual annuity payment due on a specified date each year. In addition, like the 1992 agreements, the 1996 agreements required the annuitant to give up all ownership interest in the contributed securities, and to accept the “risks attendant with respect to the acquisition of an unsecured high risk private annuity.”<sup>678</sup> The 1996 agreements also required the IOM corporations to make the promised annuity payments whether or not the stock options provided sufficient earnings.<sup>679</sup>

The 1996 annuity agreements differed from the 1992 agreements in a few ways. For example, instead of commencing in the year the annuitant attained the age of 65, the 1996 annuity payments commenced when the annuitant attained 68.<sup>680</sup> Also, the 1996 agreements used a 6.8 percent interest rate per annum, rather than the 8.4 percent in the 1992 annuity agreements, since that was the IRS-recommended interest rate for February 1996.<sup>681</sup> In addition, to meet U.S. tax deferral requirements, each of the 1996 annuity agreements stated that the relevant offshore trust warranted that it was “a grantor trust for United States income tax purposes” and was holding the annuity “as an agent” for a natural person, naming either Sam or Charles Wyly.<sup>682</sup>

**1996 Legal Opinions.** In February and March 1996, Chatzky and Associates issued several legal opinion letters concluding that the 1996 stock option-annuity swaps were not

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<sup>677</sup> Compare, e.g., Private Annuity Agreement involving Tensas Ltd. (PSI00009472-88) with Private Annuity Agreement involving the Arlington Trust and Sarnia Investments Ltd. (PSI00092914-28). The Subcommittee has obtained copies of six of the ten 1996 annuity agreements. All six were virtually identical, except for the names of the parties involved, the list of contributed assets, and the valuations provided for those assets.

<sup>678</sup> See, e.g., Private Annuity Agreement involving the Arlington Trust and Sarnia Investments Ltd. (PSI00092914-28), at Section 1.1(f).

<sup>679</sup> *Id.* at Section 6.1.

<sup>680</sup> *Id.* at Section 2.4.

<sup>681</sup> *Id.* at Section 2.4(a) and (b).

<sup>682</sup> *Id.* at Section 12. See IRC 72(u), explained above.

taxable events at the time they occurred.<sup>683</sup> These opinion letters were addressed to the IOM grantor trusts that had entered into the annuity agreements with the IOM corporations.

The reasoning was similar to that used in the 1992 opinion letters. Each of the 1996 letters reasoned that an unsecured private annuity issued by a “foreign situs United States grantor trust” which was not in the annuity or insurance business, had no determinable value at the time of issuance and was not immediately taxable.<sup>684</sup> The opinion letters also reasoned that the stock options had no readily ascertainable value at the time of transfer, receipt of an “unfunded and unsecured promise to pay money in the future” was not a taxable event at the time of transfer, and the subsequent annuity payments were “more likely than not taxable as ordinary income upon receipt.”<sup>685</sup> In addition, the opinion letters determined that, because the value of the private annuity being provided equaled the fair market value of the stock options contributed in exchange for the annuity, the transaction would be considered arms-length and more likely than not exempt from the federal gift tax.<sup>686</sup>

Like the 1992 opinion letters, the 1996 letters failed to analyze whether the stock options had been transferred to related parties and subsequently, under Section 83, any stock option gains had to be attributed to the original stock option holders, Sam and Charles Wyly. The opinions also failed to acknowledge or discuss any of the facts since 1992 indicating that the Wyllys were exercising direction over when the stock options held offshore would be exercised and how the cash proceeds would be used.

Later in 1996, Congress enacted legislation that stiffened the tax on transfers to foreign trusts and treated those foreign trusts as grantor trusts with respect to assets transferred after a specified date. In response, in November 1996, Chatzky and Associates issued another set of opinion letters concluding that the new law did not reach the stock options that had been transferred to the IOM trusts earlier in the year. To reach this conclusion, the opinion letters provided a hyper-technical reading of the new provisions, while failing to address the plain meaning of the overall statute. For example, the new law stated that the new tax treatment applied to all “direct or indirect” transfers to a foreign trust, and the Senate committee report provided a pages-long list of examples of the types of transfers covered. The opinion letters

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<sup>683</sup> The Subcommittee has obtained copies of four of these opinion letters. See 2/22/96 letters from Chatzky and Associates to Tallulah International Trust (PSI00131205-24) and Woody International Trust (PSI00132396-416), and 3/7/96 letters to Woody International Trust (PSI00132210-31) and Crazy Horse Trust (provided by SBC Communications without bates numbers).

<sup>684</sup> See, e.g., 2/22/96 letter from Chatzky and Associates to Tallulah International Trust at 5-6 (PSI00131205-24).

<sup>685</sup> *Id.* at 12, 14 (PSI00131216, 18).

<sup>686</sup> *Id.* at 9 (PSI00131213).

essentially concluded that, because a transfer to a foreign trust's corporation was not included in the list of examples, it must not be an "indirect transfer" to a trust.<sup>687</sup>

**Dissolution of the IOM Trusts.** In December 1996, all seven IOM trusts that had participated in the 1996 stock option-annuity swaps were dissolved. Each trust distributed its assets to its grantor, including the rights to payments under the private annuities.<sup>688</sup> Sam and Charles Wyly later assigned their annuity interests to their U.S. partnerships, Tallulah Ltd. and Stargate Ltd.

Like the 1992 stock option-annuity swaps, the evidence indicates that the 1996 stock option-annuity swaps were orchestrated by U.S. legal counsel and facilitated by publicly traded corporations. In this instance, on the advice of counsel, the Wyllys transferred millions of valuable stock options to newly created offshore trusts with no assets. The trusts, in turn, transferred them to offshore shell corporations in exchange for unsecured annuity agreements. Again, these transactions make no economic sense absent the tax deferral. The end result was that the Wyly-related offshore corporations took possession of 8.6 million stock options with an ascribed value of \$118.4 million. The Wyly legal advisers took the same position they did in 1992, that the Wyllys did not have to pay taxes on any of the \$118.4 million in stock option compensation, unless and until they began to receive annuity payments from the offshore corporations years in the future.

Together, the 1992 and 1996 stock option-annuity swaps moved offshore over 11 million stock options and warrants with a total ascribed value of about \$160 million. All of these stock options and warrants represented compensation paid by Michaels, Sterling Software, and Sterling Commerce to Sam and Charles Wyly. On advice of counsel, the Wyllys deferred paying taxes on any of this compensation, which not only put off millions of dollars in tax payments, but also provided the offshore corporations with millions of U.S. securities that could easily be converted to cash and used for further investment.

### **(e) 1999 and 2002 Stock Option Transfers For Cash**

A third set of transactions moved still more stock options offshore in 1999 and 2002. In contrast to the 1992 and 1996 transfers, these stock options were not exchanged for annuity agreements; instead they were exchanged for cash. In these transactions, Sam and Charles Wyly

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<sup>687</sup> See, e.g., 11/27/96 letters from Chatzky and Associates to Tallulah International Trust (PSI00131258-94) and Woody International Trust (PSI00132257-97).

<sup>688</sup> See, e.g., 12/31/96 "General Assignment From the Crazy Horse Trust to the Settlor of the Crazy Horse Trust" (PSI00009081-83); 12/31/96 "Acknowledgment of Receipt of Trust Assets" (PSI00093171)(regarding Sam Wyly's receipt of assets from the Crazy Horse Trust); 12/31/96 "Obligor's Consent and Acknowledgment of Annuity Assignment" and "Assignee's Consent and Acknowledgment to Assume Duties Under Annuity" (PSI00093172-73)(regarding Locke's consent to the assignment of the annuity from Crazy Horse Trust to Sam Wyly); and similar documents involving the Arlington Trust, Sarnia Investments, and Sam Wyly (PSI00093229-35); the Lincoln Creek Trust, Elegance, and Charles Wyly (PSI00029181, 84952); and the Woody International Trust, Soulieana, and Charles Wyly (PSI00013663-64).

transferred a total of about 6 million Sterling Software and Sterling Commerce stock options directly to the offshore corporations in return for about \$31 million.

The Subcommittee was told by Wyly representatives that the Wyllys reported the \$31 million paid by the offshore corporations as taxable income and paid tax on it. On the advice of counsel, the Wyllys took the position that the transfers of the stock options were final “sales” to unrelated third parties, even though the Wyllys exercised direction over the offshore corporations and the trusts that owned them. Because the offshore corporations were unrelated parties, the Wyllys and their advisers concluded that any further action taken by the offshore corporations to exercise the stock options or otherwise dispose of them imposed no obligation on the Wyllys to report additional income obtained after the transfer. If the offshore corporations had instead been treated as related parties, the stock option transfers to those related parties would have been disregarded, and any stock option exercise gains would have produced income attributable to the original stock option holders, Sam and Charles Wyly.

Some of the stock options that the Wyllys had transferred to the offshore corporations were not exercised but were redeemed for cash in connection with the 2000 sale of Sterling Commerce. In March 2000, when SBC Communications, Inc. (SBC), now owned by AT&T, purchased Sterling Commerce, SBC paid cash for all outstanding Sterling Commerce stock options, including \$74 million for the options held by the Wyly-related offshore corporations. SBC informed the Wyllys at the time that it planned to report the \$74 million as stock option compensation for Sam and Charles Wyly, the original stock option holders, by filing a 1099 with the IRS. Wyly representatives persuaded SBC not to report this compensation, however, and SBC never sent a 1099 filing to the IRS. SBC nevertheless took a compensation deduction for the \$74 million.

The details of the 6 million stock options sold offshore for cash can be summarized as follows.

**1999 Cash Transfers.** During the summer of 1999, according to sworn testimony provided by Sam Wyly in a deposition taken in a civil lawsuit, a decision was made to sell Sterling Software and Sterling Commerce.<sup>689</sup> He explained: “In July of ‘99 we retained Goldman Sachs with a view to the sale of two companies: First, Sterling Commerce ... and also Sterling Software. ... Goldman was retained by both Sterling Commerce and Sterling Software to find potential buyers.”<sup>690</sup> At the time this decision was made, Sam and Charles Wyly held millions of stock options that had been granted to them as compensation from both companies.

On about September 30, 1999, Sam and Charles Wyly transferred about 3.3 million options that had been granted to them by Sterling Software and Sterling Commerce to four

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<sup>689</sup> 7/26/05 deposition of Sam Wyly, Sam Wyly and Ranger Governance, Ltd. v. Computer Associates International Inc. And Sterling Software, Inc., Civil Action No. 3:04-CV-1984-B (N.D. Texas)(hereinafter “Sam Wyly Deposition”).

<sup>690</sup> Id. at 20.

Wyly-related offshore corporations, East Carroll, Elegance, Greenbriar, and Quayle.<sup>691</sup> In exchange, East Carroll and Greenbriar paid Sam Wyly about \$17.8 million, while Elegance and Quayle paid Charles Wyly's partnership Stargate Ltd. about \$9.3 million, for a total of about \$27 million in offshore dollars.<sup>692</sup> According to Ms. Hennington, Sam and Charles Wyly included all of the cash received from "selling" these stock options to offshore entities as taxable income on their 1999 tax returns. Sterling Commerce apparently took a corresponding tax deduction for this compensation;<sup>693</sup> it appears that Sterling Software did not.<sup>694</sup>

In early 2000, Computer Associates International Inc., now known as CA, Inc. (CA), made an offer to buy Sterling Software, and SBC made an offer to buy Sterling Commerce. By March 2000, both sales were complete. The Sterling Software sale was accomplished through a \$4 billion stock transaction in which Sterling Software shares and options were converted into a smaller number of CA shares and options. That meant, for example, that the 2.6 million Sterling Software stock options that had been "sold" to the four IOM corporations in 1999, were converted into a total of about 1.5 million CA stock options. In contrast, the Sterling Commerce sale was accomplished through a \$4 billion cash transaction. That meant, for example, that SBC redeemed for cash the 712,500 Sterling Commerce stock options that had been "sold" to the offshore entities in 1999, as explained further below.

Because the 1999 stock option transfers took place within six months of the sales of Sterling Software and Sterling Commerce, the stock options sent offshore got caught up in events that followed the sales.

**CA Proxy Contest.** In July 2000, several months after completion of the Sterling Software sale, CA announced that it would miss earnings estimates, and its stock price dropped

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<sup>691</sup> See chart entitled, "Transferring Assets Offshore," prepared by the Subcommittee Minority Staff, summarizing the offshore transfers of Wyly assets. See also 9/29/99 Assignment Agreements transferring the Sterling Software and Sterling Commerce stock options (PSI\_ED00005980; HST\_PSI023218-23); 7/23/02 letter from Computer Associates to Sam and Stargate Ltd. (PSI00059890-92)(describing transfers of Sterling Software options); 9/30/99 untitled document circulated by Ms. Robertson to Sam and Charles Wyly and others identifying the number of stock options transferred in September 1999, their characteristics, and the "sales price" (HST\_PSI089318); Subcommittee interview of Keeley Hennington (4/26/06 and 5/8/06) (confirming these stock options were transferred in exchange for cash). Sam transferred 1,725,000 Sterling Software options and 462,500 Sterling Commerce options, while Charles transferred 900,000 Sterling Software options and 250,000 Sterling Commerce options, to the offshore corporations. East Carroll and Greenbriar are owned by trusts associated with Sam; while Elegance and Quayle are owned by trusts associated with Charles.

<sup>692</sup> See October 1999 faxes ordering Lehman Brothers to transfer funds from East Carroll and Greenbriar's accounts to a Sam Wyly account (CC019988, 21648, 21720) and to transfer funds from Elegance and Quayle's accounts to a Stargate Ltd. account (CC019661, 19666, 24086).

<sup>693</sup> Information provided by SBC (7/13/06).

<sup>694</sup> Information provided by CA (7/20/06).

dramatically in a single day.<sup>695</sup> By 2001, Sam Wyly had lost confidence in CA's management. He established a new U.S. corporation, Ranger Governance Ltd., which launched a proxy contest to replace the CA board of directors with an alternate slate.<sup>696</sup> Mr. Wyly called for the resignation of the company founder and chairman of the board, Charles Wang, as well as the current chief executive officer, Sanjay Kumar. The 2001 proxy contest failed, but Mr. Wyly, through Ranger Governance, did not give up, launching a second proxy contest with the same objective in 2002. These proxy battles generated negative publicity for CA.

In early 2002, one of the CA board members, Richard Grasso, then head of the New York Stock Exchange, arranged a private meeting in his office between Sam Wyly and Sanjay Kumar, and encouraged them to resolve their differences.<sup>697</sup> During this and two subsequent meetings, Mr. Wyly and Mr. Kumar reached a complex agreement to resolve a range of concerns.<sup>698</sup> Among other actions, Mr. Wyly agreed to end his proxy contest, refrain from new proxy contests for five years, extend an agreement not to compete with CA for five years, and make a public statement in support of CA's management. In return, among other matters, CA agreed to remove Mr. Wang from the CA board, elect an additional independent director, pay Mr. Wyly \$10 million in partial reimbursement of the proxy contest expenses, and address some pending personnel matters related to former Sterling Software executives. CA also agreed to address issues related to the Sterling Software stock options that had been granted to Sam and Charles Wyly and transferred offshore.

Stock options were included in the CA proxy issues resolved in 2002, at the request of Sam Wyly.<sup>699</sup> Mr. Wyly may have made this request in part because, earlier in 2002, the IRS had made an inquiry about the 1999 stock option transfers by Sam and Charles Wyly to East Carroll, Elegance, Greenbriar, and Quayle during a routine audit. The IRS had apparently asked "who the options were sold to so they could make a determination as to arms-length."<sup>700</sup> In response, neither CA nor the Wylys had disclosed the relationship between the offshore corporations, their parent trusts, and the Wyly family.<sup>701</sup>

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<sup>695</sup> Sam Wyly Deposition at 31 (CA/NDTX000581). According to a press report, Mr. Wyly later estimated that "he and his family trusts lost \$50 million in one day." "Wyly's War," Forbes (4/25/05).

<sup>696</sup> Sam Wyly Deposition at 36 (CA/NDTX000584). See also 7/27/01 proxy statement filed by CA.

<sup>697</sup> Sam Wyly Deposition at 139-40 (CA/NDTX000687-88).

<sup>698</sup> Id. at 132-34, 149-50, 152-56, 184 (CA/NDTX000680-82, 697-98, 700-704, 732).

<sup>699</sup> Id. at 127-28, 130 (CA/NDTX000675-76, 78).

<sup>700</sup> 6/12/02 email exchange between Ms. Hennington and Ms. Boucher (PSI00040005).

<sup>701</sup> Id. In this email exchange, Ms. Hennington wrote in part: "If [the IRS] comes back asking for the owners of the companies, I plan to give him the trustees name." Ms. Boucher responded in part: "[C]ouldn't you say that based on the documentation provided in the transaction, you have no information indicating who the shareholders are?"

When asked about this email exchange, Ms. Hennington admitted that, in fact, both she and Ms. Boucher

**2002 Letter Agreement and Additional Transfers.** A letter dated July 23, 2002 sets forth the agreement reached between the Wyls and CA over stock options transferred to Wyly-related offshore corporations.<sup>702</sup> In it, CA agreed to treat the 1999 stock option transfers, as well as a new set of stock option transfers in 2002, as sales to independent third parties, even though the offshore corporations receiving the options and the trusts that owned the corporations were under the direction of the Wyls and benefitted them and their families.<sup>703</sup> CA also agreed, with respect to the 1999 stock option transfers, not to file any 1099 or W-2 form attributing additional income to the Wyls when the offshore corporations exercised the stock options.<sup>704</sup> Finally, CA stated that, while it would treat the amount of funds paid to the Wyls for the 2002 stock options as income, it would then treat that transaction as a “third party” and, if the offshore corporations exercised the stock options, would not attribute any additional stock option gains to the Wyls as income.

In addition to signing the letter, CA executed four stock option transfer agreements that acknowledged the 2002 stock option transfers from the Wyls to Greenbriar and Quayle, waived a five-day notice requirement, and amended the relevant stock option agreements to reflect the

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knew the identity of the owners and shareholders of the offshore corporations. She also said that the IRS never actually asked for the company owners, so she did not have to answer the question. Subcommittee interviews of Ms. Hennington (4/26/06 and 5/8/06).

<sup>702</sup> 7/23/02 letter from CA to Sam Wyly and Stargate Ltd. (PSI00059890-92). The letter is executed solely by CA. This letter was the subject of extensive negotiations between Wyly and CA representatives who began discussing the issue in July and apparently concluded their discussions in October. See, e.g., Sam Wyly Deposition, exhibits 49-53 (containing multiple drafts of 7/23/02 letter); series of emails from 8/19/02 until 10/30/02 (PSI\_ED00011051-58). The documents suggest that the letter was actually signed in September or October 2002, and backdated to July.

<sup>703</sup> The first group of stock options addressed in the letter were the more than 2.6 million Sterling Software stock options which Sam and Charles Wyly had transferred to East Carroll, Elegance, Greenbriar, and Quayle in 1999, and which were later converted into nearly 1.5 million CA stock options.

The second group of options addressed in the letter involved stock options that had been held by the Wyls domestically but, in connection with the letter, were being transferred offshore in 2002. They consisted of another 2.6 million Sterling Software stock options that had been granted to Sam and Charles Wyly as compensation years earlier, held by them domestically, and converted after the 2000 sale of the company into about 1.5 million CA options. The letter states that on 7/23/02, the same date as the letter itself, the Wyls were transferring the 1.5 million CA stock options to two offshore corporations, Greenbriar and Quayle.

<sup>704</sup> Again, this tax position assumes that the offshore corporations that received the stock options were unrelated to the Wyls. If the offshore corporations were treated as related parties, the 1978 Treasury regulations, cited earlier, would apply and require that the 1999 transfers be disregarded and any stock option exercise gains be attributed as taxable income to the original stock option holders, Sam and Charles Wyly. The letter also implies that compensation was actually reported in 1999, when the stock options were transferred to the offshore entities in exchange for about \$27 million in cash, but the documentation produced to the Subcommittee by CA suggests that Sterling Software did not, in fact, report this \$27 million as Wyly income on 1099 or W-2 forms filed in 1999.

new ownership.<sup>705</sup> CA's chief financial officer signed both the July 23, 2002 letter and the four stock option transfer agreements. CA indicated to the Subcommittee that, although the letter described the 1999 and 2002 stock option transfers as "third party transactions," the company knew at the time that the four offshore corporations who purchased the stock options were not completely independent third parties, but were associated with Sam and Charles Wyly.<sup>706</sup>

In exchange for the 1.5 million options, Greenbriar apparently paid Sam Wyly about \$2.5 million, and Quayle apparently paid Charles Wyly about \$1.3 million, for a total of about \$3.8 million.<sup>707</sup> This amount is substantially less than the approximately \$15 million that the same two offshore corporations paid for the same number of shares in 1999, but CA's shares had dropped in value over the intervening three years. The \$3.8 million in offshore dollars was wired to Sam and Charles Wyllys' accounts in the United States.

CA told the Subcommittee that, to date, none of the four offshore corporations that obtained CA stock options from the Wyllys has exercised those options, perhaps due to relatively low CA stock prices in the wake of a significant accounting scandal.<sup>708</sup> If the stock options were to be exercised prior to their expiration dates in 2006 and 2007, CA told the Subcommittee that it would take into consideration the 2003 IRS Notice disallowing the executive stock option tax shelter, and re-evaluate whether to treat the stock option gains as compensation attributable to the Wyllys. Currently, the four offshore corporations collectively hold nearly 3 million CA stock options.

**Sterling Commerce Options.** The transactions just discussed involved Sterling Software stock options. Transactions involving the Sterling Commerce stock options raise

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<sup>705</sup> See 9/30/02 Agreement to Transfer Stock Options and Amend Stock Option Agreement, executed by CA, the relevant offshore corporation, and either Sam or Charles Wyly (CA/NDTX000860-63); related emails dated 8/19/02 to 10/30/02 (PSI\_ED00011051-58). Sam Wyly transferred options to buy 859,185 CA shares at an exercise price of \$25.071 per share and 112,680 CA shares at \$24.1835 per share to Greenbriar, while Charles Wyly transferred options to buy 450,720 CA shares at \$25.071 per share and 56,340 CA shares at \$24.1835 per share to Quayle. The total number of CA stock options involved in these sales was 1,478,925. See 7/23/02 letter from CA to Sam Wyly and Stargate Ltd. (PSI00059890-92).

<sup>706</sup> Subcommittee interview of CA representatives (4/11/06). See also 6/20/00 email from Ms. Hennington to CA (PSI\_ED00081631-32)(listing 1999 stock option transfers and indicating which the four offshore corporations receiving options was associated with Sam Wyly and which was associated with Charles Wyly).

<sup>707</sup> See, e.g., 7/29/02 emails between Ms. Hennington and CA (PSI\_ED00010321, 26-29). See also 2002 W-2 Forms issued by Computer Associates International Inc. to Sam and Charles Wyly, provided by CA to the Subcommittee without bates numbers.

<sup>708</sup> In 2004, CA admitted filing misleading financial reports which, among other matters, overstated its revenues. See, e.g., United States v. Computer Associates International, Inc., Case No. 04-CR-837, Deferred Prosecution Agreement (E.D.N.Y. 9/22/04). In 2005 and 2006, a number of its senior officers, including former CEO Sanjay Kumar, pled guilty to accounting fraud or related charges. See, e.g., transcript of guilty plea by Mr. Kumar, United States v. Richards, Case No. 04-CR-846 (E.D.N.Y. 4/24/06).

different issues. These Sterling Commerce options were moved offshore in two batches, through the 1996 stock option-annuity swaps and the 1999 transfers.

The first Sterling Commerce options were issued in February 1996, in anticipation of its initial public offering of stock. The company gave options to a number of its executives, including Sam and Charles Wyly who were then company directors.<sup>709</sup> Sam Wyly obtained 3 million options, while Charles obtained 1.6 million. Three weeks later, on March 7, 1996, both men transferred all of these stock options offshore as part of the 1996 stock option-annuity swaps. Sam Wyly transferred 3 million stock options to Crazy Horse Trust which, in turn, transferred them to Moberly in exchange for a private annuity. Charles Wyly transferred 1.6 million stock options to Woody International Trust which, in turn, transferred them to Elysium in exchange for a private annuity.

From 1996 until 1999, Moberly and Elysium exercised some of the Sterling Commerce stock options, sold some of the shares, and transferred some of the options to Devotion and Elegance.<sup>710</sup> In September 1999, as explained earlier, Sam and Charles Wyly transferred another 712,500 Sterling Commerce stock options offshore to Greenbriar and Elegance.

In March 2000, SBC Communications completed its purchase of Sterling Commerce in a \$4 billion cash transaction, paying \$44.25 per share. As part of that transaction, SBC redeemed all outstanding Sterling Commerce stock options and paid option holders cash equal to the difference between \$44.25 and the option strike price.<sup>711</sup> As a result, on March 27, 2000, SBC paid Moberly \$46,575,000, and Elysium \$27,337,500, for a total of nearly \$74 million.<sup>712</sup>

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<sup>709</sup> See, e.g., 2/12/96 "Sterling Commerce, Inc. 1996 Stock Option Plan: Stock Option Agreement" with Sam Wyly (PSI00085949-52).

<sup>710</sup> See, e.g., 2/17/00 emails exchanged between Ms. Robertson and Ms. Boucher about these stock option transactions (MAV007928-36), including a detailed chart prepared by Sterling Commerce personnel (MAV007932).

<sup>711</sup> See, e.g., 1/11/01 letter from SBC to Sam Wyly (PSI00063565); undated chart produced by the Wyls listing the Sterling Commerce stock option holdings of the offshore entities, identifying the relevant strike price for the options, and estimating the likely proceeds and net proceeds from the SBC redemption at \$44.25 per share (PSI\_ED00046876). The list includes stock options from both the 1996 stock-option annuity swap and 1999 transfers.

<sup>712</sup> See 5/11/06 letter from AT&T to the Subcommittee. (AT&T now owns SBC.) A chart apparently prepared for the Wyls in 2000 (PSI\_ED00046876), indicates that, at the time of the SBC offer, five offshore corporations, Devotion, Elegance, Elysium, Greenbriar, and Moberly, belonging to five different Wyly-related offshore trusts, held about 4.5 million Sterling Commerce stock options. Despite that chart, the evidence is clear that SBC paid only two of the corporations, Moberly and Elysium, for all of the options held offshore. Moberly, which is associated with Sam Wyly, appears to have been paid for all the stock options on the chart listed as being held by IOM corporations associated with him; and Elysium, which is associated with Charles Wyly, appears to have been paid for all the stock options on the chart held by IOM corporations associated with him. The two payments suggest that the offshore entities must have coordinated and consolidated their stock option holdings before dealing with SBC.

On January 11, 2001, SBC sent a letter to Sam Wyly informing him that “SBC is preparing to issue a Form 1099 to you/your trust showing taxable income of \$46,575,000. If you are aware of any reason that this Form 1099 should not be issued, please contact [the company].”<sup>713</sup> A similar letter informed Charles Wyly that SBC was planning to issue a 1099 form attributing income to him totaling \$27,337,500.<sup>714</sup>

Representatives of the Wyllys promptly contacted SBC to persuade the company not to file the 1099 forms reporting the \$74 million. Ms. Hennington apparently spoke with Al Hoover, Sterling Commerce’s former general counsel who had moved to SBC’s legal department after the 2000 sale.<sup>715</sup> On January 26, 2001, Rodney Owens of the Meadows Owens law firm sent letters to SBC as legal counsel for Elysium and Moberly, asserting that no 1099 form had to be filed since both companies were foreign corporations not subject to U.S. tax.<sup>716</sup> On February 2, 2001, Mr. French sent SBC a two-page memorandum with a collection of supporting documents, explaining why no Wyly compensation should be reported to the IRS.<sup>717</sup> The memorandum described the 1996 stock option-annuity swaps involving Sterling Commerce stock options, and noted that the transfers “were disclosed to [Sterling Commerce] management in 1996 when they occurred.” It stated that, had the stock options been transferred in exchange for cash, “there would have been a taxable event at that time, triggering an income tax liability on the part of SW, CJW and EW and a corresponding tax deduction on the part of [Sterling Commerce]. However, in exchange for such options, SW, CJW and EW received private annuity agreements ... with annual payments commencing after a period of deferral. ... As of this date, payments have not yet commenced.” In other words, the memorandum claimed that no taxes were due on the Wyly stock option compensation because the stock options had been

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<sup>713</sup> 1/11/01 letter from SBC to Sam Wyly (PSI00063565).

<sup>714</sup> 1/11/01 letter from SBC to Charles Wyly (PSI00063567).

<sup>715</sup> See 1/17/01 email from Ms. Hennington to Ms. Boucher (PSI-WYBR00607)(“Al Hoover is sending over some info from SBC’s tax department on 1099’s. They are saying there is nothing in their file to show why the offshore trusts should not be issued a 1099 and they plan to do so at 1/31 unless they receive documentation from us. ... Evan wants me to call Rodney which I will do ....”); 1/17/01 email from Ms. Hennington to Rodney Owens about issue (PSI-WYBR00608).

<sup>716</sup> See 1/26/01 letters from Meadows Owens, signed by Mr. Owens, to SBC in which Mr. Owens stated that he represented Elysium (PSI-WYBR00612-13) and Moberly (PSI-WYBR00616-17). While it is true that 1099s normally do not need to be issued for payments made to foreign corporations not subject to U.S. tax, neither letter addressed the real issues at stake, whether the offshore corporations were related parties to the Wyllys, whether the stock option compensation had to be attributed to the Wyllys, and whether 1099 forms had to be issued with respect to Sam and Charles Wyly.

<sup>717</sup> 2/9/01 memorandum to file by Mr. French, provided to the Subcommittee by SBC (without bates numbers), with five attachments: the March 1996 transfer by Sam Wyly of three million Sterling Commerce stock options to the Crazy Horse Trust, the subsequent transfer of the options from the Trust to Moberly, the private annuity agreement obtained in exchange, the legal opinion letter to the Crazy Horse Trust provided by Chatzky and Associates, and a 2/7/01 valuation of the annuity agreements by Milliman & Robertson, Inc. Mr. French had severed business ties with the Wyly family two months earlier, but nevertheless agreed to provide them the memorandum on this matter. Subcommittee interview of Mr. French (4/21/06).

transferred to independent parties in exchange for private annuities of equivalent value, and that taxes had to be paid only when the Wyls began receiving the promised annuity payments years later. The memorandum also stated that Sterling Commerce management had “agreed to the deferred tax treatment of the Annuities” in 1996. It noted further that the “independent foreign entities that had purchased the options” were “not subject to U.S. income taxation.”

On March 28, 2001, Ms. Hennington sent the following email to Sam and Charles Wyly, Ms. Robertson, Ms. Boucher, Mr. French, and others, indicating that SBC had agreed not to report the \$74 million to the IRS:

“Wanted to let everyone know that I heard a final answer from SBC today that they will not be issuing any 1099's to Sam, Charles or Evan for the option exercises. They are sending a letter to me with what information they need. The good news is that I do not think they are going to require anything from the trustees or directors directly. They seem to be most focused on the annuity payout schedules and getting yearly updates on these. We also will not need to do any indem[nity] agreement with regard to penalties.

“The only issue they are looking into is whether they have any reporting requirements with regard to payments to foreign corporations. I have a call into Rodney to check this out (they do not sound too concerned about it). They also said there is a very slim chance they may find a strong enough position to take a deduction on their return this year. If they do and are audited the private annuity agreement could be challenged. Again, they did not think this was a high likelihood and we will likely have this risk whenever they take the deduction.

“I will keep everyone informed when I get their letter, but looks like we do not have to worry about any 1099's surfacing.”<sup>718</sup>

Subsequently, although SBC did not file the 1099 forms declaring the compensation, it nevertheless took a 2000 tax deduction for the \$74 million it had paid to the offshore corporations, treating the payments as stock option compensation.<sup>719</sup> When asked about this contradiction – taking a tax deduction for compensation that SBC did not report to the IRS – SBC told the Subcommittee that it was their understanding that, because the \$74 million had been paid to the offshore corporations, tax code Section 6041 excused them from filing 1099s for payments made to foreign corporations.

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<sup>718</sup> 3/28/01 email from Ms. Hennington to Sam, Charles and Evan Wyly, Ms. Robertson, Ms. Boucher, and Mr. French on SBC (PSI00088942).

<sup>719</sup> Information provided to the Subcommittee by SBC’s legal department. Section 83(h) of the tax code permits an employer to deduct only the amount of stock option gains included in the employee’s income during the year, yet here, SBC knew that the Sam and Charles Wyly did not plan to include any of the \$74 million in their 2000 income.

SBC provided a copy of a 2001 memorandum prepared by Ms. Hennington, advising the company that it had no obligation to file a 1099 due to the Section 6041 exception; it had no obligation to withhold any portion of the payments made to the offshore corporations under tax code Sections 881 and 1442; and it had no obligation to file a related Form 1042-S with the IRS.<sup>720</sup> This analysis, however, does not address the real issue – whether SBC had to report the \$74 million paid to the offshore corporations as income to the original stock option holders, Sam and Charles Wyly. SBC’s position also ignores Treasury Regulation Section 1.83-6(a)(2) which provides that a corporation may take a deduction for stock option compensation under IRC Section 83 only if the option holder includes the stock option gains in income, unless the corporation issues a W-2 or 1099 form reporting the compensation to the IRS.<sup>721</sup>

### **(f) Current Status of Private Annuities**

Altogether, the 1992, 1996, 1999, and 2002 transactions moved more than 17 million Wyly stock options and warrants offshore.<sup>722</sup> About 11 million of those stock options and warrants were exchanged for private annuities. The 1992 transactions involved nearly 3 million stock options and warrants valued by the parties at \$41.8 million, while the 1996 transactions involved 8.6 million options valued by the parties at \$118.4 million, for a total of about \$160 million. The stock options and warrants ended up being held by 20 offshore corporations, of which twelve held annuities payable to Sam Wyly and eight held annuities payable to Charles Wyly or his wife.

Over the following years, the Wyly family office closely tracked the value of the private annuities and the annual payments that each agreement would be required to provide once the annuitants reached the specified age for payments to begin. These valuations fluctuated in part due to the varying interest rates used to determine the net present value of payments due in the future. To calculate the net present value of the annuities, the Wyly family office repeatedly obtained written annuity valuations from Milliman & Robertson, Inc., a large actuarial firm with offices in Texas. The key contact at the firm was Eric Ammann, described as a principal in the

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<sup>720</sup> See 9/12/01 email from Ms. Hennington to John Brockman of SBC and attached “Memo to File” regarding “Sale of Sterling Commerce Options to SBC,” produced by SBC without bates numbers. Ms. Hennington wrote in part: “Attached is the memo I did for our files after discussions with our attorneys. Please review and let me know your thoughts.” See also 5/2/01, 6/8/02, and 7/5/01 emails exchanged between Ms. Hennington and Lawrence Ruzicka of SBC’s legal department (produced by SBC without bates numbers)(discussing whether SBC was obligated to withhold 30 percent of the payments to the offshore corporations under Section 1442, and file Form 1042-S with the IRS).

<sup>721</sup> See response by Wyly legal counsel to an IRS inquiry (PSI00090729, 1883).

<sup>722</sup> In addition to these offshore transfers made by the Wyls, Michaels Stores sold four million shares to five Wyly-related offshore corporations, Audubon Assets (then called Fugue), Devotion, Elegance, Locke, and Quayle, in private transactions that took place in March 1996, December 1996, and February 1997, in exchange for cash totaling about \$40 million. See, e.g., 4/29/96 10-K405/A filing by Michaels; 5/2/97 10-K filing by Michaels; 12/23/96 and 5/20/97 Schedules 13D filed by Trident with respect to Michaels shares.

Texas office. When Mr. Ammann later moved to Retirement Horizons, Inc., a smaller Texas actuarial firm, the annuity valuations were performed by that firm.

**Annuity Adjustments.** On two occasions in 1998 and 2004, adjustments were made to the terms of the annuities which increased their overall value and resulted in an increase in the amount of payments due under them. By the end of 2004, the overall value of the private annuities and the total amount of payments required to be paid under the agreements had more than tripled, from a total of \$158 million to about \$483 million.

**1998 Adjustment.** The first adjustment occurred in January 1998, when all 20 of the annuity agreements were amended to delay the commencement date of the first annuity payment by four years.<sup>723</sup> These amendments meant that the first annuity payment due under the 20 annuity agreements was postponed from October 1999 to October 2003. The added four years also meant that the offshore corporations could continue to use and invest the assets that had been sent to them offshore without having to make any annuity payments to the Wyllys in the United States that could be taxed.

The 1998 amendments to the annuity agreements did not specify the interest rate to be applied during the additional four-year deferral period. In December 1998, Milliman & Robertson recalculated the value of the 20 private annuities using a 5.4 percent per annum interest rate, which was the IRS-recommended rate applicable during the month of December. This interest rate was used to determine the value of each annuity, taking into account the additional four-year deferral period. The general impact on the annuities was to increase their overall value as well as to increase the amount of the annual payment due under each agreement. For example, according to the calculations, the annual annuity payment owed under the Little Woody annuity increased from the original projected amount of \$909,050 in 1992, to \$1,363,889 in 1998, an increase of nearly 50 percent.<sup>724</sup>

In May 2000, Ms. Boucher suggested to Ms. Robertson that the annuity values be recalculated again.<sup>725</sup> She wrote: "I spoke with Eric Ammann today. I think they should recalculate the annuity payments as follows. ... Eric Ammann doesn't fully understand the annuities, and is not happy to tell us which way to go. Since it could be a tax issue ... I'm happy to run it by Rodney, but maybe Keeley should consider it too, or even think about asking EY [Ernst & Young]."

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<sup>723</sup> See, e.g., chart entitled "Summary of Private Annuities" (PSI00040139); 1/31/98 "Amendment of Private Annuity" related to annuity agreement between Locke and Sam Wyly (PSI00093174-75) and between Soulicana and Charles Wyly (PSI00009469-70).

<sup>724</sup> See, e.g., 7/23/04 letter from Retirement Horizons, Inc., Eric Ammann, Principal, to Mr. Francis Webb, c/o Little Woody Ltd., on "Modifications to the Private Annuity between Little Woody Limited and Charles J. Wyly, Jr. dated April 15, 1992" (PSI00078316-19). See also "Private Annuity Valuations (Revised\* 3/3/99)" prepared by Milliman & Robertson (PSI00040135-39).

<sup>725</sup> 5/16/00 email from Ms. Boucher to Ms. Robertson (PSI\_ED00048169).

It is unclear whether her proposal was followed, but over the next few years, the present value of the private annuities continued to increase. By 2001, written valuations showed that the annuities had a net present value of about \$252 million.<sup>726</sup> Two years later, by the end of 2003, the value had increased again, to about \$437 million.<sup>727</sup>

**2004 Adjustment.** In 2004, a formal change was made in the methodology used to value the private annuities, and the new methodology further increased the annual payments required to be made under the annuity agreements. An undated chart entitled, “Comparison of Retirement Horizon Annuity Valuations” as of December 31, 2003, shows that three valuation alternatives were considered, using different interest rates and different dates on which those rates would be applied.<sup>728</sup> Each alternative produced different amounts of annual payments due under the private annuities, with the 1992 annual payment totals ranging from \$133 to \$149 million, and the 1996 annual payment totals ranging from \$329 to \$350 million. In July 2004, new values were calculated.

In a July 2004 letter, for example, Retirement Horizons applied the new methodology to an annuity held by Little Woody, and calculated “an increase in the annual annuity payment.”<sup>729</sup> A “history of the calculated annuity payments” due under the Little Woody annuity, included in the letter, showed that the annual payment had grown from the original projected amount of \$909,050 in 1992; to \$1,363,889 in 1998; to \$1,459,871 in 2004.<sup>730</sup>

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<sup>726</sup> See, e.g., PSI00038779, 45213 (together valuing the annuities at about \$252 million).

<sup>727</sup> 12/31/03 letter from Retirement Horizons, Inc. to Ms. Boucher at the Irish Trust Company (PSI00040189-93).

<sup>728</sup> Undated chart entitled, “Comparison of Retirement Horizon Annuity Valuations: December 31, 2003 Valuations” (PSI00040193).

<sup>729</sup> 7/23/04 letter from Retirement Horizons, Inc., Eric Ammann, Principal, to Mr. Francis Webb, c/o Little Woody Ltd., on “Modifications to the Private Annuity between Little Woody Limited and Charles J. Wyly, Jr. dated April 15, 1992,” with copy faxed to Michelle Boucher (PSI00078316-19). In the letter, the firm explained as follows: “When the original deferral calculations were completed several years ago, the discount rate used was the rate ... in effect at the end of the year that the contract was modified (1998). Thus, the discount rate used was the December, 1998 Federal Mid-term Rate of 5.4%. However, the Contract amendment was effective eleven months earlier in January of 1998. Furthermore, this eleven month period experienced a significant change in the Federal Mid-term Rate, as the January 1998 rate was 7.2%. ... Given this degree of change in the applicable discount rate between January and December of 1998, coupled with the valuation principle that an amendment to the terms of the Contract that affects the timing of the receipt of the annuity payments should be accomplished based upon a current market discount rate, the new payment amount ... is the more appropriate payment value.”

<sup>730</sup> Id. The letter also noted that the first payment under the Little Woody annuity had been made in October 2003 in the amount of \$1,363,889, which meant that, due to the recalculation, an additional payment of \$99,051 was owing.

On August 2, 1994, a letter containing virtually identical phrasing and analysis required an increase in the annual payments due under the private annuity provided by Elegance.<sup>731</sup> A “history of the calculated annuity payments” due under the Elegance annuity showed that the annual payment had grown from the original projected amount of \$1,380,999 in 1996; to \$2,461,209 in 1998; to \$2,634,138 in 2004. A virtually identical letter dated June 9, 2004, addressed to IFG, performed the same analysis for the East Carroll annuity, requiring an increase in its annual payment from the original projected amount of \$1,956,558 in 1992; to \$2,934,569 in 1998; to \$3,142,095 in 2004.<sup>732</sup>

It is unknown whether similar letters were sent to the other 17 corporations holding annuities payable to the Wyllys. What is known is that, by the end of 2004, an internal Wyly financial document valued the 20 offshore annuities at about \$483 million.<sup>733</sup> The Subcommittee saw no documentation indicating that, as one might expect in a truly arm’s-length relationship, any offshore corporation, parent trust, or trustee raised an objection to the tripling of their payment obligations.

**Annuity Payments.** When the 1992 and 1996 annuities were first established, the dollar values specified in the annuity agreements produced a combined total value of about \$158 million. By the end of 2004, internal Wyly financial reports showed that the combined value of these same annuities had tripled to about \$483 million, requiring the offshore corporations to make significantly larger annual payments than originally specified.

The first two payments due under the 20 private annuities were made by Little Woody and Roaring Creek to Charles Wyly in October 2003.<sup>734</sup> By 2004, all ten of the 1992 annuities commenced making annual payments to Sam, Charles, or Charles Wyly’s wife. The 1996 annuities payable to Charles Wyly are scheduled to commence making annual payments to him in October 2006, while the 1996 annuities payable to Sam Wyly are scheduled to commence making annual payments in 2007. According to a chart prepared for the Wyllys at the end of

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<sup>731</sup> 8/2/04 letter from Retirement Horizons, Inc., Eric Ammann, Principal, to Mark Lewin of Close Trustees (IOM) Ltd. on “Modifications to the Private Annuity between Elegance Limited and The Lincoln Creek Trust dated February 22, 1996,” (PSI00058430-31).

<sup>732</sup> 6/9/04 letter from Eric Ammann to IFG International (PSI\_ED00014767-68)(copy is unsigned and not on letterhead so it is not certain that it was sent).

<sup>733</sup> 12/31/04 document entitled, “Annuity Pricing” (PSI\_ED00024122-23)(pricing the annuities each year from 12/31/00 to 12/31/04). The \$483 million includes only the 20 offshore annuities payable to Sam, Charles or Charles’ wife. See also, e.g., 12/31/04 financial report entitled, “Family Offshore” (PSI\_ED00095235) (showing an “Annuity Payable” for the offshore system of \$507,794,514); 12/31/04 financial report entitled, “Global SW Family” (PSI\_ED00095232-33) (showing an “Annuity Payable” of \$341,370,493); and 12/31/04 financial report entitled, “Global CW Family” (HST\_PSI006887) (showing an “Annuity Payable” of \$166,424,021). The figures in the financial reports include offshore annuities payable not only to Sam, Charles and Charles’ wife, but also to Sam’s son and son-in-law.

<sup>734</sup> The payment dates for the 20 offshore annuities are set out in an undated chart, likely prepared in 1999, entitled “Summary of Private Annuities” (PSI00040139).

2004, when all 20 annuities are activated – which should take place in 2007 – the twelve offshore corporations obligated to make payments to Sam Wyly were expected to pay him a total of about \$42.8 million that year, while the eight offshore corporations obligated to make annual payments to Charles Wyly or his wife were expected to pay them a total of about \$20.6 million during that year.<sup>735</sup>

The Subcommittee was told that, to date, one annuity payment has been missed and remains unpaid. A scheduled payment for \$1.138 million should have been paid by Roaring Creek to Charles Wyly in November 2005.<sup>736</sup> Roaring Creek is an IOM corporation owned by the Pitkin Trust, which was established by Charles Wyly and benefits his family. The Pitkin Trustee apparently informed Mr. Wyly that Roaring Creek had failed to make the required annuity payment, because it had insufficient assets.<sup>737</sup> Although the payment was due on November 1, 2005, the Subcommittee was told that, to date, Mr. Wyly had not made a written request for payment.<sup>738</sup>

Since 1992, Roaring Creek has been an active participant in activities undertaken by the Wyly-related offshore entities, as described in subsequent sections of this Report. For example, it was one of the ten IOM corporations that participated in the 1992 stock option-annuity swaps, obtaining 187,500 Michaels stock options.<sup>739</sup> It apparently exercised these stock options and sold most of the shares in 1992.<sup>740</sup> Other documents suggest that Roaring Creek issued a loan for more than \$1 million to Little Woody in 1992 (PSI00028097-98, 118054, CSFB0007000); obtained a \$414,000 loan from Roaring Fork in 1993 (PSI00128354, PSI00127139); issued a loan for \$1.5 million to Castle Creek International Trust in 1993 (PSI00128354, 128357, PSI\_ED00094807); issued a loan of more than \$100,000 to Scottish Re in 1994 (PSI00121413, 136238, 137814); issued a \$1.4 million loan to Roaring Fork in 2000 (CC016311); and obtained a \$1 million loan from the Bulldog Trust in or before 2004 (PSI\_ED00094521-23). In addition, in 2000, Roaring Creek appears to have been a lender to and one of four owners of First Dallas International Ltd., part of a private investment fund established by Charles Wyly.<sup>741</sup> These

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<sup>735</sup> See undated document providing “Value of Annuity at 12/31/04” for Sam and Charles Wyly (PSI\_ED00024950-53).

<sup>736</sup> Information provided by Ms. Hennington’s legal counsel (5/30/06).

<sup>737</sup> Subcommittee interview of Ms. Hennington (4/26/06).

<sup>738</sup> Information provided by Ms. Hennington’s legal counsel (5/30/06).

<sup>739</sup> Private Annuity Agreement involving Roaring Creek, Schedule A (PSI00133289-305).

<sup>740</sup> See 4/20/92 letter from Mr. French and Ms. Robertson to Lorne House (PSI00028097-98); “Roaring Creek Limited Summary of Profit & Loss on Investments for the Period 1/05/92 to 3/11/93” (PSI00128352).

<sup>741</sup> See 5/28/02 emails between Louis Schaufele of Bank of America and Ms. Hennington (PSI\_ED00006917)(Mr. Schaufele wrote: “Could you tell ... me whom the owners of 1<sup>st</sup> Dallas, I assume that it is IOM corps.” Ms. Hennington responded: “[T]he companies are: Roaring Creek Limited, Roaring Fork Limited, Elysium Limited, Elegance Limited.”). For more information about First Dallas International, see Report section on

transactions suggest that Roaring Creek has assets of its own as well as a history of being able to borrow funds from other Wyly-related offshore entities. In addition, the Subcommittee has been told that its parent, the Pitkin Trust, has considerably more than \$1.1 million in assets and could lend funds to Roaring Creek to satisfy the missing annuity payment.<sup>742</sup> It is unclear why neither the Pitkin Trust nor any other Wyly-related offshore entity has provided Roaring Creek with the funds needed for the annuity payment.<sup>743</sup>

If Roaring Creek were to continue to default on its unsecured annuity obligation, the Wyls could choose to sue the corporation and its parent trust in the Isle of Man to obtain payment. Alternatively, the Wyls could choose to accept the default and simply allow the untaxed annuity assets to remain offshore. Accepting this default would free Mr. Wyly of any obligation to pay U.S. tax on the funds that he otherwise would have received from Roaring Creek.

If annuity payments were to be missed by any of the other IOM corporations, the Wyls would face the same choice of filing an IOM lawsuit to obtain payment or accepting the default and allowing the annuity assets to remain offshore and untaxed. Ms. Hennington told the Subcommittee that, as far as she knew, the Wyls had no plans to forego the annuity payments, because they were planning to use the funds to help them meet their financial goals and obligations. She also told the Subcommittee that the Wyly family office had obtained legal advice that the offshore corporations could meet their obligations with in-kind contributions of assets in lieu of cash payments.<sup>744</sup>

The Subcommittee was told that, to date, the Wyls have received about \$35 million in annuity payments.<sup>745</sup> The next annuity payments are due in October 2006.

### **(g) Analysis of Issues**

The 17 million stock options and warrants moved offshore over a ten-year period, from 1992 until 2002, represented at least \$190 million in compensation provided to Sam and Charles Wyly by Michaels, Sterling Software, and Sterling Commerce.<sup>746</sup> Of this \$190 million, Sam and

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Supplying Offshore Dollars to Wyly Business Ventures, below.

<sup>742</sup> Subcommittee interview of Ms. Hennington (4/26/06).

<sup>743</sup> Because the Pitkin Trustee, the IOM office of Trident, refused to meet or discuss client specific matters, the Subcommittee has been unable to obtain its views on this issue.

<sup>744</sup> Subcommittee interview of Ms. Hennington (4/26/06).

<sup>745</sup> Information provided by Ms. Hennington's legal counsel as of 7/21/06.

<sup>746</sup> The \$190 million was calculated as follows. The annuity agreements in 1992 and 1996 ascribed a fair market value of about \$160.2 million to the 11 million stock options involved in those transactions. Another 6 million stock options were exchanged for \$31 million. By the Wyls' own calculation, then, their stock option

Charles Wyly appear to have reported \$31 million as taxable income in 2002. Since 2003, another \$35 million was transferred to the Wylys in the form of annuity payments, for which taxes were presumably paid. It appears that the remaining \$124 million in stock option compensation remains offshore and untaxed.

The U.S. publicly traded corporations that issued the stock options could have reported to the IRS the stock option gains realized when the options were exercised, but chose not to do so. The 20 offshore corporations that exercised the stock options and warrants then sold the shares or used them in securities transactions to produce additional income that was also untaxed.

The offshore transfers at the center of this case history involve sending valuable stock options and warrants to newly created shell entities with no employees, offices, or assets, in exchange for unsecured promises to make annuity payments years in the future. These transactions do not make economic sense, unless the recipients of the assets are understood to be related parties under the direction of the persons who sent the assets offshore.

Also key to understanding these transactions is the immense effort that was undertaken to keep them secret. Securities were directed to shell corporations in Nevada which sent them to IOM corporations bearing the same corporate names. Offshore grantor trusts were established to act as intermediaries for stock options intended to be transferred to still other offshore entities. Public corporations were persuaded not to file W-2 or 1099 forms reporting stock option gains to the IRS. A public corporation that made nearly \$74 million in cash payments to offshore corporations was told it had no legal obligation to file forms reporting those payments to the IRS. When the IRS asked CA, in 2002, about Wyly stock option transfers to four offshore corporations, no one disclosed to the IRS that the offshore corporations were owned by trusts benefitting the Wyly family. In short, the extent of the stock option compensation sent offshore was kept hidden from the IRS.

Five publicly traded corporations, Michaels, Sterling Software, Sterling Commerce, SBC and CA, facilitated these offshore transfers and helped the Wylys avoid the immediate payment of taxes on their stock option compensation. Michaels and Sterling Software allowed the transfer of stock options that were supposed to be nontransferable. Four of the five amended their ownership records to accept stock option ownership by the offshore corporations. All five chose not to file 1099 or W-2 forms reporting Wyly stock option compensation to the IRS. All but one gave up taking multi-million-dollar tax deductions for the Wyly stock option compensation. As part of a repricing of all its employee stock options, Michaels even repriced the stock options held by the offshore entities, substantially increasing their value. None conducted a detailed investigation into the true relationship between the offshore entities and the Wylys to determine whether, in fact, they were independent or related parties.

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compensation totaled \$191.2 million. This valuation figure is conservative, since it does not include the additional millions of dollars in gains obtained when the 11 stock options were exercised, nor the additional \$33 million obtained when SBC paid \$74 million for the 6 million options.

## TRANSFERRING ASSETS OFFSHORE

### Part I: 1992 STOCK OPTION-ANNUITY SWAPS

Initial Assets	Annuitant and Annuity Date	IOM Entity Obligated to Pay Annuity	Parties Involved, Exercises
187,500 MIK options	Charles Wyly 4/13/92	Roaring Creek Limited	Charles Wyly transferred options in exchange for annuity from Roaring Creek Limited of Nevada, which assigned annuity and options to Roaring Creek Limited of IOM.  Options exercised in May and August 1992.
187,500 MIK options	Charles Wyly's Wife 4/13/92	Rugosa Limited	Charles Wyly's wife transferred options in exchange for annuity from Maroon Limited of Nevada, which assigned annuity and options to Rugosa Limited of IOM.  Options exercised in May and August 1992.
166,500 SSW options & 169,432 SSW warrants	Charles Wyly 4/15/92	Little Woody Limited	Charles Wyly transferred options in exchange for annuity from Little Woody Limited of Nevada, which assigned annuity and options to Little Woody Limited of IOM.  Options exercised May 1992; warrants exercised January 1994.
166,500 SSW options & 169,432 SSW warrants	Charles Wyly's Wife 4/15/92	Roaring Fork Limited	Charles Wyly's wife transferred options in exchange for annuity from Roaring Fork Limited of Nevada, which assigned annuity, options and warrants to Roaring Fork Limited of IOM.  Options exercised May 1992; warrants exercised January 1994.
375,000 MIK options	Sam Wyly 4/13/92	East Baton Rouge Limited	Sam Wyly transferred options in exchange for annuity from East Baton Rouge Limited of Nevada, which assigned annuity and options to East Baton Rouge Limited of IOM.  Options exercised May and August 1992.
100,000 MIK warrants & 110,000 MIK options	Sam Wyly 4/13/92	Tensas Limited	Sam Wyly transferred options in exchange for annuity from Tensas Limited of Nevada, which assigned annuity and warrants and options to Tensas Limited of IOM.  Options and warrants exercised May 1992.

<b>Initial Assets</b>	<b>Annuitant and Annuity Date</b>	<b>IOM Entity Obligated to Pay Annuity</b>	<b>Parties Involved, Exercises</b>
667,000 SSW options	Sam Wyly 4/15/92	East Carroll Limited	Sam Wyly transferred options in exchange for annuity from East Carroll Limited of Nevada, which assigned annuity and options to East Carroll Limited of IOM.  Options exercised May 1992.
204,725 SSW warrants	Sam Wyly 4/15/92	Morehouse Limited	Sam Wyly transferred options in exchange for annuity from Morehouse Limited of Nevada, which assigned annuity and options to Morehouse Limited of IOM.  Warrants exercised January 1994.
240,000 SSW warrants	Sam Wyly 4/15/92	Richland Limited	Sam Wyly transferred warrants in exchange for annuity from Richland Limited of Nevada, which assigned annuity and options to Richland Limited of IOM.  Warrants exercised January 1994.
200,000 SSW warrants	Sam Wyly 4/15/92	West Carroll Limited	Sam Wyly transferred options in exchange for annuity from West Carroll Limited of Nevada, which assigned annuity and options to West Carroll Limited of IOM.  Warrants exercised January 1994.

**Part II: 1996 STOCK OPTION-ANNUITY SWAPS**

<b>Initial Assets</b>	<b>Annuitant and Annuity Date</b>	<b>IOM Entity Obligated to Pay Annuity</b>	<b>Parties Involved, Exercises</b>
100,000 MIK options & 300,000 SSW options	Charles Wyly 2/22/96	Soulieana Limited	Charles Wyly transferred options to Woody International Trust of IOM, which transferred them to Soulieana in exchange for annuity. Trust terminated on 12/31/96 and transferred annuity to Mr. Wyly.  SSW options exercised February 1996. MIK options exercised August 2000.
350,000 MIK options & 250,000 SSW options	Charles Wyly 2/22/96	Quayle Limited	Charles Wyly transferred options to Maroon Creek Trust of IOM, which transferred them to Quayle in exchange for annuity. Trust terminated on 12/31/96 and transferred annuity to Mr. Wyly.  SSW options exercised March 1996. MIK options exercised August 2000.
333,334 SSW options	Charles Wyly 2/22/96	Elegance Limited	Charles Wyly transferred options to Lincoln Creek Trust of IOM, which transferred them to Elegance in exchange for annuity. Trust terminated on 12/31/96 and transferred annuity to Mr. Wyly.  Options exercised in May and June 1996.
1.6 million Sterling Commerce options	Charles Wyly 3/7/96	Elysium Limited	Charles Wyly transferred options to Woody International Trust of IOM, which transferred them to Elysium in exchange for annuity. Trust terminated on 12/31/96 and transferred annuity to Mr. Wyly.  Options exercised April 1998, May 1999 and March 2000.
666,666 SSW options	Sam Wyly 2/22/96	Devotion Limited	Sam Wyly transferred options to the Sitting Bull Trust of IOM, which transferred them to Devotion in exchange for annuity. Trust terminated on 12/31/96 and transferred annuity to Mr. Wyly.  Options exercised in May and June 1996.
300,000 SSW options	Sam Wyly 2/22/96	Fugue Limited (renamed in 1997 Audubon Asset Limited)	Sam Wyly transferred options to Crazy Horse Trust of IOM, which transferred them to Fugue in exchange for annuity. Trust terminated on 12/31/96 and transferred annuity to Mr. Wyly.  Options exercised March 1996.

<b>Initial Assets</b>	<b>Annuitant and Annuity Date</b>	<b>IOM Entity Obligated to Pay Annuity</b>	<b>Parties Involved, Exercises</b>
650,000 SSW options	Sam Wyly 2/22/96	Locke Limited	Sam Wyly transferred options to Crazy Horse Trust of IOM, which transferred them to Locke in exchange for annuity. Trust terminated on 12/31/96 and transferred annuity to Mr. Wyly.  Options exercised in February and March of 1996.
150,000 SSW options	Sam Wyly 2/22/96	Sarnia Investments Limited	Sam Wyly transferred options to Arlington Trust, which transferred them to Sarnia in exchange for annuity. Trust terminated on 12/31/96 and transferred annuity to Mr. Wyly.  Options exercised in March 1996.
900,000 MIK options	Sam Wyly 2/22/96	Yurta Faf Limited	Sam Wyly transferred options to Tallulah International Trust of IOM, which assigned them to Yurta Faf in exchange for annuity. Trust terminated on 12/31/96 and transferred annuity to Mr. Wyly.  Options exercised between March 2000 and September 2001.
3,000,000 Sterling Commerce options	Sam Wyly 3/7/96	Moberly Limited	Sam Wyly transferred options to Crazy Horse Trust which transferred them to Moberly in exchange for annuity. Trust terminated on 12/31/96 and transferred annuity to Mr. Wyly.  Options exercised April 1998 and January 1999.

**Parts III and IV: 1999 AND 2002 TRANSFERS OF STOCK OPTIONS FOR CASH**

<b>Transfer Date</b>	<b>Assets</b>	<b>Transferor and Transferee</b>	<b>Cash Paid</b>
9/30/1999	1,525,000 Sterling Software options (converted to 859,185 CA options in 2000)	Sam Wyly to East Carroll Limited	\$13,668,880
9/30/1999	200,000 Sterling Software options (converted to 112,680 CA options in 2000)	Sam Wyly to Greenbriar Limited	\$1,771,400
9/30/1999	800,000 Sterling Software options (converted to 450,720 CA options in 2000)	Stargate, Ltd (partnership of which Charles Wyly is general partner) to Quayle Limited	\$7,170,560
9/30/1999	100,000 Sterling Software options (converted to 56,340 CA options in 2000)	Stargate, Ltd to Elegance Limited.	\$885,700
9/30/1999	462,500 Sterling Commerce options	Sam Wyly to Greenbriar Limited	\$2,357,657
9/30/1999	250,000 Sterling Commerce options	Stargate, Ltd. to Elegance Limited	\$1,274,409

<b>Transfer Date</b>	<b>Assets</b>	<b>Transferor and Transferee</b>	<b>Cash Paid</b>
7/23/2002	859,185 CA options (converted from 1,525,000 Sterling Software options in 2000)	Sam Wyly to Greenbriar Limited	\$2,213,776
7/23/2002	112,680 CA options (converted from 200,000 Sterling Software options in 2000)	Sam Wyly to Greenbriar Limited	\$329,026
7/23/2002	450,720 CA options (converted from 800,000 Sterling Software options in 2000)	Stargate, Ltd. to Quayle Limited	\$1,161,325
7/23/2002	56,340 CA options (converted from 100,000 SSW options in 2000)	Stargate, Ltd. to Quayle Limited	\$164,513

The Wyls have contended that they did not escape taxes on their compensation income; they merely deferred the taxes due until the annuity payments began. More than ten years passed from when the first stock option went offshore in 1992, until the first annuity payment was made in 2003. To date, about \$35 million in annuity payments have been made and presumably included in Wyly taxable income. That means the bulk of the stock option compensation, about \$124 million out of \$190 million, remains offshore and untaxed. Moreover, the first and, to date, only default on a promised annuity payment took place in November 2005. If more follow, many millions of dollars of untaxed compensation may remain offshore and untaxed.

This case history is not one in which the Wyls sent assets offshore to purchase an annuity from an independent party, kept their distance, and waited for the annuity payments to begin. As other sections in the Report show, the Wyls and their representatives continually exercised direction over the offshore assets, directing when the stock options should be exercised, how the proceeds should be invested, and what should be done with the resulting cash. In response, the offshore entities invested their untaxed dollars in Wyly-related business ventures, acquired U.S. real estate, financed the construction of multiple residences, and purchased furnishings, artwork, and jewelry used by Wyly family members.

The next section explains how the offshore corporations, under the direction of Sam and Charles Wyly, converted the 17 million stock options and warrants into tradeable securities and then into hundreds of millions of untaxed offshore dollars.

### **(3) Converting U.S. Securities into Offshore Cash**

From 1992 to 2002, Wyly-related offshore corporations took possession of about 17 million stock options from three publicly traded companies, Michaels, Sterling Software, and Sterling Commerce, at which Sam and Charles Wyly were directors and large shareholders. Using U.S. securities firms, the offshore corporations exercised many of these stock options and took possession of the shares. Over the following years, the offshore entities sold some shares, pledged others to obtain multi-million-dollar loans, and used still others to buy new securities or hedge against drops in the stock price. The decisions to engage in these securities transactions were made by the Wyls and their representatives, and conveyed by the trust protectors to the offshore trustees who implemented them.

The Wyls did not report or pay taxes on any of the trusts' investment gains, even though the U.S. tax code requires income earned by a trust controlled by a U.S. person who provided the trust assets or is a trust beneficiary to be attributed to that U.S. person for tax purposes. The Wyls also did not include the stock holdings of the offshore entities in their filings with the SEC until 2005, even though, as large shareholders, the Wyls were required to disclose all of the shares they beneficially owned as well as shares held by groups with whom they acted in concert to buy and sell the securities. Wyly representatives helped the offshore entities avoid and circumvent SEC disclosure requirements for major shareholders, told U.S. financial institutions to treat them as exempt from SEC trading restrictions on corporate affiliates, and

helped the offshore entities conduct securities transactions during periods in which the Wyllys may have had material nonpublic information.

The U.S. securities brokers who carried out securities transactions for the Wyly-related offshore entities failed, with one exception, to investigate and fully understand the relationship between the offshore entities and the Wyllys. They treated the offshore entities as exempt from SEC trading restrictions on affiliates, despite knowing that the Wyllys directed their investment activities. The three public corporations whose securities were traded by the offshore entities failed to disclose the offshore holdings in their SEC filings, even though they knew the offshore entities had large holdings and were associated with the Wyllys. As a result, for many years until 2005, U.S. securities regulators and the investing public were unaware of the extent of the Wyly-related offshore stock holdings and trading activity.

During the period examined in this Report, Sam and Charles Wyly were directors and large shareholders of three publicly traded corporations and, under U.S. securities law, were subject to certain disclosure requirements, trading restrictions, and insider trading prohibitions. A key issue is whether, by sending millions of stock options to offshore entities whose investments they directed, the Wyllys were using offshore secrecy laws to circumvent basic principles in the United States intended to ensure fair and transparent markets, including disclosure requirements for major shareholders, trading restrictions on privately acquired shares, and prohibitions against trading on nonpublic information.

### **(a) Trading Offshore**

The Wyly-related offshore entities used the services of three securities firms, Credit Suisse First Boston (CSFB), Lehman Brothers, and the securities divisions of Bank of America, to convert their stock options and warrants into shares and undertake a complex array of securities transactions that, over time, generated millions of dollars in investment gains. These sophisticated offshore trading strategies were not initiated, devised, or directed by the trustees of the offshore trusts or by the directors or officers of the offshore corporations that held the stock. Instead, Sam and Charles Wyly and their representatives routinely reviewed the trading options available to the offshore entities, decided on the securities transactions that should take place, and coordinated the offshore transactions. At times, they also took steps to coordinate offshore and domestic trades of the same stock.

A key facilitator of the securities trades conducted by the Wyly-related offshore entities was Louis Schaufele, a U.S. stock broker based in Dallas, Texas.<sup>747</sup> The Wyly-related offshore entities first used his services in 1992, when they asked CSFB to arrange their initial stock

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<sup>747</sup> Mr. Schaufele first began working for the Wyllys around 1990, when their previous broker, Drexel Burnham Lambert, filed for bankruptcy, and the Wyllys contacted the Dallas office of First Boston Securities, looking for a new broker. Subcommittee interview of Mr. Schaufele (6/28/05). Mr. Schaufele was assigned to call on Sam Wyly and opened several domestic accounts for the Wyly family at First Boston. His primary contact was Ms. Robertson. Id.

option exercises.<sup>748</sup> Mr. Schaufele soon became the primary stock broker for all of the Wyly-related offshore entities, carrying out numerous securities transactions for them over the next thirteen years. He changed jobs twice during this period, moving from CSFB to Lehman Brothers in 1995, and then to Bank of America in early 2002. Both times, he took the Wyly-related offshore accounts with him when he moved, apparently after obtaining the consent of the Wyls.<sup>749</sup> Throughout this period, as explained below, he was in frequent contact with Wyly representatives as well as with Sam, Charles, and other Wyly family members.

Mr. Schaufele helped the Wyly-related offshore entities engage in a wide range of complex securities transactions. For example, he helped them exercise the stock options they had acquired, at times arranging for them to borrow millions of dollars from CSFB or Lehman Brothers to buy the specified shares.<sup>750</sup> Once the offshore entities took possession of the shares,

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<sup>748</sup> Mr. Schaufele told the Subcommittee that he first became involved with the offshore entities when, in 1992, Ms. Robertson asked him for help in finding a foreign bank to open accounts for them. He said that he traveled at least twice to Switzerland with Ms. Robertson to meet with banks, including Credit Suisse, a Swiss financial institution that was then the majority shareholder of First Boston. The two firms formally merged in 1997, taking the name of Credit Suisse First Boston.

<sup>749</sup> See, e.g., 2/19/02 email from Ms. Boucher to Ms. Robertson (PSI\_ED00009278-79) (“Lou’s move to BofA [Bank of America] was final last week. Sam & Charles have consented to moving all their stuff with him. ... Lou is planning on travelling to IOM to ensure everything is properly executed and pay everyone over there a visit.”).

<sup>750</sup> See, e.g., 4/22/92 letters exercising stock options owned by East Baton Rouge, Roaring Creek, and Tensas to buy 510,000 Michaels shares, using more than \$1.5 million supplied by CSFB (PSI00028461-63); 5/12/92 letters exercising stock options owned by East Carroll, Little Woody, and Roaring Fork to buy one million Sterling Software shares, using more than \$6.2 million supplied by CSFB (PSI00135895, 897, 900-01); 9/1/95 documents discussing the exercise of stock options owned by Greenbriar, Quayle, and Sarnia Investments to buy one million Sterling Software shares, using more than \$18.8 million supplied by Lehman Brothers (CC021900-05). See also undated document listing all 1996 stock options obtained by the offshore entities and showing the dates on which those stock options were exercised (PSI\_ED00093578-83).

he helped them obtain margin and other loans,<sup>751</sup> and participate in various stock sales,<sup>752</sup> stock collars,<sup>753</sup> call options,<sup>754</sup> equity swaps,<sup>755</sup> prepaid forward contracts,<sup>756</sup> and other transactions.

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<sup>751</sup> See, e.g., May 1992 CSFB statements referencing margin accounts for East Baton Rouge and Tensas (CSFB0004205, 4221); 8/30/95 letter establishing a Lehman margin account for Greenbriar (CC021746) (authorizing the margin account and an exercise of 500,000 Sterling Software options “using funds to be borrowed on margin”); 8/31/95 letter establishing \$10 million multicurrency loan facility for Greenbriar (CC021969-71); 9/12/95 internal Lehman memorandum journaling one million Sterling Software shares owned by Greenbriar, Quayle, and Sarnia Investments to a Lehman account as collateral for loans (CC021548); 12/18/95 internal Lehman memorandum (CC038440)(“I intend to ask credit for permission to increase loan amounts to Devotion and Elegance. On 13 November 1995, these two Isle of Man counterparties bought two year calls on 500,000 shares of Sterling Software at a strike price of \$41 .... We agreed to lend them 50% of the cost of these calls .... Sterling Software is now trading above \$55 per share .... [T]he outstanding loan value is \$2.3 million.”); 6/20/97 internal Lehman email discussing Sterling Software and Sterling Commerce stock sales and use of sale proceeds to pay off millions of dollars in outstanding loans issued to Greenbriar and Sarnia Investments (CC021859); 8/6/98 memorandum discussing status of \$8 million Lehman Brothers Finance loan to Greenbriar (CC021557); 1/31/99 internal Lehman email listing “collateral positions” involving hundreds of thousands of Sterling Software and Sterling Commerce shares pledged by Greenbriar, Quayle, and Sarnia Investments to secure loans from Lehman Brothers (CC021928).

<sup>752</sup> See, e.g., May 1992 CSFB statement for East Baton Rouge showing 50,000 Michaels shares sold for \$1.1 million (CSFB0004221); May 1992 CSFB statement for Tensas showing 60,000 Michaels shares sold for about \$1.3 million (CSFB0004205); December 1992 CSFB statement for Little Woody showing 57,500 Sterling Software shares sold for about \$1.2 million (CSFB0004128); 1/11/96 fax directing sale by East Carroll of 116,667 Sterling Software shares (CC020032); March 1996 Lehman statement for Soulieana showing Sterling Software shares sold for about \$14.5 million (CC004305-08) and undated chart entitled “Tyler Trust Soulieana Limited” (PSI00130274)(showing 2/26/96 exercise of 300,000 Sterling Software stock options and March sales of the shares); May 1996 Lehman statement for Devotion showing Sterling Software shares sold for \$31 million (CC011688); 3/19/97 sale of 300,000 Michaels shares from Greenbriar to East Baton Rouge and East Carroll for \$5.3 million (CC021552); June 1997 Lehman statement for Greenbriar showing Sterling Software shares sold for about \$26 million (CC000083-88); 3/24/98 letter directing sale of Michaels, Sterling Software, and Sterling Commerce shares from Quayle (CC027192) and 4/14/98 fax reporting sales proceeds of about \$10 million (CC027192, 262-63); 9/30/99 sales of Sterling Software and Sterling Commerce stock options by Sam Wyly to East Carroll and Greenbriar for more than \$17 million (CC019988, 21648, 21720) and by Stargate Ltd., associated with Charles Wyly, to Elegance and Quayle for more than \$9 million (CC019661, 66, 24086); 1/21/00 “Summary of Michaels exercises/sales” showing that Yurta Faf sold about 596,000 Michaels shares in January and February 2000, for about \$11.2 million (PSI\_ED00071925); undated chart, likely from 2001, entitled, “Michaels Off-Shore Trading” (HST\_PSI007055)(listing Michaels stock sales from August 2000 to November 2001).

<sup>753</sup> See, e.g., 8/30/95 fax on collar involving Sterling Software shares and the Bulldog and Pitkin Trusts (PSI00117939); 10/27/95 Lehman document discussing collars involving Greenbriar, Quayle, and Sarnia Investments (CC021995-96); 11/3/95 Lehman memorandum discussing Sterling Software collar (PSI00119018); 1/2/96 memorandum proposing new collars for “the offshore entities” (CC038759); 2/9/99 summary of proceeds from Sterling Software and Sterling Commerce collars involving Greenbriar, Quayle, and Sarnia Investments (CC038824-25). A collar is a combination of put and call options that can limit the risk that the value of the relevant shares will increase or decrease.

<sup>754</sup> See, e.g., 8/20/96 memorandum from Mr. Schaufele to Mr. French and Ms. Robertson with copies to Sam and Evan Wyly discussing Michaels calls “that you are short”(CC039284); 12/18/95 internal Lehman memorandum (CC038440)(“On 13 November 1995, these two Isle of Man counterparties [Devotion and Elegance] bought two year calls on 500,000 shares of Sterling Software at a strike price of \$41.”); 10/28/96 Lehman memorandum (CC038283)(reporting that Elegance and Devotion sale of 500,000 Sterling Software calls generated \$7.4 million and referencing sale of Sterling Commerce calls to take place the next day); undated handwritten

The number, range, and size of the securities transactions going on at one time is illustrated, for example, by a December 1995 chart prepared by Lehman solely on “Sterling Software Trades” related to Sam Wyly, listing \$38 million in outstanding loans to eight Wyly-related offshore corporations; two “zero cost collars” with a total market value in excess of \$7.4 million; two sets of call options involving 500,000 shares; and a “Hedge” involving about 495,500 shares.<sup>757</sup> Many of these securities transactions were carried out by Credit Suisse or Lehman Brothers Finance in Switzerland; some also used accounts in London and the United States.<sup>758</sup>

The evidence indicates that these complex, multi-million-dollar securities transactions were not devised or directed by the offshore trustees or the officers or directors of the offshore corporations. The transactions were instead the result of decisions made by Sam and Charles Wyly after consulting with their advisers and broker, Mr. Schaufele. Mr. Schaufele told the

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document, likely from late 1997, listing multiple calls involving Greenbriar, Quayle, and Sarnia Investments, and long and short positions on hundreds of thousands of Sterling Software and Sterling Commerce shares (CC022085-87); 3/17/98 letter discussing call and put option transactions and related loans involving East Carroll and Sterling Software and Sterling Commerce shares (CC020302-04); 6/15/01 email from Ms. Boucher to Ms. Hennington (PSI\_ED00013896)(discussing Sarnia Investments plan to buy \$2.5 million worth of “\$35 CA calls”); 6/15/01 call option documentation involving Computer Associates shares and Greenbriar (CC021913); 6/21/01 call option documentation involving Computer Associates shares and Sarnia Investments (CC017267). A call option is an agreement that gives an investor the right, but not the obligation, to buy a security at a specified price within a specified time period.

<sup>755</sup> See, e.g., 7/22/99 memorandum from Mr. Schaufele to Ms. Robertson suggesting swap involving Michaels shares (CC026148)(“The offshore entity would be a seller and the buyer would be Lehman. As Lehman bought stock, they in turn would enter into a swap arrangement with the company at the current price. This would offer the protection from upward price movement. The offshore entity could sell stock without pressuring the market.”); and detailed proposal at PSI\_ED00046395-401. See also 10/8/99 “Equity Swap (LONG)” involving Sterling Software stock and Greenbriar (CC022040-41); 10/8/99 “Equity Swap (LONG)” involving Sterling Software stock and Sarnia Investments (CC017344-45); 10/8/99 “Equity Swap (LONG)” involving Sterling Software stock and Quayle (CC029349-50); 1/25/00 fax from Lehman Brothers Finance to Greenbriar on a “Reset of SSW swap” (CC021686) with similar resets on 3/3/00 (CC021920) and 6/5/00 (CC021692); 3/2/00 “Equity Swap (LONG) Amendment” involving 2 million Sterling Software shares and Greenbriar, Quayle, Moberly, Roaring Fork and Sarnia Investments (CC031181-83); and 3/3/00 “Equity Swap Amendment (SSW)” involving 1.5 million Sterling Software shares and Greenbriar, Moberly, and Sarnia Investments (CC031175-77). An equity swap is a swap in which the payments on one or both sides are linked to the performance of specified equities or an equity index.

<sup>756</sup> See, e.g., 2002 prepaid forward contract involving 800,000 Michaels shares, Devotion and \$25 million, described in 4/7/05 amended Schedule 13D filed by the Wylys with the SEC at 4 and in items 4 and 7. A prepaid forward contract is an agreement in which the investor receives an up-front payment in exchange for a commitment to deliver securities in the future.

<sup>757</sup> See 12/18/95 Lehman fax to Mr. Schaufele, including 12/12/95 chart entitled “Sterling Software Trades” (CC038439-42). See also undated chart, likely from 6/97, entitled “Offshore Stock Analysis” showing ownership by the Wyly-related offshore entities of Sterling Software, Michaels, and Sterling Commerce shares, options, and collars (PSI00087628).

<sup>758</sup> See, e.g., 10/11/95 chart prepared by Lehman Brothers showing transactions in New York, London, and Geneva offices (CC038765).

Subcommittee that he typically spoke with a Wyly representative, such as Ms. Hennington or Ms. Boucher, but it was not uncommon for him to speak directly with Wyly family members, such as Sam Wyly.<sup>759</sup> He said that, for complex securities transactions, he often worked out the details of a transaction with Ms. Hennington or Ms. Boucher. After agreement was reached, he typically prepared a term sheet which he provided to Ms. Hennington or Ms. Boucher and to the relevant offshore trustee. He said that he would then discuss the transaction with the offshore trustee who, by the end of the conversation, would typically provide a verbal or written authorization to proceed. He said that it was typical for the offshore trustee to have already spoken with Ms. Boucher or one of the other trust protectors prior to the time Mr. Schaufele made this contact.

Mr. French, Ms. Robertson, and Ms. Hennington each told the Subcommittee that they did not themselves initiate, devise, or direct the securities transactions involving the offshore entities.<sup>760</sup> Mr. French, Ms. Robertson, and Ms. Hennington each told the Subcommittee that, in their experience, the offshore trustees also did not initiate or devise the securities transactions or commit trust assets without seeking the approval of the trust protectors. Mr. French and Ms. Robertson told the Subcommittee that, in their experience, the key decisions on securities investments were initiated or approved by Sam or Charles Wyly. These decisions were then communicated by Wyly representatives to Mr. Schaufele who worked with them to iron out the details of the transactions. After agreement was reached on how the transactions would proceed, Mr. French and Ms. Robertson, in their role as trust protectors, then “recommended” that the offshore trusts participate in the transactions.<sup>761</sup> In response, the offshore trustees or the officers or directors of the corporations supplied any needed funds, authorizations, or documents.

Numerous documents demonstrate that Sam and Charles Wyly, and their representatives, were actively involved with the offshore securities transactions, and that the Wylys made the decisions to buy and sell securities. For example, in April 2000, Sam Wyly’s son Evan Wyly sent Ms. Boucher an email stating: “Sam recommends that the trustees exercise and sell the remainder of the Michaels options that expire this summer. Sell at \$40 or better.” Ms. Boucher responded: “I did confirm with the trustees this morning, and they are proceeding on the

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<sup>759</sup> Subcommittee interview of Mr. Schaufele (7/26/06).

<sup>760</sup> Subcommittee interviews of Mr. French (6/30/06), Ms. Robertson (3/9/06), and Ms. Hennington (4/26/06).

<sup>761</sup> See, e.g., detailed recommendations from trust protectors to offshore trustees directing specific securities transactions, including a 4/20/92 recommendation by Mr. French and Ms. Robertson to Lorne House for three specified offshore corporations to exercise a specified number of options and sell a specified number of shares at a minimum of \$20 per share (PSI00081460-64); 3/13/95 recommendation by Mr. French to Lorne House for six specified offshore corporations to use 900,000 Sterling Software shares on a collar and related loans (PSI-WYBR00292-93); 1/19/99 recommendation by Ms. Boucher to IFG for a specified offshore corporation to exercise specified options and sell the shares to another specified offshore corporation (CC040417); 1/11/00 recommendation by Ms. Boucher to IFG for Yurta Faf and another offshore corporation to sell 200,000 Michaels shares at “\$30 or better” (PSI\_ED00044236); 10/25/01 recommendation by Ms. Robertson to Trident for Quayle to sell 100,000 Michaels shares at “\$52 or better” (MAV008375).

offshore options, selling at \$40 or better.”<sup>762</sup> Later, Ms. Boucher sent an email to Sam and Evan Wyly stating: “I received a fax from Charles tonight indicating that Sam has cancelled his request to exercise and sell the offshore options at \$40 or better – please confirm. ... Please let me know asap, so I can amend the recommendation with the Trustees.” Evan responded: “Yes, I spoke with Sam, who has spoken with Charles. We do not recommend re-booking the 10,000 shares [already sold], but we do recommend canceling further sales by the Trustees.”<sup>763</sup> This email exchange shows that the persons making the decisions about these stock sales were not the offshore trustees, but Sam and Charles Wyly.

On another occasion a few months later, Ms. Boucher wrote: “I spoke to Sam today, he wants us to proceed with selling 200,000 Michaels Stores shares from offshore to aid in raising funds for Ranger/Precept projects.”<sup>764</sup> On another occasion, Ms. Boucher sent an email asking Charles Wyly for his decision on whether Mr. Schaufele should liquidate certain government securities owned by Quayle to obtain cash needed for a stock option exercise.<sup>765</sup> At another point, Evan Wyly told Ms. Boucher, “I just spoke to Sam, and he recommends proceeding with the exercise and sale of the \$12.50 Michaels options now.” Ms. Boucher responded: “I’ll speak to Shari to obtain the protector’s recommendation and get it started.”<sup>766</sup> Other documents show Mr. Schaufele seeking Wyly approval of specific offshore securities transactions.<sup>767</sup> These and other documents demonstrate that it was Sam and Charles Wyly, rather than the offshore trustees or corporate officers and directors, who exercised actual direction over the securities transactions undertaken by the offshore entities.<sup>768</sup>

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<sup>762</sup> 4/26/00 emails between Ms. Boucher and Evan Wyly (PSI\_ED00043559).

<sup>763</sup> 4/26 and 4/27/00 emails between Ms. Boucher, Evan Wyly and others (MAV010782-83).

<sup>764</sup> 9/15/00 email from Ms. Boucher to Ms. Robertson and Evan Wyly (MAV010831).

<sup>765</sup> 12/23/99 email from Ms. Boucher to Charles and Evan Wyly and Ms. Robertson on Michaels options (MAV010726)(“Lou Schaufele called today, and if we want to liquidate US Government Agencies for CW entities – (Quayle Limited) for the option exercise then he would like to liquidate these today. ... Let me know how you feel about this – I need to get back with Lou today.”).

<sup>766</sup> 1/10/00 emails exchanged among Evan Wyly, Ms. Boucher, Ms. Robertson, and others (PSI\_ED00070164-65).

<sup>767</sup> See, e.g., 8/22/95 fax from Mr. Schaufele to Sam Wyly proposing Sterling Software collar and call alternatives for Maverick, Pitkin and Bulldog (CC038776)(“Sam, Call me when you have time to discuss.”); 10/4/95 fax from Mr. Schaufele to Sam Wyly (CC038769)(suggesting new Sterling Software collar and stating: “[p]lease call me if you would like to discuss.”); 5/13/96 memorandum from Mr. Schaufele to Sam and Evan Wyly discussing alternatives for Sterling Software collars and long positions (CC039763-65); 1/16/97 memorandum from Mr. Schaufele to Sam and Charles Wyly (CC038779-80)(explaining availability of certain hedging transactions and warning that “the window may close soon on some methods of monetization for large shareholders of common stock”).

<sup>768</sup> See, e.g., 10/5/92 memorandum from Ms. Robertson to Lorne House (PSI00135818)(informing Lorne House that Sam and Charles Wyly “wish to sell private company stock to the foreign corporations. ... Do you need to know anything other than the company name, number of shares and purchase price?”); 8/20/95 memorandum

Additionally, a number of documents suggest that there was coordination between the offshore securities transactions and transactions involving securities owned by the Wyls domestically.<sup>769</sup> For example, a 1997 memorandum from Ms. Robertson to Sam and Charles Wyly, among others, presented two different scenarios on how to proceed with certain Sterling Software and Sterling Commerce collars.<sup>770</sup> The memorandum analyzed each scenario in terms of its cashflow and tax implications, and presented the analysis for both onshore and offshore

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from Mr. Schaufele to Mr. French and Ms. Robertson with copies to Sam and Evan Wyly discussing Michaels calls “that you are short”; undated fax, likely in 1995, from Mr. Schaufele to “Shari/Mike/Sam” on Sterling Software puts and calls (CC038772); 1/2/96 fax from Mr. Schaufele to Mr. French and Ms. Robertson discussing Sterling Software collar held by “the offshore entities” (CC038759); 8/20/96 memorandum from Mr. Schaufele to Mr. French and Ms. Robertson with copies to Sam and Evan Wyly discussing Michaels calls and requesting a telephone call to discuss Sterling Commerce and Sterling Software (CC039284); 1/11/99 email from Ms. Robertson to Ms. Boucher (PSI\_ED00046560)(“I have begun discussions with Lou to collapse the SSW/SE collars. ... Moberly needs to exercise 300,000 shares of SE and sell the shares to Greenbriar/Sarnia prior to 2/9/98. ... Lou assures me ... we can come to terms on what the sale price of the stock is and there will be no trading in the marketplace.”); 1/19/00 email from Ms. Boucher to Sam and Evan Wyly and Ms. Robertson (MAV010737-38)(informing them that “Lehman’s has been cleared to start on the next 200,000 share block” of sales of Michaels options held by offshore entities); 3/2/00 email from Ms. Robertson to Ms. Boucher on “CW,” meaning Charles Wyly (PSI\_ED00047852)(“He’s not ready to decide what he’s doing on SSW options. Will let us know.”); 7/27/00 emails between Ms. Boucher and Evan Wyly (MAV010800-01)(forwarding message from Mr. Schaufele about exercising stock options for Quayle, Soulicana, Yurta Faf and others on a certain date; Evan responded: “OK with me”); 5/23/01 email from Ms. Boucher to Sam and Evan Wyly (PSI00088927)(updating the Wyls on plans for the offshore entities to sell Scottish Re shares and stating that the protectors were “prepared to recommend” that the trustees sell the shares “at no less than \$15 per share”); 10/4/01 emails on Quayle sales of Michaels shares (PSI\_ED000006660)(after learning Lehman had sold 82,500 Michaels shares for Quayle, Ms. Hennington asked her colleague: “Would you let Mr. Wyly know this.”); 10/4/01 email from Mr. Schaufele to a Lehman colleague (CC031033)(“I spoke with the family last night, they do understand that we will be collaring 20% more stock than Devotion would be purchasing. ... Here, is a negative which they did not bring up but I bet Sam picks up on it. If Sam sells into the open market he must comply with rules of an insider on selling versus he can cross it to Devotion.”). See also documents cited in discussions below.

<sup>769</sup> See, e.g., 8/22/95 Lehman memorandum from Mr. Schaufele to Sam Wyly (CC038776)(discussing existing and proposed collar involving Sterling Software shares and Maverick Entrepreneurs, with a handwritten notation from Mr. Schaufele stating: “The #'s for Bulldog/Pitkin would be similar but the net borrow is less due to the fact that we are only stepping the put up from 36 [to] 42”)(emphasis in original); 9/28/99 chart entitled “Analysis of Options Shares as of September 24, 1999” (PSI00064844)(listing Michaels shares for offshore and onshore entities); 1/12/00 email from Ms. Boucher to Sam and Evan Wyly and Ms. Robertson (MAV010735) (discussing sale of Michaels shares by Yurta Faf and others after which Ms. Boucher wrote: “Evan & Sam – I discussed the transactions with Elaine today and advised her that once we are finished, you may be interested in starting on some domestic options, or alternatively exploring the sale of them to offshore.”); 1/10/00 emails exchanged among Evan Wyly, Ms. Boucher, Ms. Robertson, and others (PSI\_ED00070164-65)(Ms. Boucher wrote to Evan Wyly that Ms. Robertson “thought that you and Sam were looking at an exercise and hold scenario for the Michaels options ... because of domestic liquidity issues, that you might want to look at having offshore acquire the domestic options, and exercise and hold the stock offshore”); 4/26 and 4/27/00 emails between Ms. Boucher and Evan Wyly on the sale of Michaels shares (MAV010782)(Ms. Boucher wrote: “Charles’ fax also had some notes indicating that we are to sell domestic first and he has an order of: Evan, Kelly, Cheryl, Sam, Charles. There was a note that Donnie was finished selling domestically. Please confirm if this is how we should proceed?” Evan responded: “Yes .... [We] recommend canceling further sales by the Trustees. Please proceed with sales domestically at 40 or better.”).

<sup>770</sup> 11/19/97 memorandum from Ms. Robertson to Sam, Charles and Evan Wyly and Donald Miller on “SSW and SE Collars” (PSI\_ED00065891-900).

holdings related to Sam and Charles. Mr. Schaufele told the Subcommittee that he often pitched ideas for securities transactions to the “whole Wyly group,” and they would decide whether to do the transaction with an onshore or offshore entity.<sup>771</sup> On an occasion in 2001, Ms. Boucher wrote to the Wyly family office about certain securities transactions to be undertaken by the offshore entities: “We are only doing this from offshore, but you should be aware. I’ve advised Shari as protector and she is on board. I’ve also cleared it ... to ensure we weren’t doing anything to[o] close to the date of Sam’s planned activities.”<sup>772</sup> On another occasion, in 2000, when Lehmans sold 10,000 Michaels shares on behalf of an offshore entity, and Sam Wyly changed his mind about selling the offshore shares, Lehman apparently offered to rebook the sales and attribute them to a Wyly domestic entity.<sup>773</sup>

Other documents demonstrate coordination of securities transactions undertaken by offshore corporations owned by different offshore trusts. For example, Greenbriar, Quayle, and Sarnia Investments, each of which is owned by a different IOM trust, undertook a number of joint or parallel securities transactions, including exercising stock options for one million Sterling Software shares on September 1, 1995, participating in 1995 Sterling Software collars, and participating in 1999 Sterling Software equity swaps.<sup>774</sup> Similarly, Devotion and Elegance participated in joint or parallel securities transactions to purchase 500,000 Sterling Software calls and to purchase two million Michaels shares in 1997.<sup>775</sup> These and other documents indicate there were many occasions on which the securities transactions of the purportedly independent offshore entities were, in fact, coordinated.<sup>776</sup> Mr. Schaufele told the Subcommittee that he was

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<sup>771</sup> Subcommittee interview of Mr. Schaufele (7/26/06).

<sup>772</sup> 6/15/01 email from Ms. Boucher to Ms. Hennington on “transaction we are doing in the trusts re: CA” (PSI\_ED00013896).

<sup>773</sup> See 4/26 and 4/27/00 emails between Ms. Boucher, Evan Wyly and others (MAV010782-83)(Ms. Boucher wrote: “I also just spoke with Lehmans, and they can rebook the 10,000 Michaels that we did today for another account (in the domestic system) if we want. I need to let them know in the morning.”); 4/26/00 emails between Ms. Boucher and Sam and Evan Wyly on the sale of these Michaels shares (PSI\_ED00043559).

<sup>774</sup> Greenbriar is owned by the Delhi International Trust, Quayle is owned by the Castle Creek International Trust, and Sarnia Investments is owned by the Lake Providence International Trust. See documents cited in the footnotes to this section of the Report describing securities transactions undertaken by all three corporations.

<sup>775</sup> Devotion is owned by the LaFourche Trust, and Elegance is owned by the Red Mountain Trust.

<sup>776</sup> See, e.g., 11/19/98 fax from Sarnia Investments to Mr. Schaufele (CC040447)(“Please accept this fax as your instruction to sell 113,074 shares of Sterling Commerce (SE). In the event that the stock is called away at \$27.75 (call price) please purchase the options from one of the other trusts to cover the call.”); 1/11/99 email from Ms. Robertson to Ms. Boucher (PSI\_ED00046560)(“I have begun discussions with Lou to collapse the SSW/SE collars. ... Moberly needs to exercise 300,000 shares of SE and sell the shares to Greenbriar/Sarnia prior to 2/9/98.”); 10/8/99 email from Ms. Boucher to Sam and Evan Wyly and Ms. Robertson on Sterling Software stock (MAV007713)(Ms. Boucher wrote: “Lehman has started the transaction”; Mr. Schaufele wrote: “We ... will be crossing the stock purchased by Moberly and Quayle into the swap.”); 3/2/00 “Equity Swap (LONG) Amendment” involving 2 million Sterling Software shares and Greenbriar, Quayle, Moberly, Roaring Fork, and Sarnia Investments (CC031181-83); 9/4/01 email from Michele Crittenden of Banc of America Securities to Ms. Boucher

often told by Ms. Boucher that more than one offshore corporation would be engaging in the same type of transaction, and he would process the transactions together.<sup>777</sup> Some documents suggest that the Wyllys may also have provided direction on how the offshore corporations were to vote their shares on proxy issues.<sup>778</sup>

The securities transactions engaged in by the offshore corporations and trusts generated hundreds of millions of dollars in profits. The Wyllys, on advice of counsel, did not pay U.S. tax on any of these trading gains, contending that the offshore trusts were independent while, at the same time, exercising significant direction over the trusts' assets and investment activities. U.S. tax law requires a foreign trust that is controlled by a U.S. person who funded or is a beneficiary of the trust to attribute its income to the U.S. person for tax purposes.<sup>779</sup> No such attribution took place here. As explained in later sections of this Report, the offshore entities used the untaxed dollars generated by the securities transactions to advance the Wyllys' business and personal interests, including Wyly-related hedge funds, Wyly-related business investments, U.S. real estate, and furnishings, artwork, and jewelry used by Wyly family members.

### **(b) U.S. Securities Law**

The offshore trading examined in this case history raises a second set of concerns in addition to those related to nonpayment of tax. These concerns focus on the fact that the offshore entities were given stock options and warrants, and conducted most of their trades, using shares of U.S. publicly traded corporations at which the Wyllys were directors and major shareholders. A key issue is whether, by trading these securities through offshore entities whose investments they directed, the Wyllys were using offshore secrecy laws to circumvent basic principles of U.S. securities laws intended to ensure fair and transparent markets, including disclosure requirements for major shareholders, trading restrictions on privately acquired shares, and prohibitions on trades by persons with inside information. Of equal concern are the actions

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(LBE000346)(discussing instructions to sell Michaels shares owned by Quayle and Sarnia Investments, which are owned by different offshore trusts; Ms. Crittenden wrote: "Do we complete Quayle first or do we split what we do today? Just let me know how you would like me to handle.").

<sup>777</sup> Subcommittee interview of Mr. Schaufele (7/26/06).

<sup>778</sup> See, e.g., 5/12/92 fax from Lorne House to Ms. Robertson (PSI00135882)("Please ask the committee of protectors who we should appoint as proxy for the Michaels Stores annual general meeting."); 5/29/97 internal Lehman memorandum discussing Michaels proxy vote (CC039534)("The Wyly accounts have appx. 2mm shares collared and I believe these shares are held in street name with Lehman Brothers Finance [in Switzerland]. Amy Browning at the Wyllys called in a panic about who was supposed to vote those shares – Lehman or them themselves. ... Rich Ladd is investigating, but since the Wyllys are a little nervous, I thought I better get you involved." Handwritten notation states: "Devotion ... 1,183,333"); 9/11/98 fax from IFG to Mr. Schaufele forwarding signed proxy votes from East Baton Rouge and East Carroll (CC019296-97)("As requested in the fax received overnight from your office, please find herewith duly signed proxies in respect of the forthcoming meeting of Michaels Stores Inc.").

<sup>779</sup> See 26 U.S.C. §§ 671-78.

taken by the public corporations, lawyers, and brokers who facilitated these securities transactions.

To analyze these issues, a short summary of key U.S. securities laws is provided, followed by a discussion of the securities trades that took place in this case history.

### **(i) Background on U.S. Securities Law**

To ensure fair and open capital markets and build investor confidence, U.S. securities laws impose a number of disclosure requirements and trading restrictions on publicly traded corporations, corporate insiders, and their affiliates. In discussing U.S. securities law, the Supreme Court has explained: “A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor [buyer beware] and thus to achieve a high standard of business ethics in the securities industry.”<sup>780</sup> Three key securities provisions at issue in this case history are Section 13(d) of the Securities and Exchange Act of 1934, which provides disclosure obligations for major shareholders of publicly traded corporations; Section 5 of and Rule 144 under the Securities Act of 1933, which restrict the trading of unregistered securities obtained by corporate affiliates in nonpublic transactions; and Section 16 of and Rule 10b-5 under the Exchange Act of 1934, which restrict trades using nonpublic information.

**Disclosure Obligations for Major Shareholders.** Section 13(d) of the Exchange Act of 1934 requires all shareholders who beneficially own more than five percent of a publicly traded corporation to file with the SEC a form called Schedule 13D disclosing the number of shares and the percentage of outstanding stock they own.<sup>781</sup> The purpose of this disclosure is to inform the investing public of the identity and the size of the holdings of major shareholders of a public corporation and their purpose for acquiring the securities. In addition, if a major shareholder’s holdings fluctuate by more than one percent of the issuer’s total stock, then the shareholder must file an amended Schedule 13D promptly after the transaction responsible for the change. This disclosure requirement alerts the investing public to actions taken by major shareholders to buy or sell a substantial number of shares.

Rule 13d-3 defines a “beneficial owner” of a security as “any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.” 17 C.F.R. § 240.13d-3(a). The Rule also provides that any persons who act as a group to acquire, hold, vote, or dispose of securities and who together

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<sup>780</sup> SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

<sup>781</sup> Section 13 is codified at 15 U.S.C. § 78; the implementing regulation is Rule 13d-1(a), codified at 17 C.F.R. § 240.13d. Under some circumstances, persons may disclose substantially the same information on a Schedule 13G. See Section 13(g).

exceed the five percent threshold must disclose the existence of the group and its stock holdings.<sup>782</sup>

To prevent circumvention of the disclosure obligation, the Rule states explicitly that any beneficial owner who attempts to evade filing a Schedule 13D by creating or using a trust or other arrangement to divest themselves of ownership of the relevant securities “shall be deemed” to be a beneficial owner of those securities subject to the filing requirement.<sup>783</sup> Together these provisions impose a clear obligation on major shareholders of publicly traded corporations to disclose their stock holdings.

**Trading Restrictions on Affiliates with Privately Acquired Shares.** Section 5 of the Securities Act of 1933 requires that securities be registered with the SEC prior to their offer or sale, unless a requirement for an exemption is met.<sup>784</sup> The purpose is to ensure that only securities with full and fair disclosure are sold in interstate commerce. One effect of Section 5 is to prohibit the resale of any securities acquired in a private transaction from a publicly traded corporation or its affiliate, unless those securities are registered with the SEC or meet the requirements for a registration exemption. The purpose of this prohibition is to prevent issuing corporations and their affiliates from circumventing U.S. securities laws by transferring company shares through private transactions not open to the investing public and then reselling those securities on public exchanges.<sup>785</sup>

Rule 144 creates a safe harbor from Section 5’s prohibition on the public resale of privately acquired securities, but only if certain conditions are met.<sup>786</sup> The purpose of this Rule is to prohibit the creation of public markets in securities where adequate information is not available to the public. At the same time, where adequate current information is available to the public, the Rule permits the public sale of private, unregistered securities subject to volume restrictions. Generally, to qualify for the Rule’s safe harbor protections, the shareholder must hold the privately acquired securities for a designated period of time and then limit the number

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<sup>782</sup> Section 13(d)(3) states that “[w]hen two or more persons act as a partnership ... or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a ‘person’ for purposes of” the filing requirement. The implementing rules require any group whose members together beneficially own more than five percent of the relevant securities to report their ownership on a Schedule 13D. See 17 C.F.R. § 240.13d-1(k)(2), 17 C.F.R. § 240.13d-5(b)(1), and 17 C.F.R. § 240.13d-101.

<sup>783</sup> Rule 13d-3 states: “Any person who, directly or indirectly, creates or uses a trust ... or any other ... arrangement ... with the purpose of effect of divesting such person of beneficial ownership of a security ... as part of a plan or scheme to evade the reporting requirements of section 13(d) ... shall be deemed ... to be the beneficial owner of such security.”

<sup>784</sup> Section 5 is codified at 15 U.S.C. § 77e.

<sup>785</sup> Examples of private transactions in which shares are transferred outside of public offerings include private sales of stock and stock option grants in exchange for services.

<sup>786</sup> Rule 144 is codified at 17 C.F.R. § 230.144.

of shares sold per quarter.<sup>787</sup> The purpose of these trading restrictions is to prevent a person who acquired shares from the issuing corporation or its affiliate in a private transaction from immediately reselling large numbers of those shares in the public marketplace.

Rule 144's trading restrictions apply to shares obtained in a private transaction from either the issuing corporation itself or from a person who is deemed an "affiliate" of the issuing corporation. The Rule defines an "affiliate" as a "person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with," the issuing corporation.<sup>788</sup> A corporation's officers, directors, and shareholders possessing at least ten percent of the corporation's outstanding shares are deemed to be "affiliates."<sup>789</sup> There is little SEC guidance or case law on when trusts and corporations qualify as affiliates, such as an offshore trust or shell corporation directed by a company officer, director, or major shareholder. Moreover, the SEC told the Subcommittee that if a person were to ask the SEC for advice on whether a particular entity qualified as an affiliate under Rule 144, the SEC would likely decline to respond as a matter of policy, due to the fact-specific nature of the analysis.<sup>790</sup>

Public corporations, when they issue non-registered shares, typically print a "legend" on each share certificate stating that the shares may not be resold in the marketplace until the shares are registered with the SEC or qualify for an exemption from the registration requirements.<sup>791</sup> The shareholder must get this legend removed before the issuing corporation will allow the shares to be resold. Typically, the shareholder will provide the issuing corporation with a written legal opinion explaining why the legend may be removed and, if applicable, pledging to sell the shares in compliance with Rule 144. The corporation will then inform its transfer agent that the legend can be removed. Once the share certificate is issued without the legend, the shareholder can sell the shares pursuant to Rule 144 or other ways permitted under the securities laws.

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<sup>787</sup> Rule 144 creates two sets of rules, one for corporate affiliates and the other for non-affiliates. Generally, an affiliate must hold restricted shares for one year before re-selling them. Then, the amount of restricted securities sold during a three-month period may not exceed the greater of: (i) one percent of the outstanding shares; (ii) the average weekly volume of trading on all national exchanges during the previous four weeks; or (iii) the average weekly volume of trading pursuant to a national market plan for the previous four weeks. 17 C.F.R. § 230.144(d) and (e). Non-affiliates of the issuer have a special rule which allows them to hold restricted shares for a period of two years and then to sell them without regard to any volume restrictions. 17 C.F.R. § 230.144(k). This two-year rule is not available, however, to corporate affiliates who are still subject to volume restrictions.

<sup>788</sup> 17 C.F.R. § 230.144(a)(1).

<sup>789</sup> 17 C.F.R. § 230.144(a)(1) - (2).

<sup>790</sup> SEC briefing on Rule 144 (3/2/06); see also SEC Release, 1980 SEC Lexis 443.

<sup>791</sup> SEC regulations do not require these legends, and the SEC does not enforce their use or regulate when they are removed. See, e.g., SEC Release, 1980 SEC Lexis 443, item (4). The legends instead represent "best practice" in the securities field to ensure compliance with Rule 16.

**Trading Restrictions on Corporate Insiders.** Section 16 of the Securities and Exchange Act of 1934 imposes a special set of rules on corporate insiders, meaning a publicly traded corporation’s officers, directors, and any person who is directly or indirectly the “beneficial owner” of more than 10 percent of the company’s securities.<sup>792</sup> The purpose of Section 16 is to prevent corporate insiders from using nonpublic information to profit from trading in their company’s securities.<sup>793</sup> Section 16(a) requires corporate insiders to file periodic reports disclosing their securities holdings and any trades in these securities, while Section 16(b) requires insiders to disgorge any profits resulting from “short-swing trading,” meaning trades that buy and then sell the company’s securities (or vice versa) within a six-month period.

Section 16 applies to securities which are “beneficially owned” by an insider. Section 16 uses essentially the same definition for beneficial ownership as Section 13D, covering “any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares a direct or indirect pecuniary interest in the equity securities.”<sup>794</sup> In the case of a trust, a trust beneficiary who is a corporate insider must report the trust’s trades involving the company’s securities, if the trust beneficiary shares “investment control” with the trustee over the securities.<sup>795</sup> The SEC has also held that where an issuer’s securities are held by a separate corporation acting as an investment vehicle for an issuer’s insider, the insider must report any transactions by the investment vehicle involving the issuer’s securities.<sup>796</sup>

Stock options qualify as securities covered by Rule 16.<sup>797</sup> With respect to stock options, the key event for purposes of applying the short-swing rule is when the stock options were first acquired or granted, rather than when they were exercised, since the exercise date is viewed as a mere change from indirect to direct ownership of the security.<sup>798</sup> Under a rule change in 1996,

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<sup>792</sup> Section 16 is codified at 15 U.S.C. § 78p; the implementing regulation is Rule 16, codified at 17 C.F.R. § 240.16a-1 et seq.

<sup>793</sup> Section 16(b). If an insider engages in short-swing trading, the company, or a shareholder on its behalf, can bring a lawsuit under Section 16(b) to recover the insider’s profits. The SEC, in contrast, has no power to enforce the liability imposed by Section 16(b). Once a person qualifies as an insider, the short-swing liability applies to all equity securities of the issuer traded by the insider, whether or not the security is registered. In addition, insiders are liable for their profits regardless of the insiders’ intent.

<sup>794</sup> Rule 16a-1(a)(1) and (2), 17 C.F.R. § 240.16a-1(a)(1) and (2).

<sup>795</sup> Rule 16a-8(b)(3), 17 C.F.R. § 240.16a-8(b)(3).

<sup>796</sup> Opinion of the SEC General Counsel, SEC Release No. 34-1965 (1938)(discussing Rule 144 obligations for a corporation that “merely provides a medium through which [the shareholder] invest[s], or trade[s] in securities”). See also SEC Rule 14a-8, 17 C.F.R. § 240.14a-8, which creates a safe harbor for certain corporations that hold an issuer’s shares.

<sup>797</sup> Rule 16a-1(c); 17 C.F.R. § 240.16a-1(c).

<sup>798</sup> SEC Release No. 34-23369 (1991).

transfer of a compensatory stock option from a corporation to a corporate insider does not trigger Section 16.<sup>799</sup>

To enforce Section 16, corporate insiders are required to file with the SEC certain forms reporting their ownership and trades of the company's securities. An "Initial Statement of Beneficial Ownership," Form 3, must be filed by all insiders within ten days of becoming a reporting person. Until 2002, a "Statement of Changes in Beneficial Ownership," Form 4, had to be filed within ten days after the end of each calendar month in which an ownership change took place. A 2002 change in the law shortened that period to two business days after the ownership change has taken place.<sup>800</sup> Finally, an "Annual Statement of Beneficial Ownership," Form 5, must be filed within 45 days of the end of the fiscal year to disclose any transaction not previously reported.

Filing these forms is the responsibility of each corporate insider subject to Section 16, but many publicly traded corporations provide their insiders with assistance in preparing and filing the forms.<sup>801</sup> In addition, most corporations rely on these forms when preparing their own SEC filings identifying the stock holdings of their officers, directors, and major shareholders.

**Prohibition on Insider Trading.** Finally, Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful to "use or employ in connection with the purchase or sale of any securities ... any manipulative or deceptive device." 15 U.S.C. § 78j(b). Rule 10b-5, which the SEC adopted over 50 years ago, has been interpreted to prohibit anyone with "material nonpublic information" from engaging in any purchase or sale of any security "on the basis of" that information.<sup>802</sup> Any purchase or sale of a security by a person in possession of such information is presumed to be "on the basis of" the nonpublic knowledge unless the buying or selling process was begun before the buyer or seller obtained the knowledge.<sup>803</sup> This prohibition

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<sup>799</sup> 17 C.F.R. 1.16b-3. This rule change was proposed in 1994, modified in 1995, and finalized in 1996. SEC Release No. 34-34514 (8/10/94), 59 F.R. 42449; SEC Release No. 34-36356 (10/11/95), 60 F.R. 53832; SEC Release No. 34-37260 (5/31/96), 61 F.R. 30376. Elimination of the requirement that options be non-transferable in order to be exempt from Rule 16's requirements was part of an over-all relaxation of the option rules. In announcing these changes, the SEC said its reason was that compensation transactions between the corporation and its officers and directors did not involve the kind of market risks that Section 16(b) was intended to discourage.

<sup>800</sup> See Section 403 of the Sarbanes-Oxley Act of 2002.

<sup>801</sup> See, e.g., memoranda which Michaels Stores circulated to its insiders explaining their Section 16 obligations and offering assistance with preparing and filing the forms. 10/4/96 memorandum from Michaels Stores general counsel Mark Beasley to "Executive Officers and Directors of Michaels Stores, Inc." on "Reporting Obligations and Liabilities Under Section 16" (MSNY003551-53)(including handwritten notations from Charles Wyly showing he had read the memorandum); 5/11/05 memorandum from Michaels Stores legal counsel Gabe Vazquez on "General Guidelines Regarding Transactions in Michaels Stock" (B00019921-37).

<sup>802</sup> See Rule 10b5-1(a).

<sup>803</sup> See Rule 10b5-1(b)-(c).

protects investors by preventing those in possession of inside information from using “any manipulative or deceptive device” to avoid SEC regulations.<sup>804</sup>

Each of these U.S. securities provisions is intended to promote market fairness and transparency and to prevent unfair trading by corporate insiders and affiliates. They impose complex requirements that depend on varying definitions of beneficial ownership and affiliates. Compliance depends in part on SEC regulated brokers and dealers and on securities lawyers with expertise in U.S. law. In this case history, it appears that these professionals may have helped the Wyly-related offshore entities to circumvent or defeat U.S. disclosure obligations, trading restrictions, and insider controls.

### **(ii) Disclosure of Offshore Stock Holdings**

When the Wyly-related offshore entities obtained large numbers of stock options and warrants in Sterling Software and Michaels Stores, they became major shareholders in those publicly traded corporations. At times, the offshore entities owned as much as 18 percent of Sterling Software and 23 percent of Michaels, ownership percentages well in excess of the five percent reporting threshold in U.S. securities law. On a few occasions, the trustees of the offshore trusts filed Schedule 13Ds disclosing the trusts’ stock holdings, but in most years, they did not. In addition, the evidence indicates that, beginning in 1995, the offshore entities began to deliberately structure their securities holdings in ways intended to circumvent SEC reporting obligations for large shareholders.

Other persons who were aware of the offshore stock holdings and the close relationship between the offshore entities and the Wyllys also failed to disclose. From 1992 until 2004, Sam and Charles Wyly did not include the offshore stock holdings in their Schedule 13D filings, despite their directing the offshore transactions and coordinating onshore and offshore stock transactions. In 2005, in a sudden reversal, both men filed an amended Schedule 13D disclosing the offshore holdings. In this filing, the Wyllys did not admit they had any legal obligation to disclose the offshore stock holdings, but said they were taking the action in the event that the SEC were to determine they beneficially owned the securities.<sup>805</sup> Mr. Schaufele, the broker who handled the offshore securities transactions and knew the Wyllys were exercising direction over them, apparently never advised the brokerage firms where he worked of possible 13D filing issues. Michaels, Sterling Software, and Sterling Commerce had an obligation to file accurate information with the SEC, including with respect to the stock holdings of their directors and major shareholders, but generally failed to disclose the Wyly-related offshore stock holdings. As

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<sup>804</sup> Securities Exchange Act, § 10(b).

<sup>805</sup> Another issue not addressed in the amended filing is whether the Wyllys had any obligation to disclose the offshore stock holding in their 13D filings because they were acting as a group with the offshore entities. In other words, even if the Wyllys were deemed not to beneficially own the shares belonging to the offshore entities, if the Wyllys acted in concert with the offshore entities to buy or sell Michaels securities, and the group together owned more than five percent of Michaels’ total shares, then shares owned by the offshore entities would likely have had to be reported on a 13D filing.

a result, until 2005, U.S. securities regulators and the investing public were unaware of the extent of the Wyly-related offshore stock holdings and trading activity.

**Initial Disclosure of Offshore Stock Ownership.** When the offshore entities first received securities from the Wyls, they disclosed their stock holdings in filings with the SEC. In April 1992, for example, Sam and Charles Wyly transferred nearly three million stock options and warrants to purchase Sterling Software and Michaels stock to ten offshore corporations. These corporations were wholly owned by the Bulldog and Pitkin Trusts. That same month, Lorne House, then trustee of the Bulldog and Pitkin Trusts, filed two Schedule 13Ds with the SEC. The first reported that Lorne House, as trustee of the Bulldog and Pitkin Trusts, beneficially owned stock options and warrants to buy about 1.9 million shares, or 18.1 percent, of Sterling Software.<sup>806</sup> The second reported that it beneficially owned stock options and warrants to buy 960,000 shares, or 5.8 percent, of Michaels Stores.<sup>807</sup> Both of these filings indicated that they were prepared by Michael French of the Jackson & Walker law firm which was then advising Lorne House on its SEC filing obligations.<sup>808</sup>

Two months later, Lorne House filed an amended Schedule 13D with respect to Michaels, reporting that it had sold over 300,000 of its shares and subsequently owned less than 5 percent of the total outstanding shares, which meant that it was no longer obligated to file. It did not file another Schedule 13D with respect to Michaels securities. Lorne House's Schedule 13D for Sterling Software, on the other hand, remained in place and unchanged during 1993 and 1994, continuing to reflect ownership of 18 percent of the company.

**1995 Plan to Circumvent SEC Disclosure.** In 1995, a specific plan was devised to eliminate Lorne House's SEC disclosure obligation by transferring a number of its Sterling Software shares to a new offshore trust with a different trustee. SEC Rule 13d-3 states explicitly that a beneficial owner cannot evade its 13D reporting obligation by creating or using a trust to take ownership of the relevant securities, but that appears to be exactly what happened.<sup>809</sup>

The plan was for the Bulldog Trust to transfer two of its offshore subsidiaries, East Carroll and East Baton Rouge, each of which owned a significant number of Sterling Software shares, to a newly created Isle of Man trust, called the Plaquemines Trust. The grantor of the

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<sup>806</sup> See cover letter and Schedule 13D (PSI00138513-23). This Schedule disclosed that Bulldog Trust had acquired "indirect beneficial ownership" of about 1.3 million options and warrants, and the Pitkin Trust had done the same for about 670,000 options and warrants.

<sup>807</sup> See Schedule 13D (PSI00127004-09). The Schedule disclosed that the Bulldog Trust had "acquired indirect beneficial ownership" of about 635,000 options and warrants, while the Pitkin Trust had acquired indirect beneficial ownership of 325,000 options and warrants.

<sup>808</sup> See, e.g., 4/22/92 memorandum from Jackson Walker to Lorne House (PSI-WYBR00271-72)(advising Lorne House on filing Schedule 13Ds and Form 4 under Rule 16).

<sup>809</sup> The Subcommittee asked to see any legal opinion supporting the approach used to end Lorne House's 13D filing obligation; none was produced.

new Plaquemines Trust was, in fact, the Bulldog Trust itself.<sup>810</sup> On March 6, 1995, a Lorne House employee wrote to Mr. French about the plan as follows:

“Thank you for your fax dated March 3<sup>rd</sup>. We intend to transfer East Carroll Limited and East Baton Rouge Limited from Bulldog to Plaquemines, this would mean that Plaquemines would hold 350,000 shares and Bulldog would hold 644,725 shares of Sterling Software.”<sup>811</sup>

The Lorne House managing director, Ronald Buchanan, sent Mr. French another fax the next day:

“Bulldog will settle Plaquemines, in the words which you suggested. Since the purpose of the exercise, as I understand it, is to divide the ownership of Sterling Software we need to split ownership of the underlying companies which own SS between the two trusts. That was the purpose of Barbara’s fax of yesterday.”<sup>812</sup>

These two faxes show that Mr. French, in his role as trust protector, was directly involved in the creation of the new trust, suggesting wording for the trust agreement, and obtaining information on how the shares would be split and transferred from Bulldog to Plaquemines to avoid SEC disclosure requirements. Mr. French told the Subcommittee that, although he had no specific recollection of these communications or creating the Plaquemines Trust, he would have been transmitting the decisions of Sam or Charles Wyly to the offshore trustees.<sup>813</sup>

Three days later, on March 10, 1995, Lorne House amended its Schedule 13D for Sterling Software, reporting that it had disposed of some of its shares and retained just 4.6 percent of the outstanding shares, which meant that it was no longer obligated to file. One month later, on April 5, 1995, the Bulldog Trust transferred East Carroll and East Baton Rouge to the Plaquemines Trust.<sup>814</sup> Lorne House did not file another Schedule 13D with respect to Sterling Software.

**Sterling Software Call Options.** Subsequent securities transactions were also structured to circumvent the SEC reporting requirement. Later in 1995, for example, the Wylys decided that the offshore entities should purchase call options to buy an additional 500,000 shares of

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<sup>810</sup> See 2/28/95 Plaquemines Trust Agreement (PSI00064668-99).

<sup>811</sup> 3/6/95 fax from Barbara Rhodes of Lorne House to Mr. French (PSI00120860).

<sup>812</sup> 3/7/95 fax from Mr. Buchanan of Lorne House to Mr. French (PSI00120859).

<sup>813</sup> Subcommittee interview of Mr. French (6/30/06). In his 6/30/06 interview, Mr. French told Subcommittee staff that “Shari and I didn’t make independent decisions on these trusts.”

<sup>814</sup> 4/5/95 Resolutions of the Trust Committee of Lorne House Trust Ltd. (PSI00122306-07). The timing of the transfer of the two corporations to the Plaquemines Trusts suggests that Lorne House may have announced the disposal of its Sterling Software shares before the transfer actually occurred.

Sterling Software. Mr. French told the offshore trustees that this purchase should be made by several trusts with different trustees in order to avoid triggering the five percent threshold for a 13D filing. Mr. French told the Subcommittee that the decision to buy the Sterling Software call options and to split them among different trusts to avoid SEC reporting came from the Wyls.<sup>815</sup>

To carry out this purchase, in July 1995, Mr. French sent a fax to Mr. Buchanan at Lorne House indicating that the trust protectors would be sending him a recommendation to buy the call options and cautioning that the offshore trusts should acquire them in a way that would “avoid SEC reporting”:

“Please dispose of this fax after reading, as there will be ample documentation as needed.

“It is expected that a recommendation will be made to Wychwood that the Plaquemines Trust, and another trust settled with Wychwood by Pitkin, should contact Lehman regarding acquiring call options on SSW [Sterling Software], probably for about two years at the market. ... Wychwood would ... be limited to approximately 600,000 to 700,000 calls, in order to stay under 5% of the outstanding shares and avoid SEC reporting.

“I am also sending a copy of this fax to Shaun Cairns [managing director of Wychwood], with the same request that he read it and then dispose of it. I will be back on this soon, perhaps tonight.”<sup>816</sup>

Two hours later, Mr. French sent a fax to Mr. Cairns:

“I recommend that you immediately contact Lehman Brothers (Lou Schaufele ...) regarding the acquisition of two year call options to purchase Sterling Software at the market. These would be acquired by the Plaquemines Trust and another trust .... As with my other fax, I suggest that you dispose of this one as there will be adequate subsequent documentation of any transactions.”<sup>817</sup>

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<sup>815</sup> Subcommittee interview of Mr. French (6/30/06). The effort to avoid 13D reporting may have been accelerated by a front page newspaper article in March 2005, that criticized certain Michaels and Sterling Software securities transactions that had been disclosed in 13D filings submitted by Sam Wyly and others. See “If These Stocks Soar, the Boss May Regret It,” *New York Times* (3/12/95); 3/13/95 memorandum by Craig Schiffer on “Michaels Stores/Sterling Software Transaction” (MSNY008885-87).

<sup>816</sup> 7/10/95 fax from Mr. French to Mr. Buchanan (PSI00136718).

<sup>817</sup> 7/10/95 fax from Mr. French to Mr. Cairns (PSI00136721).

Mr. French told the Subcommittee that he had asked the offshore entities to destroy the faxes, because he was worried that he was giving them more specific instructions than were proper for a trust protector.<sup>818</sup>

One month later, on August 16, 1995, Mr. Buchanan sent the following message to Mr. Cairns, Janek K. Basnet, and others about purchasing the call options and structuring the purchase in ways which would avoid triggering SEC reporting requirements. He wrote in part:

“Shari Robertson, who administers the Wyly Brothers’ affairs from Dallas, rang yesterday afternoon BST to say that Mike French – presumably on Sam’s prompting – does not wish to await John Willis’s return to set up [new] ... Trusts or ... a new credit line with which to buy options on Sterling Software. They will, instead, use the existing facilities with Lehman Brothers in Dallas and Wychwood as trustee. ... Wychwood must not be trustee of the two sets of trusts which are buying options simultaneously since the amount involved would trigger a reporting requirement.”<sup>819</sup>

Still another fax, from Ronald Buchanan to his brother A.J. Buchanan, also referenced the desire to buy the call options without triggering SEC reporting:

“Sam and Charles wish to arrange a bank borrowing to finance the purchase of a large number of call options on Sterling Software shares. I would be grateful if you could find a bank in London which would be interested. ... The pattern will be exactly the same as for the exercise which we recently completed with Lehmann [sic] Brothers in Dallas. The new purchase will be in the name of two new trusts which we are establishing and which will have separate trustees. The Wyllys, who are officers of and shareholders in SS, have been advised that, in consequence, there is no reporting requirement under SEC regulations, such as there would have been had all their potential interests been aggregated.”<sup>820</sup>

Each of these communications indicates that Sam and Charles Wyly and their representatives were directing the offshore entities to buy the call options, and that the offshore trustees were ready, willing, and did take direction from them. These communications also show that the offshore trusts were willing to and did act in concert to arrange their stock holdings to circumvent SEC disclosure requirements for large shareholders in U.S. public companies.

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<sup>818</sup> Subcommittee interview of Mr. French (6/30/06).

<sup>819</sup> 8/16/95 message, presumably a fax, from Mr. Buchanan to AJB, JKB, Shaun Cairns, RJC, FKVC, DJ, JEP, BAR (PSI00118019). The urgency described in this fax may have been related to plans to establish Sterling Commerce as a separate company by the end of the year.

<sup>820</sup> Undated fax from R. Buchanan to A.J. Buchanan (PSI00117994).

During 1995, the Bulldog, Pitkin, Bessie, Tyler, Plaquemines, and Delhi International Trusts appear to have collectively owned nearly 3 million Sterling Software securities, including the 500,000 call options.<sup>821</sup> Other than Lorne House, however, the trustees of the offshore trusts owning Sterling Software securities – IFG, Wychwood, and Janek K. Basnet – did not report the holdings in a Schedule 13D filing even though, as a group, each took direction from the Wyls and their representatives, coordinated their securities purchases, and together owned substantially more than the five percent reporting threshold.

**Continued Nondisclosure, 1996-2000.** Over the next five years, the offshore entities obtained additional stock options and shares in Michaels, Sterling Software, and Sterling Commerce, but continued their practice of not disclosing their holdings to the SEC. In early 1996, for example, Sam and Charles Wyly moved another mass of stock options offshore, including 8.6 million Michaels and Sterling Software stock options and 4.6 million Sterling Commerce stock options. The ten corporations that received these stock options were wholly owned by a variety of Wyly-related offshore trusts, including the Bulldog, Pitkin, Bessie, Tyler, Lake Providence International, LaFourche, and Red Mountain Trusts.

In March 1996, three Wyly-related offshore corporations purchased 2 million Michaels shares in private transactions intended to provide \$25 million in additional capital to the company.<sup>822</sup> These purchases were publicly disclosed at the time, and the offshore corporations described as “entities owned by independent trusts of which family members of Sam Wyly and Charles J. Wyly, Jr. are beneficiaries.”<sup>823</sup> The trusts were characterized as “independent” despite the direction being exercised by the Wyls over the trusts’ investment activities. In December 1996, two more Wyly-related offshore corporations bought another 2 million Michaels shares in private transactions that provided another \$21 million in new capital to the company. These purchases were, again, publicly disclosed at the time.<sup>824</sup>

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<sup>821</sup> See, e.g., chart entitled, “Foreign Systems Priced @ 8/31/95,” (PSI\_ED00042175)(listing Sterling securities owned by the Wyly-related offshore entities).

<sup>822</sup> On 3/29/96, Audubon Assets (then called Fugue) purchased 433,333, Locke purchased 900,000, and Quayle purchased 666,667 shares. See Michaels 1996 10-K filing, Exhibits 4.7, 4.8, 4.9, and 13.

<sup>823</sup> *Id.* at 170. Audubon Assets was owned by the Bessie Trust associated with Sam Wyly, Locke was then owned by the Plaquemines Trust associated with Sam Wyly, and Quayle was then owned by the Pitkin II Trust associated with Charles Wyly.

<sup>824</sup> On 12/23/96, for \$1 million, Devotion and Elegance purchased options from Michaels to buy two million shares. On 2/28/97, both corporations exercised their options and, for another \$20 million, actually purchased the underlying shares. See 1/2/97 Schedule 13D and 5/2/97 10-K (disclosing that, as a result of these transactions, Devotion held 1,333,333 and Elegance held 666,667 options to buy Michaels shares as a result of the two 12/23/96 option agreements, and that in October 1996, Audubon Assets (then called Fugue) transferred another 433,333 Michaels shares to Devotion “in a private sale for cash”). Devotion was owned by the LaFourche Trust associated with Sam Wyly; Elegance was owned by the Red Mountain Trust associated with Charles Wyly. Both then had Trident as their offshore trustee.

As a result of the stock option-annuity swaps and private stock sales, the Wyls have since disclosed that, by November 1996, the Wyly-related offshore entities collectively held over 3.3 million Michaels shares or about 14.2 percent of the total outstanding shares and, one month later, collectively held 5.4 million shares or nearly 23 percent.<sup>825</sup> In December 1997, according to the Wyls' amended 13D filing, the offshore entities collectively held over 3.5 million shares or 12 percent. But those totals were not disclosed to the investing public at the time. Instead, in January 1997, only one trustee, Trident, filed a Schedule 13D, reporting 2.4 million Michaels options and warrants or 9.5 percent of the total shares.<sup>826</sup> At the end of 1997, Trident filed an amended Schedule 13D reporting only 1.3 million shares and options, or 4.6 percent of the total, which meant that it was no longer obligated to file. No other Wyly-related offshore entity filed a Schedule 13D related to Michaels during 1996 or any subsequent year, until the Wyls' amended filing in 2005. During this nine-year period, the stock holdings of these major shareholders of this publicly traded company remained hidden from the investing public.

The same was true for Sterling Software and Sterling Commerce. From 1996 until the companies were sold in 2000, none of the Wyly-related offshore entities filed a Schedule 13D disclosing their stock holdings, even though from the 1995 call options, 1996 stock option-annuity swaps, and other securities transactions, they collectively owned millions of shares of both companies.<sup>827</sup> Again, the stock holdings of these major shareholders remained hidden from the investing public.<sup>828</sup>

**Failure to Disclose.** From 1992 until 2005, neither Sam nor Charles Wyly included in their Michaels, Sterling Software, or Sterling Commerce 13D filings any of the securities held by the Wyly-related offshore entities, even though the Wyls and their representatives were directing the investment of those securities.

In April 2005, in a dramatic turnaround, the Wyls filed an amended Schedule 13D for Michaels disclosing the offshore holdings, not only for 2005, but since 1992, in the event that Sam or Charles Wyly were "deemed to beneficially own" the shares held by the offshore

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<sup>825</sup> See 4/7/05 Schedule 13D filed by the Wyls with respect to Michaels Stores.

<sup>826</sup> See 1/2/97 Schedule 13D filed by Trident with respect to Michaels Stores.

<sup>827</sup> See, e.g., chart entitled, "Foreign Systems Priced @ 8/31/95," (PSI\_ED00042175)(showing Wyly-related offshore entities then collectively owned nearly 3 million Sterling Software shares); chart entitled, "Foreign Systems Priced @ 10/31/99" (PSI00109904,12)(showing Wyly-related offshore entities then collectively owned about 2.7 million Sterling Software shares and options and 4.3 million Sterling Commerce options).

<sup>828</sup> In addition, none of the offshore entities filed a Schedule 13D with respect to Scottish Annuity & Life Holdings Inc. after it went public, even though at least one document suggests that the offshore entities collectively owned more than five percent of its outstanding shares. See undated chart, likely after the year 2000, entitled "Offshore Stock Analysis" (PSI00071735)(showing Bulldog, Bessie, and Tyler Trusts then collectively owned about 1 million shares and 1.6 million warrants, or more than 16 percent of the company's outstanding securities).

entities.<sup>829</sup> The 2005 filing disclosed, for example, that had the offshore securities been included in the Schedules that the Wylys originally filed for Michaels Stores in 1992, the Wyly Group would have reported beneficial ownership of an additional 960,000 shares in April and an additional 190,000 shares in September.<sup>830</sup> The amended filing disclosed that, as of the end of 1996, the shares held by the offshore entities had grown to 5.4 million shares or nearly 23 percent of the company. After that, the offshore entities began selling their Michaels stock. In 2005, the amended filing shows that, without including the offshore securities, the Wyly Group collectively owned about 6 million shares or 4.3 percent of Michaels, an amount which is below the reporting threshold. With the offshore securities, the amended filing states that the Wyly Group collectively owned about 10.8 million shares or 7.9 percent, an amount requiring disclosure.<sup>831</sup>

The Subcommittee was told that the Wylys filed the amended Schedule 13D, because they had received new legal advice on their filing obligations. The Subcommittee was told that prior legal counsel had advised the Wylys that they did not have to include the offshore securities in their 13D filings, but, in 2005, new counsel advised the opposite. The Subcommittee was told that the Wylys' counsel was still reviewing whether the law would deem them to be beneficial owners of the securities held by the offshore entities, which is why their 13D filings continue to express uncertainty on the issue.<sup>832</sup> Apparently counsel is also uncertain as to whether the Wylys had an obligation to include the offshore holdings in a group filing. The Subcommittee was told that the Wylys are awaiting an SEC determination on these matters.

The Wylys have not taken similar action to amend past 13D filings with respect to Sterling Software or Sterling Commerce, now owned by CA and SBC, respectively. The SEC has advised the Subcommittee that, as a general rule, while an amended 13D filing does not cure a prior failure to disclose, such amended filings represent the best way to handle past non-disclosures and should be filed.

To execute their securities transactions, the Wyly-related offshore entities used the services of their broker, Mr. Schaufele, and his employers, CSFB, Lehman Brothers, and Bank of America. Mr. Schaufele knew that the Wylys were directing the offshore securities transactions, and that the Wylys and offshore entities were coordinating their stock buys and

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<sup>829</sup> See 4/7/05 Schedule 13D filed by Sam and Charles Wyly with respect to Michaels.

<sup>830</sup> See *id.*, referring to Wyly Schedule 13Ds originally filed on 4/23/92 and 10/6/92. The term "Wyly Group" refers to Sam and Charles Wyly and Maverick Entrepreneurs Fund Ltd., whose combined holdings are reported in the 13D filings.

<sup>831</sup> See 4/7/05 Schedule 13D.

<sup>832</sup> See 10/17/05 and 1/17/06 Schedules 13D for Michaels Stores. A related question is whether, under Schedule 13D rules for groups acting in concert, Sam and Charles Wyly should have filed as a group with the offshore entities, whether or not they beneficially owned the offshore securities. See, e.g., documents indicating that the offshore entities were coordinating their securities transactions with those of the Wylys, above.

other securities transactions, but he apparently never advised his employers of this fact or raised any SEC compliance issue with them.<sup>833</sup>

The three corporations whose securities were the subject of most of the trades, Michaels, Sterling Software, and Sterling Commerce, had an obligation to file accurate information with the SEC, including with respect to the stock holdings of their directors and major shareholders. All three companies were aware of the close relationship between the Wylys and the offshore entities, and all three knew of the massive transfers of stock options offshore. Yet, except on rare occasion, these three corporations did not include the offshore stock holdings in their SEC filings, either as separate items or in consolidation with the Wyly holdings. As a result, each failed to inform the investing public that the company's directors and major shareholders had transferred a substantial portion of their stock holdings to offshore entities that were continuing to trade in those securities.

### **(iii) Restrictions on Private Stock Sales**

A second securities issue raised in this case history involves non-registered securities that were transferred to the offshore entities in private transactions and then sold by them into the public stock markets, apparently at times without complying with the trading restrictions established to protect the investing public. The key issue is whether the offshore corporations should have been treated as "affiliates" of the publicly traded corporations whose securities they obtained from the Wyly stock options and warrants. If so, their shares should have been sold subject to the timing and volume restrictions established under Rule 144 for corporate affiliates. For many years, the offshore corporations were not treated as affiliates by financial institutions such as Lehman Brothers. In 2001, Lehman lawyers tentatively concluded that one of the offshore entities should be treated as an affiliate subject to the trading restrictions. Mr. Schaufele subsequently left the firm, took a position with Bank of America, taking the offshore corporation accounts with him, and continued to treat the offshore entities as nonaffiliates.

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<sup>833</sup> In contrast, when the clearing broker for Bank of America reviewed the securities transactions being conducted by the offshore entities, he wrote the following:

"If all of the accounts were funded by the same 'grantor', then they are all related in that aspect. ... Who are the beneficial owners of all the grantor trusts? ... My concern is that I do not believe that this company is reporting the ownership of the shares adequately. The fact that they are all being treated as separate companies does not impact the matter because they clearly have a link due to the original deposit. In addition, some of the accounts also maintain a control relationship even as independent accounts. Therefore, an account like ... [Quayle Ltd.] which made a sale of 100,000 shares of Michael's on 09/02/03 should have filed a form 144 with the SEC because of their control relationship before the sale. Do we have a copy of that form on file? This is an important issue that I do not believe can be explained in a paragraph and without documentation. I know that this issue will take a lot of time to resolve, but I do not believe that we understand their business, and I want to make sure they are in compliance with SEC regulations."

**The Affiliate Issue.** Under Rule 144, when Sam and Charles Wyly transferred Sterling Software and Michaels stock options to the offshore entities, both men qualified as “affiliates” of those companies due to their status as directors and large shareholders. Shares sold by an affiliate in a private transaction become “restricted shares” that cannot be freely resold on a U.S. stock exchange unless they are registered with the SEC or meet the requirements for a registration exemption. Restricted shares can be resold to the public under Rule 144, but only if the shareholder complies with certain timing and volume restrictions. Another key factor is whether the person obtaining the shares also qualifies as an affiliate of the issuing corporation, and is therefore subject to the same trading restrictions.

Here, the Wyly-related offshore entities took the position that they were not corporate affiliates for purposes of Rule 144.<sup>834</sup> Documents show that Mr. Schaufele steadfastly maintained that position within the securities firms that employed him. For example, in 1999, when Lehman Brothers was conducting securities transactions involving Sterling Software shares held by three offshore corporations, in response to a question by a colleague, Mr. Schaufele wrote: “for the 100th time the client never was an affiliate nor had to file when sold, stock is clean.”<sup>835</sup>

By taking this position, the offshore entities not only avoided having to comply with Rule 144’s timing and volume restrictions, but also claimed that their shares did not have to be aggregated with those of Sam or Charles Wyly who, as company directors, were already subject to the trading restrictions.<sup>836</sup> They were also able to pledge the shares as collateral in certain securities transactions that permitted only unrestricted shares. In addition, in some instances, the offshore entities asserted that they had met the two-year holding period specified in Rule 144(k), which is available only to nonaffiliates, and so were free to sell specified shares without the trading restrictions put in place to protect the investing public.<sup>837</sup>

Rule 144 defines an “affiliate” as a “person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with,” the issuing

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<sup>834</sup> The offshore service providers serving as trustees of the Wyly-related offshore trusts and as directors and officers of the offshore corporations refused to provide interviews to the Subcommittee, so this analysis is based solely on a review of the documents obtained by the Subcommittee related to these matters.

<sup>835</sup> 1/26/99 email from Mr. Schaufele to a Lehman colleague, Michael C. Cohen, regarding Sterling shares held by Sarnia, Greenbriar, and Quayle (CC041983).

<sup>836</sup> See, e.g., 4/27/92 fax from Ms. Robertson to Russell Collister of Lorne House, with copy to Mr. French (PSI00126713), discussed below. See also Rule 144(e)(3)(iv) and (vi); 17 C.F.R. § 240.144e-3.

<sup>837</sup> See, e.g., 6/30/00 letter from Lehman Brothers to Michaels Stores with attachment (MSNY025479-80)(stating Devotion could sell 750,000 restricted Michaels shares because they had “been beneficially owned ... for a period of at least two years”); similar letters dated 6/30/00 (MSNY025474-76)(involving 466,667 Michaels shares owned by Elegance), and 7/20/00 (MSNY006415-16)(involving 150,000 Michaels shares owned by East Baton Rouge).

corporation.<sup>838</sup> The key regulation defines “control” as “possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person whether through the ownership of voting securities, by contract, or otherwise.”<sup>839</sup> The broader question raised by the Wyly-related offshore entities is when an offshore trust or shell corporation under the direction of a company officer, director, or major shareholder also qualifies as an affiliate.

**Affiliate Issue First Arose in 1992.** In this case history, the affiliate issue arose as early as April 1992, when a Lorne House employee apparently asked whether the Sterling Software and Michaels shares held by the offshore entities were subject to Rule 144 trading restrictions. Ms. Robertson, then head of the Wyly family office and a trust protector, responded as follows:

“I had a short discussion with Ronnie [Buchanan] yesterday regarding your transmittal of April 24. I wanted to make sure you were clear on the reporting/volume selling requirements of these securities. The securities owned by Little Woody Limited (166,500 options), Roaring Fork Limited (166,500 options) and East Carroll Limited (667,000 options) will be registered securities of Sterling Software when exercised. Michael French’s firm [Jackson & Walker] can provide Lorne House and the banks with which you are having discussions, a legal opinion stating that these securities are not subject to any Securities and Exchange Commission Form 144 volume Rules and that the Securities in no way need to be aggregated with the Settlers of the Trusts – Charles and Sam Wyly.... “I gather the banks are showing concern that the eventual beneficiaries - the children of Charles Wyly and Sam Wyly are shareholders .... Again, these shares would not be aggregated for volume rule selling purposes with the other shares owned by the children. The only requirement for reporting to the [SEC] is to file Form 13D which just states that Lorne House beneficially controls or votes more than 5% of the outstanding stock of Sterling software.”<sup>840</sup>

The Subcommittee requested a copy of any Jackson & Walker opinion provided to Lorne House, as referenced in this communication, but it was not produced. Mr. French told the Subcommittee that Jackson & Walker did not issue such an opinion.<sup>841</sup> The Subcommittee did obtain copies of other Jackson & Walker letters opining that the restrictive legends on shares obtained by the offshore trusts could be removed. These letters either cited the two-year holding period that is available only to nonaffiliates, or presented the conclusion that the legends could

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<sup>838</sup> 17 C.F.R. § 230.144(a)(1).

<sup>839</sup> 17 C.F.R. § 230.405. See also SEC v. Kern, 425 F.3d 143 (2<sup>nd</sup> Cir. 2005)(finding that individuals controlled several corporations even though they did not own the corporate shares).

<sup>840</sup> 4/27/92 fax from Ms. Robertson to Mr. Collister of Lorne House, with copy to Mr. French (PSI00126713).

<sup>841</sup> Subcommittee interview of Mr. French (6/30/06).

be removed without providing a supporting explanation.<sup>842</sup> Legends were, in fact, routinely removed from the share certificates presented by the offshore entities.

During the thirteen year period examined in this Report, the Wyly-related offshore entities sold hundreds of thousands of Michaels and Sterling Software shares without following the trading restrictions established to protect the investing public from shares acquired in private transactions. CSFB, Lehman Brothers, and Bank of America also engaged in many securities transactions with the offshore entities, including margin loans, stock collars, call options, and equity swaps, and, with the exception explained below, treated the offshore entities as if they were nonaffiliates. If they had been treated as affiliates, with shares subject to trading restrictions, their shares may not have qualified as acceptable collateral for some of the loans and other securities transactions that, in fact, took place.

**Affiliate Status Questioned.** In 2001, Lehman Brothers legal counsel began to question the affiliate status of one of the Wyly-related offshore entities. In September 2001, after Sam Wyly had expressed interest in selling a significant number of Michaels shares held domestically, Mr. Schaufele recommended that, instead of selling them, Mr. Wyly consider entering into a derivative securities transaction, such as a collar or prepaid forward sale, in which he could retain ownership of the shares while obtaining a cash payment representing some of their value.<sup>843</sup> Mr. Schaufele presented several alternatives, some of which called for the participation of one of the offshore entities, Devotion, which could buy the shares from a Wyly domestic entity or buy equivalent shares on the open market.<sup>844</sup> Several internal emails, in which Mr. Schaufele discussed the possible transaction with his colleagues, contrasted the domestic entity's affiliate status with Devotion's nonaffiliate status and possible impacts on the Wylys' SEC reporting obligations and insider obligations. For example, Mr. Schaufele wrote:

"I spoke with the family last night, they do understand that we will be collaring 20% more stock than Devotion would be purchasing. ... If Sam sells into the open market he must comply with rules of an Insider on selling versus he can cross it to Devotion. It means not as liquid and perhaps multiple filing. I also understand more why Sam won't do the forward, when we did the original collar on MIKE there was a lot of negative press (front page NY times). what would be the best is if we could effect our hedge into the open market then cross stock to

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<sup>842</sup> See, e.g., Jackson & Walker letters to the Harris Trust Company of New York on 6/24/97 regarding 245,454 Michaels shares sold by Locke (MSNY025121-22), on 7/11/97 regarding 300,000 Michaels shares sold by Quayle (MSNY008917-18), on 10/27/97 regarding 166,667 Michaels shares sold by Elegance and Devotion (MSNY025087-88), (all of which opine that the legend may be removed from the relevant share certificates, but without providing a specific explanation); letters citing two-year holding period in footnote 322, above.

<sup>843</sup> See, e.g., 9/24/01 email from Ms. Hennington to Mr. Schaufele (CC031044); 9/28/01 email from Mr. Schaufele to Sam and Evan Wyly (CC012973)(discussing possible derivatives securities transaction).

<sup>844</sup> See October emails between Mr. Schaufele and Sam Wyly, Ms. Hennington, and others about the proposed transaction. (CC027640-45).

Devotion as we get stock off on the US side or elsewhere (meaning if it could happen in London that is ok).”<sup>845</sup>

On October 4, 2001, Mr. Schaufele suggested that Devotion enter into a three-year prepaid forward contract with Lehman Brothers to sell the Michaels shares, a type of transaction which the offshore entities had not previously done. As part of Lehman’s internal review process, the transaction was presented to Lehman’s in-house lawyers to get legal clearance for Devotion to participate. In response, the legal department expressed the view that Devotion may qualify as a Michaels “affiliate” due to Devotion’s ties to Sam Wyly. The lawyers warned that if Devotion were an affiliate, its restricted shares would not qualify as acceptable collateral for the proposed transaction.

Mr. Schaufele immediately objected to this “legal intervention,” described prior occasions on which Lehman Brothers had entered into transactions with the offshore entities without raising the affiliate issue, and urged his superiors to approve going forward with the proposed transaction. In one October 2001 email, he wrote: “I think we are being a little to[o] zealous here. [T]he only reason this happened is us explaining to them the transaction. [W]e are over lawyering this.”<sup>846</sup> In another email, he wrote:

“It was on the Sterling Software collar and options that we did derivative trades with the offshore entities (of which Devotion was one). Sam Wyly was a director of Sterling Software, just like he is in Michaels Stores. We have also done numerous trades both buys and sales of these stocks in these entities without this legal intervention. In 1996 we sold over 666,000 shares of SSW and in 1997 we sold over 400,000 shares of Michaels Stores. I do not understand why we cannot proceed given that we have talked with the Michaels Stores outside company counsel and that they do not consider Devotion Ltd. an affiliate. Here we want to purchase stock and enter into a forward sale, I am assuming this is a very profitable trade for the firm and really wonder what is going on here.”<sup>847</sup>

On the same day, one of his colleagues sent an email to other Lehman personnel summarizing the issues as follows:

“Below are the facts to date on the devotion trade.

“Devotion Ltd. wants to enter into a three year Pre-Paid Forward on Michaels Stores. Devotion is an Isle of Man corp. that is owned by a trust whose beneficiary’s are either children or grandchildren of Sam Wyly. The trust is run by independent trustees. Lehman has done multiple trades ... over the years with

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<sup>845</sup> 10/4/01 email from Mr. Schaufele to a Lehman colleague, Michael C. Cohen (CC027645).

<sup>846</sup> 10/4/01 email from Mr. Schaufele to Michael C. Cohen (CC027649).

<sup>847</sup> 10/5/01 email from Mr. Schaufele to Michael C. Cohen with a copy to John Wichham (CC027651).

various similar entities set up by the Wyly's, (ie...Sarnia, Greenbriar, Quayle, Roaring Fork, Moberly and Devotion).

“As with all trades we do where we are borrowing the client's shares and desire to have a physical settlement option, we need to be satisfied that the client is not an affiliate of the issuer. The client is willing to represent to us that it is not an affiliate and Michaels Stores counsel, Bob [Estep] of Jones Day, has spoken to Gordon on the issue. Bob told Gordon that Devotion is not considered an affiliate by Michaels Stores. However, he also indicated that he did not necessarily agree with that determination. Gordon rightly requested more comfort on the issue. It was hoped comfort would come in the form of an opinion.

“This afternoon we spoke with ... Bob [Estep] and a colleague who has a securities background, John McCaferty, and Rodney Owen who is counsel for Devotion. They all reiterated that the client was not an affiliate of MIKE. [Redaction] Since none of these attorney's have been asked to ever investigate those details, they could not render the opinion we have asked for. ... I do not believe we will get an opinion.”<sup>848</sup>

This email shows that the Jones Day and Meadows Owens law firms, as well as Michaels Stores legal counsel, were willing to tell Lehman Brothers orally, but not in writing, that Devotion was not an affiliate of Michaels Stores. It also indicates that Bob Estep of Jones Day expressed some disagreement with that determination, as did Lehman's lawyers.

The next day, Mr. Schaufele sent an email to several colleagues alerting them to the issue:

“I just wanted to give you a heads up on a situation: We have an offshore entity Devotion Ltd. (They are [an] offshore corporation that is owned by a trust whose beneficiaries are some members of the Wyly family) who wants to do a forward sale on 600k of Michaels Stores. Sam Wyly is a director/insider at Michaels Stores. Lehman's counsel is of the opinion that Devotion is therefore an affiliate. Now we have had a conference call with Gordon Kiesling (LB), Russ Hackmann (LB), Michael Cohen (LB), John McCaferty (Michaels Stores outside counsel), Bob [Estep] (Michaels Stores outside counsel), Rodney Owens (tax counsel for Devotion and the Wyly's) and myself. Basically (this is my read on the situation) the company counsel and Devotion Ltd. counsel said that they are not an affiliate but that getting an opinion would probably be time consuming and expensive. As a little history, we have done derivative trades for this entity and other offshore entities in the past in companies that the Wyly's control. ... I don't want to jeopardize the firm but I do believe that we are getting a little 'over lawyered' and

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<sup>848</sup> 10/5/01 email from Michael C. Cohen to David Gittings and others within Lehman Brothers (CC037563)(emphasis and redaction in original as produced to the Subcommittee).

in not doing this trade I believe would cause some serious problems in Lehman's relationship. I can tell you that in my dealings with these entities for the past 5+ years you do not talk offshore business with the family and all dealings/orders come via phone and fax from the offshore directors and to me everything appears in order."<sup>849</sup>

Although Mr. Schaufele indicated in this email that he did "not talk offshore business" with the Wyly family, this statement is contradicted by many other documents including an email from the previous day in which Mr. Schaufele wrote to a different Lehman colleague: "I spoke with the family last night, they do understand that we will be collaring 20% more stock than Devotion would be purchasing. I talked thru the risk of not doing this simultaneously."<sup>850</sup>

A few days later, the Wyly family office informed Lehman Brothers that Sam Wyly had decided against going forward with the Devotion transaction.<sup>851</sup> Two weeks after that, a senior Lehman official urged the firm to reconsider and resolve the affiliate issue in favor of the Wyls:

"I need to get the details on the atty's opinion as it relates to the offshore entity being an affiliate. It seems like we have done trades in the past without issues. The Wyly groups internal counsel does not consider them an affiliate. This relationship has been exclusive to Lehman in the past. Mr. Wyly is not going to bitch and moan, if we make it to[o] difficult to do business here, without emotion he will take his business across the street. We do not want that!! Lou said it felt like we got over Lawyered on the last enquiry. ... I would like to be proactive and get the issue put to bed so Lou could go back to them next week and tell them that the affiliate issue will no longer be a problem. Getting that done may require us to get Ed or Charlie involved to make a business decision. This is very important to me and to the team, we may have to jerk some chains but we need to get this resolved."<sup>852</sup>

Mr. Schaufele subsequently left the firm and moved to Bank of America, taking the offshore accounts with him. He had begun employment negotiations in the fall of 2001, and told

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<sup>849</sup> 10/5/01 email from Mr. Schaufele to Edward Feigeles, Kurt Haney, and Michele Crittenden (CC018669).

<sup>850</sup> 10/4/01 email from Mr. Schaufele to his colleague Michael C. Cohen (CC031033).

<sup>851</sup> See 10/9/01 email from Ms. Hennington to Mr. Schaufele (CC027680)("Sam has decided to not go forward with the forward sale or the call spread. He said he was sorry for wasting everyone's time ...."). This email shows that it was Mr. Wyly rather than Devotion's officers or directors who made the decision not to enter into the prepaid forward transaction.

<sup>852</sup> 10/26/01 email from Kurt Haney to Michael C. Cohen and others (CC027681).

Bank of America in September that he was willing to make the move.<sup>853</sup> In fact, in early October, while Lehman resistance to the Devotion trade due to affiliate concerns was firming up, Mr. Schaufele suggested that Bank of America price the same transaction:

“[I] may have a trade for you guys. [A] forward sale in MIKE. For kicks you might just price 3yr fwd with 40% upside. [Y]ou can use my stock for borrow, clean and non affiliate. This is for an offshore corporation (Isle of Man). The OC is owned by a trust whom the beneficiaries are Wyly family children/grandchildren. MIKE’s counsel has said that they do not consider it an affiliate, they are not listed in the proxy but our legal eagles want something more which is ridiculous. I still may get it to happen but . . .”<sup>854</sup>

The Private Client Services division of Banc of America Securities (BAS) extended a formal job offer to Mr. Schaufele on January 16, 2002.<sup>855</sup> He accepted and began working to persuade the Wyls to have the offshore accounts follow him to the new firm. Shortly before starting his new job, Mr. Schaufele sent the following email to Sam and Charles Wyly:

“I would like to thank you for your support. ... In coming to a new organization we do not have the history that we had at Lehman (which is a good thing). Each entity is going to be a totally separate entity without any linkage. While we were at Lehman it evolved to the point that Lehman viewed some of the accounts (off and on) as linked. They went as far as getting the counsel for Michaels on the phone to see if they viewed the offshore accounts as affiliates. Even though the counsel did not view the offshore as affiliates, Lehman chose to treat them as affiliates. Should the offshore accounts come here they would come as independent new entities, which I would work to maintain. Again I just wanted to let you know that I am very aware of the situation and will work accordingly. Again thanks for your confidence.”<sup>856</sup>

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<sup>853</sup> See 9/9/01 email from Mr. Schaufele to Jeff Spears at Bank of America (BA054831-32)(discussing plans to move to the new job).

<sup>854</sup> 10/7/01 email from Mr. Schaufele to Mr. Spears at Bank of America (BA057340).

<sup>855</sup> 1/16/02 letter from Banc of America Securities to Mr. Schaufele (BA055294-97)(extending formal job offer). The Private Client Services division handled securities accounts for wealthy individuals.

<sup>856</sup> 2/14/02 email from Mr. Schaufele to Ms. Boucher forwarding his email to Sam and Charles Wyly (BA056311). See also email from Ms. Hennington to Ms. Boucher and Ms. Robertson (PSI\_ED00009278-79).

Mr. Schaufele's employment with BAS officially began on February 19, 2002.<sup>857</sup> By then, the Wyls had consented to the Wyly-related offshore entities moving with him.<sup>858</sup> Later in 2002, Mr. Schaufele arranged for Devotion to enter into a prepaid forward contract, which Banc of America Securities called a Specialized Term Appreciation Retention Sale (STARS), involving 800,000 Michaels shares. Mr. Schaufele assured his new colleagues that Devotion was not a Michaels affiliate and had no restrictions on its stock.<sup>859</sup>

**Analysis.** Section 5 and Rule 144 are intended to prevent issuing corporations and their affiliates from circumventing U.S. securities laws by transferring company shares through nonpublic transactions and then allowing those securities to be immediately resold in public markets. In this case history, Sam and Charles Wyly were affiliates of three publicly traded corporations. While affiliates, they provided millions of stock options and warrants to offshore entities whose investments they directed, using private transactions not open to the investing public. These private transactions included the stock option-annuity swaps, private sales of stock options, and private placements. The facts suggest that this is a situation where Section 5 and Rule 144's trading restrictions ought to limit the ability of the offshore entities to re-sell their privately acquired shares. Instead, the offshore entities were able to exercise their stock options, immediately sell many of the resulting shares on the open market, and use other shares as collateral for profitable securities transactions, all the while claiming they were not corporate affiliates subject to trading restrictions.

The offshore entities succeeded in selling their privately acquired shares in the public markets in part because of the assistance they received from their broker and the public corporations who issued the shares. Mr. Schaufele knew that the Wyls and their representatives were directing the securities trades by the offshore entities. He nevertheless insisted that the offshore entities be treated as independent actors and nonaffiliates free of any trading restrictions.

Michaels, Sterling Software, and Sterling Commerce also treated the offshore corporations as nonaffiliates, even though they knew the offshore corporations were associated with the Wyls. None of the companies ever conducted a factual inquiry into the evidence suggesting the offshore corporations were under the direction of the Wyls. Michael's outside legal counsel, Jones Day, also failed to conduct a factual inquiry, yet told Lehman that it had concluded Devotion was not an affiliate. The Jones Day lawyer closest to the Wyly-related

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<sup>857</sup> 2/19/02 email from BAS to Virgil Harris and Mr. Schaufele (BA056293).

<sup>858</sup> 2/19/02 email from Ms. Boucher to Ms. Robertson (PSI\_ED00009279)("Lou's move to B of A was final last week. Sam & Charles have consented to moving all their stuff with him. ... Lou is planning on travelling to IOM.").

<sup>859</sup> See, e.g., 10/7/01 email from Mr. Schaufele to Jeff Spears at BAS (BA057340)(characterizing Devotion's Michaels shares as "clean and non affiliate" and stating that, "MIKE's counsel has said that they do not consider it an affiliate, they are not listed in the proxy but [Lehman's] legal eagles want something more which is ridiculous.").

offshore entities “indicated that he did not necessarily agree with that determination,” but he, too, failed to press the issue. Meadows Owens, a law firm that at various times represented both the Wyllys and the offshore entities, also asserted that the offshore entities were not affiliates. None of the lawyers offering this legal conclusion, however, was willing to place this opinion in writing. At one point, Mr. Schaufele explained the lawyers’ reluctance to provide a written opinion by saying the necessary fact investigation would be too “time consuming and expensive.” After years of treating Devotion as a non-affiliate, Lehman tentatively concluded that Devotion was an affiliate subject to SEC trading restrictions.

By treating the Wyly-related offshore entities as nonaffiliates, the lawyers and public corporations involved in this matter appear to have facilitated the circumvention of U.S. trading restrictions on affiliates and prohibitions on the re-sale of privately acquired shares in the public markets.

#### **(iv) Restrictions on Insider Trading**

A final set of securities issues raised by the Wyly-related offshore entities has to do with what is commonly called insider trading. Under U.S. securities law, Section 16 of the Exchange Act imposes special disclosure obligations and short-swing profit limits on corporate insiders who trade in their companies’ stock. Section 10(b) of the Exchange Act, together with Rule 10b-5, prohibit anyone with “material nonpublic information” from engaging in the purchase or sale of any security “on the basis of” that information. Both provisions are intended to prevent persons with inside information from taking unfair advantage of the investing public.

Over the thirteen years examined in this Report, the Wyly-related offshore entities engaged in numerous stock trades involving Michaels, Sterling Software, and Sterling Commerce shares, companies where the Wyllys were directors and major shareholders. Some of these trades appear to have included buys and sells within a six-month period. Others appear to have taken place during periods in which Michaels, Sterling Software, or Sterling Commerce were anticipating engaging in transactions that could affect their stock prices. These trades were conducted by offshore entities whose activities were not reported to the SEC – unlike trades conducted by the Wyllys personally that would have been reported – and so information about these trades was not available at the time to U.S. securities regulators or the investing public.

In April 2005, when Sam and Charles Wyly filed their amended Schedule 13D disclosing the Michaels securities held by the offshore entities, they made “a proposal to settle any issue of potential Section 16 liability” from trades in Michaels stock by the offshore entities that took place within a six-month period.<sup>860</sup> On March 15, 2006, Michaels established a special committee of its Board of Directors “to investigate and make decisions on behalf of Michaels with respect to any potential Section 16 liability issue” in connection with trades by the offshore

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<sup>860</sup> 1/17/06 Michaels 10-K filing with the SEC at 23-24; see also 3/29/06 10-K filing at 23.

entities.<sup>861</sup> A draft agreement between the Wyls and Michaels proposed that the Wyls disgorge any short-swing profits that might have arisen from these trades.<sup>862</sup> The Michaels special committee is currently in negotiations with the Wyls to determine the scope of their potential Section 16 liability and reach agreement on the amount of short-swing profits to be disgorged, which the Subcommittee was told could involve millions of dollars.<sup>863</sup> The Subcommittee has been told that no parallel negotiations are underway with CA or SBC regarding possible short-swing trades of Sterling Software, Sterling Commerce, or CA shares by the offshore entities.<sup>864</sup>

Similar concerns apply to securities trades during periods when the Wyls may have had material nonpublic information about the corporations whose shares were being traded by the offshore entities. Sterling Commerce, for example, was first incorporated in December 1995, as a subsidiary of Sterling Software, and made its initial public offering of stock in March 1996. In July 1995, five months before Sterling Commerce was incorporated, Sam and Charles Wyly directed the offshore entities to purchase call options to buy 500,000 Sterling Software shares.<sup>865</sup> Sterling Software was to become the majority shareholder of Sterling Commerce. The call options were purchased by two of the offshore corporations, Devotion and Elegance, in 1995, for about \$5 million. After they purchased the call options, Sterling Software's stock price increased. When they sold the Sterling Software call options in October 1996, a little over a year later, the two offshore corporation apparently made a profit of at least \$2 million.<sup>866</sup> Mr. French told the Subcommittee that when he "recommended" that the offshore trusts buy the call options, he had not known about the plans for Sterling Commerce to be incorporated and go public; he indicated that he did not know whether Sam and Charles Wyly had this information when they directed the purchase of the call options in July.<sup>867</sup>

A second example involves the six months prior to the sale of Sterling Software and Sterling Commerce in March 2000. Sam and Charles Wyly apparently knew in July 1999 that

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<sup>861</sup> *Id.* at 24.

<sup>862</sup> See, e.g., 4/5/05 draft "Settlement Agreement" (MSNY-9000714-17).

<sup>863</sup> Information provided by the Michaels special committee (7/10/06).

<sup>864</sup> Information provided by CA (7/09/06) and SBC (7/13/06).

<sup>865</sup> See discussion of "Sterling Software Call Options" in this section, above.

<sup>866</sup> See, e.g., the following documents showing the purchase of the call options for about \$5 million (CC039125, 39; CC038274-76, 394, 396-404, 440, 643, 722-26, 765) and their sale for about \$7.4 million (CC038283, 427, 433, 443-44).

<sup>867</sup> Subcommittee interview of Mr. French (6/30/06). The Wyls declined the Subcommittee request for an interview, asserting their Fifth and Fourth Amendment rights.

both companies were to be sold.<sup>868</sup> On September 30, 1999, Sam and Charles Wyly transferred about 3.3 million Sterling Software and Commerce stock options to four Wyly-related offshore corporations, East Carroll, Elegance, Greenbriar, and Quayle, in exchange for about \$27.2 million in cash. About a week later, on October 8, 1999, three offshore corporations, Greenbriar, Quayle, and Sarnia Investments, entered into a swap transaction with Lehman Brothers, pursuant to which Lehman began buying Sterling Software shares on the open market to hedge the swap.<sup>869</sup> Five days later, Lehman had purchased over 550,000 Sterling Software shares at a total cost of about \$20 per share or \$11.4 million. On a Lehman document reporting the stock buys, a handwritten note from Evan Wyly to his father Sam Wyly states: "Looks like they're doing a great job buying a big % of the volume without moving the price."<sup>870</sup> Additional securities transactions involving the offshore corporations and Sterling Software securities followed.<sup>871</sup>

The 1995 and 1999 securities transactions raise a number of issues. It appears that, during both periods, the Wyllys may have been in possession of material nonpublic information. During both periods, the offshore entities engaged in securities transactions that would turn a profit if the Sterling Software stock price increased. During both periods, it appears that the existence of these offshore entities, their status as major shareholders of Sterling Software and Sterling Commerce, their close association with the Wyllys, and the timing, nature, and extent of their securities transactions were not reported to U.S. securities regulators or the investing public. If the same trades had been conducted by the Wyllys themselves, the trades would have been reported to the SEC and available to the investing public.

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<sup>868</sup> See discussion of these sales, above, including deposition testimony by Sam Wyly indicating that the decision to sell the two companies was made in July.

<sup>869</sup> See draft term sheets for equity swaps, including 10/8/99 "Equity Swap (LONG)" involving Sterling Software stock and Greenbriar (CC022040-41); 10/8/99 "Equity Swap (LONG)" involving Sterling Software stock and Sarnia Investments (CC017344-45); 10/8/99 "Equity Swap (LONG)" involving Sterling Software stock and Quayle (CC029349-50). These swaps had identical terms and were apparently carried out in tandem by Lehman personnel. See also 10/8/99 email from Ms. Boucher to Sam and Evan Wyly and Ms. Robertson on "SSW" (MAV007713)("Lehmans has started the transaction." Ms. Boucher also forwarded an email from Mr. Schaufele in which he stated: "We have started, we will be crossing the stock purchased by Moberly and Quayle into the swap.").

<sup>870</sup> 10/13/99 document entitled, "SSW Swap Execution Report: Sarnia, Greenbriar, Quayle," that appears to have been prepared by Lehman (PSI00109917). See also 10/13/99 email from Evan Wyly to Ms. Boucher (PSI\_ED00069083)("I think Lehman is doing a great job of buying a high % of the trading volume near the VWAP without moving the stock price. ... [I]t would be reasonable to pay a small premium to get a big block of stock.").

<sup>871</sup> See, e.g., 10/18/99 email from Ms. Boucher to Sam, Charles and Evan Wyly and Ms. Robertson on "SSW" (PSI\_ED00043758)(forwarding an email from Mr. Schaufele proposing additional securities transactions; Ms. Boucher asked the Wyllys: "Please advise on how you would like to proceed."); 1/25/00 fax from Lehman Brothers Finance to Greenbriar on "Reset of SSW swap" (CC021686) with additional resets on 3/3/00 (CC021920) and 6/5/00 (CC021692); 3/2/00 "Equity Swap (LONG) Amendment" involving 2 million Sterling Software shares and Greenbriar, Quayle, Moberly, Roaring Fork and Sarnia Investments (CC031181-83); and 3/3/00 "Equity Swap Amendment (SSW)" involving 1.5 million Sterling Software shares and Greenbriar, Moberly, and Sarnia Investments (CC031175-77).

#### **(4) Bringing Offshore Dollars Back with Pass-Through Loans**

After the 1992 and 1996 stock option-annuity swaps moved millions of stock options and warrants offshore, the offshore entities began to exercise the stock options and warrants, sell the shares, and engage in other securities transactions that collectively generated millions of dollars in untaxed investment gains. In 1998, a new shell corporation was established in the Cayman Islands called Security Capital Ltd., which was used to funnel millions of these offshore dollars back into the United States. On ten occasions from 1998 until 2003, various Wyly-related offshore corporations made substantial loans of offshore funds or other financial assets to Security Capital Ltd., which loaned the same amount of funds or assets to Wyly-related persons or entities. Over that five year period, Security Capital functioned essentially as a transit point for nearly \$140 million in offshore assets, including \$33 million loaned to Sam Wyly; \$31 million loaned to Charles Wyly; \$56 million in financial assets other than cash loaned to Cayman entities associated with Sam Wyly's children; \$14.5 million loaned to Green Mountain, a Wyly-related U.S. business venture, or one of its executives; and \$5 million loaned to the Wrangler Trust, a U.S. trust established by Sam Wyly.

The Security Capital transactions show that, over a five-year period, the Wyly-related offshore corporations sent millions of untaxed offshore dollars into the United States. These transactions also provide additional evidence of Wyly influence over the Isle of Man offshore corporations, eight of which transferred millions of dollars and other financial assets to a newly-created shell corporation with no assets, employees, or offices, apparently without requiring any collateral as security. Finally, the Security Capital transactions show that Sam and Charles Wyly utilized the untaxed capital gains produced by the offshore entities to advance their personal and business interests in the United States. By using the offshore dollars and assets supplied by the Wyly-related corporations, Security Capital was able to issue corresponding loans to Wyly-related persons and entities. These loans offered generous terms that, for example, allowed Sam Wyly to use \$10 million and Charles Wyly to use \$25 million for 15 years before any principal had to be repaid. Security Capital offered its loans only to Wyly-related parties. Together these facts suggest that Security Capital functioned to make offshore assets available to the Wyllys to advance their interests.

##### **(a) Security Capital Formation and Operations**

Although Security Capital and the offshore bank that formed and administered Security Capital, Queensgate Bank & Trust Co. Ltd. (Queensgate), refused to provide interviews or information requested by the Subcommittee, the Wyllys' legal counsel and others provided the Subcommittee with their understanding of how Security Capital was established and operated. According to the Wyllys' legal counsel, in August 1998, with assistance from U.S. and Cayman legal counsel, Queensgate Bank formed both Security Capital Trust and Security Capital Ltd.<sup>872</sup>

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<sup>872</sup> See 1/26/06 letter and attachments from Wyllys' legal counsel, Bickel & Brewer, responding to Subcommittee questions about Security Capital (hereinafter "Bickel & Brewer letter and attachments"). A chart entitled "Security Capital Timeline," states that Queensgate Bank settled the Trust and incorporated Security Capital Ltd. in August 1998. The incorporation date for Security Capital Ltd. appears to be 8/24/98. First attachment at 1.

Security Capital Trust is a Cayman charitable trust whose grantor and trustee is Queensgate Bank, the offshore bank that established it.<sup>873</sup> Security Capital Ltd. is a Cayman corporation that is wholly-owned by the Trust. Security Capital Ltd.'s directors are four Queensgate Bank employees and two Isle of Man residents who were also the managing directors of IFG and Trident. IFG and Trident are IOM companies that served as trustees of several Wyly-related offshore trusts whose corporations supplied funds and assets to Security Capital Ltd.<sup>874</sup>

According to the Wyllys' legal counsel, since its inception Security Capital has done business only with parties related to the Wyllys.<sup>875</sup> The Subcommittee has been told that neither Security Capital Trust nor Security Capital Ltd. has any employees or offices of its own; instead Security Capital Ltd. pays a fee to Queensgate Bank to administer its affairs.<sup>876</sup> Further, it is the Subcommittee's understanding that Security Capital owns no assets other than the offsetting loan payables and receivables related to its transactions with Wyly-related interests. Together, this evidence indicates that Security Capital was a shell corporation created for a single purpose: to function as a transit point for pass-through loans of cash and other assets among Wyly interests.<sup>877</sup>

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Bickel & Brewer state that Michael French, Maples & Calder, Meadows Owens, and Jones Day helped to establish, develop, and oversee Security Capital and arrange its initial transaction. First attachment at 2; Chart entitled, "Professionals Involved In Development and Oversight." Maples & Calder told the Subcommittee, however, that it did not have Security Capital as a client and implied that it also did not work on matters pertaining to Security Capital. 3/23/06 letter from Maples & Calder to the Subcommittee at 1.

<sup>873</sup> Bickel & Brewer letter and attachments, first attachment at 1. The materials state that Security Capital Trust's beneficiaries are "any qualified charity designated by the trustee at the time the trust terminates." The materials state that, as of the date of the letter in January 2006, the Trust had not made any disbursement to any beneficiary. *Id.* To date, Security Capital Trust appears to have engaged in no activity other than holding the shares of Security Capital Ltd.

<sup>874</sup> *Id.* at 1. According to the Wyllys' legal counsel, Security Capital Ltd.'s directors are: John Dennis Hunter, Karla Boddien, Blair Gauld, Jane Fleming (who also serves as the corporation's sole officer), David Harris, and David Bester. The first four also work for Queensgate Bank in the Cayman Islands. Mr. Harris is the managing director of IFG, and Mr. Bester is the managing director of Trident.

<sup>875</sup> See Bickel & Brewer letter and attachments, first attachment at 2 ("So far as we know, Security Capital has only been involved in transactions in which companies, owned by the foreign trusts in which Wyly family members are beneficiaries, are involved.").

<sup>876</sup> *Id.* at 1. See also, e.g., 7/31/02 email from Ms. Boucher to Ms. Robertson (MAV010534)(stating Mr. Gauld, a Queensgate Bank director, "does the work on Security Capital").

<sup>877</sup> See Bickel & Brewer letter and attachments, first attachment at 1 ("Security Capital Ltd. was created as a special purpose vehicle (SPV) to participate in back-to-back credit facilities."); undated document providing an agenda for discussion between Irish Trust Group and Wyly family members on 3/27/01 (PSI00110232-33)(listing as one item: "Possible Loan Arrangements via Special Purpose Vehicle administered at Queensgate to facilitate back to back transactions.").

## **(b) Security Capital Transactions In General**

Over a five-year period, from 1998 to 2003, Security Capital Ltd. (Security Capital) participated in ten transactions with Wyly-related parties involving offshore assets totaling nearly \$140 million.<sup>878</sup> The general pattern was that a Wyly-related offshore entity loaned funds or assets to Security Capital, and Security Capital loaned the same amount of funds or assets to a Wyly-related party. Nine out of ten of the loan recipients were in the United States. Cash loans ranged from \$300,000 to \$25 million. One transaction involved the transfer of more than \$56 million in financial assets other than cash, including shares of stock and interests in real estate and partnerships.

Although the transactions involved different amounts and terms, the promissory notes obtained by the Subcommittee follow the same format and contain many virtually identical passages.<sup>879</sup> Each promissory note examined by the Subcommittee stated, for example, that it was an “unregistered debt instrument issued by a foreign lender to a United States of America obligor,” and a “portfolio debt investment” not subject to U.S. income taxation.<sup>880</sup> Each note stated that the “principal and interest payable per the terms and condition of this Note shall be payable only outside the United States,” and the “interest payable hereunder shall not be subject to income or excise taxation, including the imposition of any withholding taxes thereon, under the laws of the United States ... or any state or municipality thereof.” Each note also stated: “It is specifically understood and intended that no ‘United States Person’ (as that term is defined and interpreted under the taxation laws of the United States of America) shall ever be an owner or holder of this Note.”

Most of the promissory notes obtained by the Subcommittee did not require repayment of any principal at all until a specified date ranging from five to fifteen years in the future.<sup>881</sup> Most

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<sup>878</sup> Two charts summarize the ten transactions. See chart entitled, “Pass-Through Loans,” prepared by the Subcommittee Minority Staff and Bickel & Brewer letter and attachments, chart entitled, “Security Capital Loans” (hereinafter “Bickel & Brewer Security Capital Chart”).

<sup>879</sup> Because Security Capital and Queensgate Bank failed to provide requested information, the Subcommittee was unable to confirm with documentation all of the information provided about Security Capital by the Wyllys’ legal counsel. For example, the Subcommittee was not provided a complete set of all the promissory notes nor proof that certain “loans” had been repaid in full. The Wyllys’ legal counsel told the Subcommittee that the Wyllys provided copies of all the promissory notes in their possession, but that they did not have a complete set of signed notes. The following discussions of the Security Capital transactions indicate when the Subcommittee was unable to find documentation substantiating certain information provided about Security Capital.

<sup>880</sup> See, e.g., promissory note for the \$5 million loan issued to the Wrangler Trust (PSI\_ED00013667-70). The promissory note for the \$8 million loan issued to the Sam Wyly Malibu Trust used the phrase “unregistered bearer debt instrument.” (HST\_PSI089324).

<sup>881</sup> For example, loans to Sam or Charles Wyly for \$10 and \$25 million required no payment of principal until fifteen years after each loan was issued; loans to Sam or Charles Wyly for \$15 and \$6 million required no payment of principal until ten years after each loan was issued; a \$5 million loan to the Wrangler Trust associated with Sam Wyly required no payment of principal until five years after the loan was issued. In contrast, a loan

of these notes allowed the borrower to make an annual interest payment rather than a monthly or quarterly payment. All of the notes specified the applicable interest rate, which varied from a low of 4.1 percent to a high of 10 percent. Only three notes were secured with collateral.<sup>882</sup>

Security Capital apparently profited from these transactions by charging slightly higher interest rates on the “loans” it issued to Wyly interests in the United States, compared to the interest rates it paid on the corresponding “loans” obtained from the Wyly-related offshore corporations, thereby obtaining income on the interest rate spread.<sup>883</sup> When the Wyllys’ legal counsel was asked why the Wyly-related interests in the United States paid the additional interest to Security Capital instead of obtaining the same loans directly from the offshore corporations at a lower cost, the Wyllys’ legal counsel offered no explanation.<sup>884</sup>

The documents reviewed by the Subcommittee show that Wyly representatives, such as Keeley Hennington, head of the Wyly family office, were actively involved in processing the loan transactions as were employees with the Irish Trust Company. The documents show limited involvement of Queensgate Bank personnel, in part because Queensgate Bank did not produce documentation to the Subcommittee. The Isle of Man service providers also participated in the transactions, authorizing the loans to Security Capital and communicating with Wyly representatives about specific matters.

Some of the Security Capital transactions appear to have been handled in an informal manner, despite the large sums involved. For example, one transaction involving \$56 million in financial assets actually transferred the assets to Cayman entities associated with Sam Wyly on June 1, 2001, but the related promissory notes apparently were not finalized and executed by the parties until nearly two years later in May 2003. A 2002 promissory note for \$5 million was apparently revised nine months after the loan was issued, but the note bears no indication that the terms were altered after-the-fact.<sup>885</sup> When the first interest payments were due under two credit lines established for Sam and Charles Wyly, the Wyly family office engaged in extensive discussions with the Irish Trust Company to pinpoint the dates on which specific amounts were

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involving \$8 million loaned to the Sam Wyly Malibu Trust required monthly payments of principal and interest.

<sup>882</sup> The three loans with collateral were a \$3 million loan secured by a securities account belonging to a Green Mountain executive, a \$8 million loan secured by certain real estate in Malibu, California, and a \$5 million loan secured by a painting.

<sup>883</sup> Bickel & Brewer letter and attachments, first attachment at 4 (“Security Capital’s income was obtained on the basis of the interest rate differential between Security Capital’s borrowing and lending rates in various loan transactions.”). Later, Security Capital may have asked Charles Wyly for a \$500,000 “retainer.” See PSI\_ED00009136-37, 50 (December 2004 emails between Ms. Boucher and Ms. Hennington discussing request). But see Bickel & Brewer letter and attachments, attachment at 4 (denying retainer request was made by Security Capital).

<sup>884</sup> Bickel & Brewer letter and attachments, first attachment at 4.

<sup>885</sup> See discussion of this promissory note involving the Wrangler Trust in Appendix 4.

provided under the credit lines and calculate the total amount of interest due. This casual treatment of the loan agreements, despite the millions of dollars at stake, is evidence that the loans were not arm's-length transactions and that Security Capital was established to facilitate loans to the Wyllys.

The funds and financial assets loaned in the ten transactions were used to support Wyly business ventures in the United States, capitalize newly-established Cayman corporations associated with Sam Wyly's children, and provide personal funds to Sam and Charles Wyly. Each of the ten transactions had unique elements. For example, one \$5 million loan was provided to the Wrangler Trust to purchase a famous Norman Rockwell painting, "Rosie the Riviter." Two were established to provide lines of credit for Sam and Charles Wyly. Two others were provided to supply investment funds to a Wyly-related energy business in the United States. Collectively, the Security Capital transactions loaned \$33 million in untaxed offshore dollars to Sam Wyly; \$31 million to Charles Wyly; \$56 million in financial assets other than cash to Cayman entities associated with Sam Wyly's children; \$14.5 million to Green Mountain, a Wyly-related U.S. business venture; and \$5 million to the Wrangler Trust, a U.S. trust formed by Sam Wyly. The Subcommittee has been told that five of these loans, totaling about \$27.5 million, have been repaid, while the remaining five, totaling about \$112 million, remain outstanding.<sup>886</sup>

### (c) Three Security Capital Transactions

The Subcommittee has summarized all ten of the Security Capital transactions that it was told took place from 1998 until 2003. Summaries of three of these transactions follow; the rest can be found in Appendix 4.

**\$25 Million Loan to Charles Wyly.** In March 2003, Security Capital established a \$25 million line of credit for Charles Wyly.<sup>887</sup> Of the ten Security Capital transactions, this loan provided the largest single injection of offshore dollars into the United States. The funds for this loan were supplied to Security Capital by an Isle of Man corporation known as Gorsemoor Ltd., which was owned by the Tyler Trust, one of the Isle of Man trusts associated with Charles Wyly.<sup>888</sup> The offshore dollars loaned in this transaction were wired from an offshore corporation associated with Charles Wyly in the Isle of Man to Security Capital in the Cayman Islands to Charles Wyly's personal bank account in the United States.

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<sup>886</sup> See Bickel & Brewer Security Capital Chart.

<sup>887</sup> See 3/1/03 Promissory Note between Security Capital and Charles Wyly (PSI00027427-30)(providing a \$25 million, 15-year revolving credit line, with a 4.80% interest rate, interest payments due in annual installments starting 3/1/04, and no repayment of principal until 2/28/18, when the loan was due in full; promissory note signed by Charles Wyly but not Security Capital). See also Bickel & Brewer Security Capital Chart.

<sup>888</sup> See Bickel & Brewer Security Capital Chart. The Subcommittee has not been provided with a copy of a promissory note between Security Capital and Gorsemoor, nor has it located documentation substantiating funds transfers from Gorsemoor to Security Capital, although other evidence suggests these transfers did occur.

The Subcommittee was told that the purpose of this transaction was to provide Mr. Wyly with personal funds.<sup>889</sup> The loan was unsecured, despite the substantial funds involved. No principal had to be repaid for fifteen years, the interest rate was 4.8 percent, and interest payments had to be made only once per year. By the end of 2003, Mr. Wyly had borrowed the entire \$25 million available in the credit line.<sup>890</sup> He apparently made the required interest payments in 2004 and 2005; it is unclear whether Security Capital used these funds to make the corresponding interest payments to Gorsemoor.<sup>891</sup> Both loans related to this \$25 million transaction apparently remain outstanding.<sup>892</sup>

**\$10 Million Loan to Sam Wyly.** The most recent Security Capital transaction took place in July 2003, when Security Capital established a \$10 million line of credit for Sam Wyly.<sup>893</sup> The funds for this transaction were supplied to Security Capital by Newgale Ltd., an Isle of Man corporation owned by the Bessie Trust, one of the Isle of Man trusts associated with Sam Wyly.<sup>894</sup> The offshore dollars used in this transaction were wired from the offshore corporation associated with Sam Wyly in the Isle of Man to Security Capital in the Cayman Islands to Sam Wyly's personal bank account in the United States.

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<sup>889</sup> Bickel & Brewer Security Capital Chart.

<sup>890</sup> See, e.g., 10/15/03 email on "cw loans re: gorsemoor" (PSI\_ED00003264)(listing 5 drawdowns on the line of credit by September 2003, totaling \$23 million); 10/15/03 email (PSI\_ED00006106); undated document entitled, "Interest Calculation 50C/SECURITY CAPITAL" (PSI\_ED00012691)(listing 6 drawdowns on the line of credit by the end of 2003, totaling \$25 million).

<sup>891</sup> See, e.g., 2/24/04 email from Ms. MacInnis to Ms. Hennington and Ms. Boucher (PSI\_ED00012680-81)(jointly calculating interest due on credit line); undated document entitled, "Interest Calculation 50C/SECURITY CAPITAL" (PSI\_ED00012691)(listing 2003 drawdowns and calculating the interest due as \$888,393.44); undated document entitled, "INTEREST RECALCULATION: \$25M PROMISSORY NOTE" (PSI\_ED00012690)(listing 2003 drawdowns for both Charles Wyly and Security Capital, and calculating the interest due to Security Capital at \$888,393.44 and the interest due to Gorsemoor at \$881,452.87); 2/25/04 wire transfer (IW001117)(showing Charles Wyly wired \$888,393.44 to Security Capital Ltd.); 3/10/05 series of emails among Ms. Hennington, Ms. Boucher, and Ms. Westbrook, on "Security Capital" (PSI\_ED00016108)(discussing interest payment due the next day, 3/11/05); 3/11/05 wire transfer (IW002128)(showing Charles Wyly wired \$1.2 million to Security Capital).

<sup>892</sup> See Bickel & Brewer Security Capital Chart; 12/31/04 financial statement for Charles Wyly (HST\_PSI006984)(under the category "Cash Flows In," and "Note Receivable," listing entry for Security Capital of \$25 million).

<sup>893</sup> See 7/15/03 Promissory Note between Security Capital and Sam Wyly (PSI00027417-20)(providing for a \$10 million, 15-year revolving credit line, with a 4.17% interest rate, interest payments due in annual installments starting 7/15/04, and no repayment of principal until 7/14/18, when the loan was due in full; promissory note signed by Sam Wyly and Dennis Hunter as director of Security Capital). See also Bickel & Brewer Security Capital Chart; 7/14/03 email discussing draft promissory note (PSI\_ED00002645-48).

<sup>894</sup> Bickel & Brewer Security Capital Chart. The Subcommittee has not been provided a copy of a promissory note between Security Capital and Newgale, nor has it located documentation substantiating funds transfers from Newgale to Security Capital, although other evidence suggests these transfers did occur.

The purpose of this loan was to provide Mr. Wyly with personal funds.<sup>895</sup> No principal had to be repaid for fifteen years, the interest rate was 4.2 percent, and interest payments had to be made only once per year. By the end of 2003, Mr. Wyly had borrowed the entire \$10 million available in the credit line.<sup>896</sup> He apparently made the required interest payments in 2004 and 2005; it is unclear whether Security Capital used these funds to make the corresponding interest payments to Newgale.<sup>897</sup> Both loans associated with this \$10 million transaction apparently remain outstanding.<sup>898</sup>

Like the Charles Wyly credit line, this \$10 million credit line for Sam Wyly was provided without any collateral securing its repayment, despite the substantial funds involved. At the time the loan was first being considered, David Harris, managing partner of IFG and a director of Security Capital, inquired as to whether Sam Wyly would be willing to make a “negative pledge” that he would not encumber the stream of annuity payments due to him from East Carroll, one of the Isle of Man corporations, to ensure that these payments would be available to repay the credit line, if needed.<sup>899</sup> Sam Wyly declined to provide that pledge due to

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<sup>895</sup> Bickel & Brewer Security Capital Chart.

<sup>896</sup> See, e.g., documents related to initial drawdown of \$6 million on \$10 million line of credit (PSI00038407-08)(discussing \$6 million drawdown), (BA095051, HST\_PSI010622)(showing \$6 million deposit from Security Capital in Sam Wyly’s personal bank account on 7/23/03); documents related to September 2003 \$1.25 million drawdown (PSI\_ED00003029)(“The \$1.25M will be wired from here to you on Monday. It just hit Security Capital.”), (BA095060, HST\_PSI010393)(showing \$1.25 million deposit from Security Capital into Sam Wyly’s account on 9/15/03); 9/23/03 document entitled, “Cash Report – SW” (PSI00040536); 9/30/03 “Cash Flow Summary-Domestic” for Sam Wyly (PSI\_ED00061524)(listing outstanding Security Capital loan of \$7,250,000); documents related to final \$2.75 million drawdown in October 2003, 10/21/03 email (PSI\_ED00011032-33)(“Security Capital will be wiring the final tranche of \$2.75M to SW in respect of the \$10M revolving credit note. You should expect the funds tomorrow.”; Ms. Hennington responded: “to the rescue”; Ms. Alexander responded: “Wonderful!!!!!!”); bank documentation (BA095064, HST\_PSI010330)(showing \$2.75 million deposit from Security Capital into Sam Wyly account on 10/21/03).

<sup>897</sup> See, e.g., July 2004 emails among Ms. Alexander, Ms. Boucher, and Ms. MacInnis jointly calculating interest owed (PSI\_ED00009759, PSI\_ED00011761-64)(listing 2003 drawdowns and calculating the interest due to Security Capital at \$374,141.67); undated document entitled, “\$10 MILLION REVOLVING NOTE,” (PSI\_ED00011759)(listing 2003 drawdowns for Sam Wyly and Security Capital, and calculating the interest due to Security Capital at \$373,157.88 and the interest due to Newgale at \$379,255.94); 7/15/04 wire transfer (BA095100, IW001524-25)(showing Sam Wyly wired \$374,141.67 to Security Capital); 7/15/05 wire transfer (IW002528)(showing Sam Wyly wired \$417,000 to Security Capital).

<sup>898</sup> Bickel & Brewer Security Capital Chart.

<sup>899</sup> See also series of July 2003 emails involving David Harris of IFG, Ms. Hennington, and Ms. Boucher (PSI00040540-42)(discussing possible line of credit and a “negative pledge” by Sam Wyly against encumbering the East Carroll annuity payments that could be used to repay the credit line).

possible “unfavorable tax consequences,” but did give Security Capital a letter stating that one of his offshore annuities had sufficient assets to repay the \$10 million if necessary.<sup>900</sup>

**\$56 Million Loan to Cayman LLCs.** The \$56 million Security Capital transaction was the largest of the ten and the most complex. On June 1, 2001, four Wyly-related offshore corporations transferred a number of financial assets to another Wyly-related offshore corporation called Greenbriar.<sup>901</sup> These assets included Michaels and Green Mountain stock; ownership interests in two Wyly-related hedge funds, Maverick and Ranger; and ownership interests in real estate used by the Wyllys in the United States. On the same date, Greenbriar loaned the assets to Security Capital, along with additional financial assets of its own, and received in return a promise from Security Capital to pay Greenbriar about \$56 million.<sup>902</sup>

After receiving the assets from Greenbriar, Security Capital divided them up and transferred certain assets to each of the six Cayman limited liability corporations (LLCs) associated with Sam Wyly’s six children.<sup>903</sup> The allocation of these assets by Security Capital followed a plan developed by Ms. Boucher, in consultation with Sam Wyly, to allocate various assets among his children.<sup>904</sup> In exchange, Security Capital apparently obtained from each LLC

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<sup>900</sup> See 7/15/03 letter signed by Sam Wyly and addressed to Security Capital (PSI00027421) (“I am entitled to payments under a private annuity agreement between myself and East Carroll Limited, an Isle of [Man] Company. These payments are to commence on November 1, 2004 and be payable on an annual basis in the amount of \$2,934,856. Although my interest in this agreement is assignable, to do so may result in unfavorable tax consequences. As such, there is no intention to assign these agreements. However, if a need arises for an assignment, you will receive prior notification and if it is deemed necessary at that time and amounts remain outstanding on the Promissory Note, East Carroll Limited may be directed to make such payments directly to Security Capital until the balance of the Promissory Note is paid in full.”) See also 7/16/03 emails exchanged among Mr. Harris of IFG, Ms. Hennington, and Ms. Boucher discussing the wording of the Wyly letter (PSI00040540-42)(indicating that the Wyly letter was actually completed later than July 15, and backdated).

<sup>901</sup> The four IOM corporations were East Baton Rouge, East Carroll, Moberly, and Yurta Faf. In 2001, these corporations were owned by two IOM trusts, the Bulldog and Bessie Trusts, both of which were associated with Sam Wyly. Greenbriar was owned by the Delhi International Trust, which was also associated with Sam Wyly. It is unclear what consideration, if any, that Greenbriar paid to each of the corporations for the assets.

<sup>902</sup> Bickel & Brewer Security Capital Chart. The precise loan amount, \$55,815,672.03, was apparently derived from calculating the value of the financial assets transferred to Security Capital. It is unclear who performed this valuation. It is the Subcommittee’s understanding that while the loan transaction took place on 6/1/01, Security Capital did not provide Greenbriar with a written promissory note for nearly two years, until May 2003. The Subcommittee does not have a copy of this promissory note.

<sup>903</sup> The six Cayman LLCs were Balch LLC, Bubba LLC, FloFlo LLC, Katy LLC, Pops LLC, and Orange LLC. All are wholly owned by the Bessie Trust.

<sup>904</sup> See, e.g., document entitled, “SW Foreign Trust Allocations to Sub-Funds based on 3/31/01 financials” (PSI00078293)(listing assets to be allocated among Sam Wyly’s children; handwritten notations state: “completely revocable ... financial reporting to kids/onshore & off-shore ... 1992 trusts to 1994 trusts./loans ... 1992 -> Security Capital -> 1994”); 6/13/01 email from Ms. Boucher to Mr. Harris at IFG and Ms. Hennington, on “allocations to LLCs” (PSI\_ED00006047)(transmitting lengthy document entitled, “Summary of Proposed transactions,” describing proposals to move the assets actually transferred during the Security Capital transaction); 6/14/01 email from Ms.

a promise to pay about \$9 million.<sup>905</sup> The Subcommittee was told that the purpose of this Security Capital transaction was to “capitalize” the newly created Cayman LLCs with financial assets.<sup>906</sup> Each of the LLCs later increased the amount it owed to Security Capital to about \$11 million so that, by the end of 2004, the Cayman LLCs together owed Security Capital a total of about \$67 million.<sup>907</sup> All of the loans associated with this transaction apparently remain outstanding.<sup>908</sup>

#### **(d) Analysis of Issues**

Loans are a common way for persons with offshore assets to bring funds back into the United States. The Security Capital transactions appear to be a variation on the same theme. The twist here is that an offshore bank, Queensgate Bank, established a shell corporation, Security Capital, to act as the offshore “lender” and as a pass-through for the offshore funds supplied by entities associated with the borrowers. Over a five-year period, Security Capital functioned as a pass-through for \$140 million in offshore dollars and other financial assets that were loaned by Wyly-related offshore corporations to the Wyllys and other Wyly-related parties. About \$56 million in financial assets went to the Cayman LLCs associated with the Sam Wyly’s children; the other \$84 million in offshore dollars went to Wyly-related persons and entities in the United States.

Security Capital is a prime example of an offshore device that used professional expertise and offshore secrecy to give U.S. citizens access to offshore assets. Bankers and lawyers designed Security Capital Trust as a charitable trust that was officially owned by no one, and could serve as an anonymous, passive parent of Security Capital Ltd. Security Capital Ltd. operated without any employees who could be held accountable for the company’s actions.<sup>909</sup>

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Hennington to Ms. Boucher (PSI\_ED00006047)(“I did not fully appreciate all you had to go through until I saw all this.”).

<sup>905</sup> One LLC promised to pay \$8.3 million, while the other five promised to pay \$9.5 million each. See 12/31/01 financial statements for the LLCs (PSI00078959-64); 12/31/01 financial statement for “Foreign Systems (SW Total Family)” (PSI00078956). The Subcommittee does not have copies of the six promissory notes that were presumably created in connection with these loans.

<sup>906</sup> See Bickel & Brewer letter and attachments, first attachment at 3 (“Shortly after the Cayman LLCs were organized, those entities acquired certain assets from Security Capital in exchange for promissory notes.”) and Bickel & Brewer Security Capital Chart.

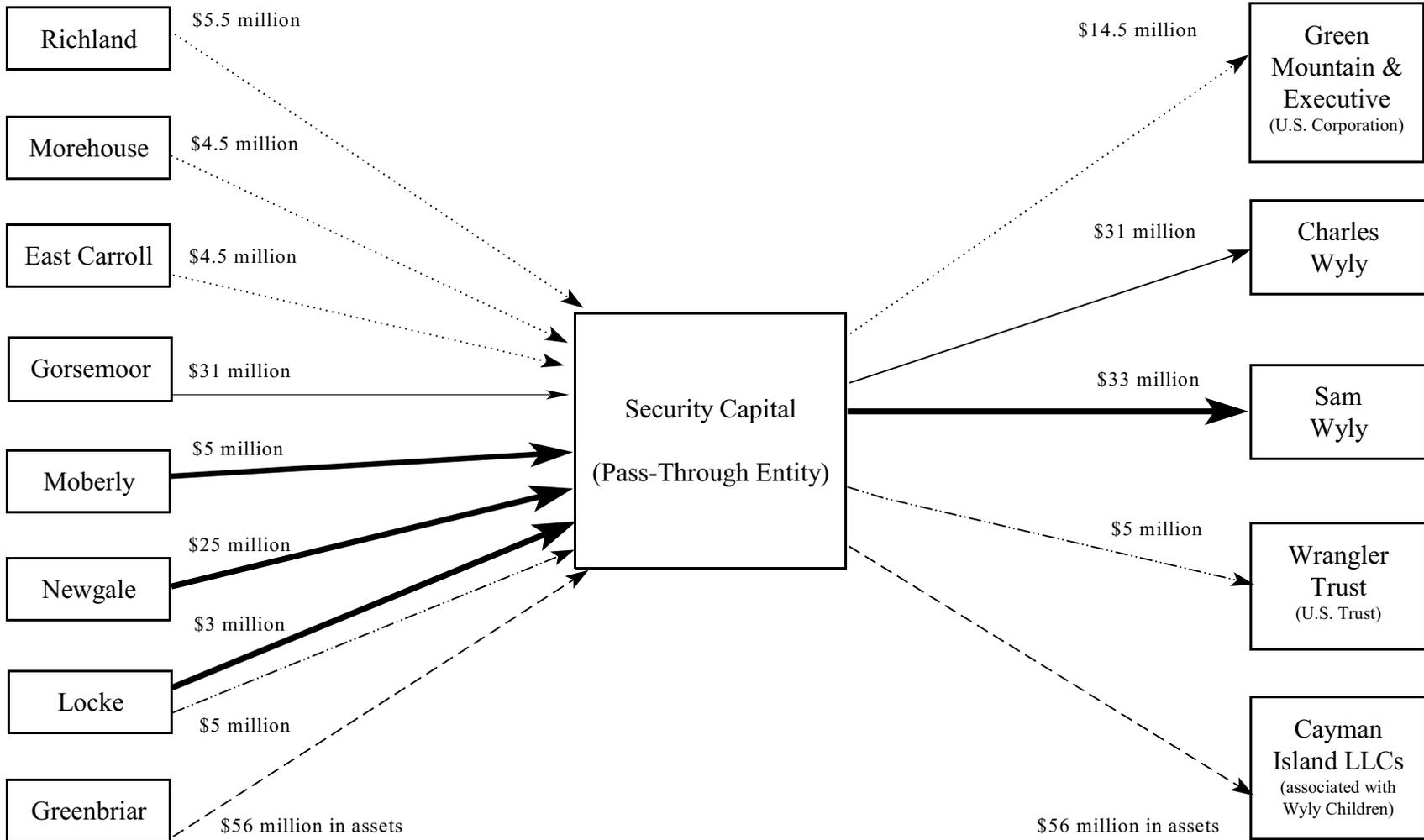
<sup>907</sup> See , e.g., 2004 financial statements for the six Cayman LLCs (PSI00071494-99)(indicating the LLCs together owe \$65.4 million in principal and \$2.1 million in interest to Security Capital, for a total of \$67.5 million).

<sup>908</sup> Id.; Bickel & Brewer letter and attachments, chart entitled, “Security Capital Loans.”

<sup>909</sup> Security Capital is not unique. In its investigation of Enron Corporation, for example, the Subcommittee uncovered similar offshore shell corporations that were established as allegedly independent entities but, in fact, were under the control of a single client and participated in transactions as pass-throughs for loans disguised as energy trades. See “The Role of the Financial Institutions in Enron’s Collapse,” hearings before the Subcommittee, S. Hrg. 107-618, at 15-16 (July 23 and 30, 2002)(discussing an Isle of Man shell corporation called Mahonia, used to disguise about \$4 billion in loans between J.P. Morgan Chase and Enron, and a Cayman shell corporation called Delta, used to disguise about \$5 billion in loans between Citigroup and Enron).

# Pass-Through Loans

(Trust-Owned Isle of Man Corporations)



# Security Capital Loans

Date	Lender	Borrower	\$	Interest Rate	Purpose	Repaid (R) / Maturity (M)
08/98	Richland	Security Capital	5,500,000	*	Green Mountain Loan	11/98* R
08/98	Morehouse	Security Capital	4,500,000	*	Green Mountain Loan	11/98* R
08/26/98	Security Capital	Green Mountain Energy Resource LLC	10,000,000	10.00%	Green Mountain Loan	11/25/98 R
10/98	East Carroll	Security Capital	1,500,000	*	Green Mountain Loan	10/22/99 R
10/98	Security Capital	Green Mountain Energy Resources LLC	1,500,000	*	Green Mountain Loan	10/22/99 R
01/99	East Carroll	Security Capital	3,000,000	6.00%	Green Mountain Loan	10/22/99 R
01/07/99	Security Capital	David White	3,000,000	6.00%	Green Mountain Loan	10/22/99 R
04/99	Locke and Moberly	Security Capital	8,000,000	6.25%	Sam Wyly Loan	2/13/02 R
04/14/99	Security Capital	Sam Wyly 1978 Malibu Revocable Trust	8,000,000	6.75%	Sam Wyly Loan (Secured by Malibu Property)	2/13/02 R
06/01/01	Greenbriar	Security Capital	55,815,672.03	5.4625%	LLC Capitalization	Open* M
06/01/01	Security Capital	Cayman LLC's	55,815,672.69	5.50%	LLC Capitalization	Open* M

Exhibit A

Charts received as an attachment to 1/26/06 letter to the Permanent Subcommittee on Investigations from Wyly counsel, Bickel & Brewer.

# Security Capital Loans

Date	Lender	Borrower	\$	Interest Rate	Purpose	Repaid (R)/ Maturity (M)
01/30/02	Greenbriar	Security Capital	15,000,000	5.4625%	Sam Wyly Loan	Replaced by Newgale loan
04/03	Newgale	Security Capital	15,000,000	5.4325%	Replaces Greenbriar loan from 1/30/02	02/15/12 M
01/30/02	Security Capital	Sam Wyly	15,000,000	5.50%	Sam Wyly Investment in Ranger	02/15/12 M
06/04/02	Locke	Security Capital	5,000,000	4.7125%	Wrangler Trust Loan	05/3/04* R
06/04/02	Security Capital	Wrangler Trust	5,000,000	4.75%	Wrangler Trust Loan (Secured by Wrangler Art)	05/03/04 R
10/01/02	Gorsemoor	Security Capital	6,000,000	4.8625%	Charles Wyly Loan	09/30/12 M
10/01/02	Security Capital	Charles Wyly	6,000,000	4.90%	Charles Wyly Investment in Ranger	09/30/12 M
03/01/03	Gorsemoor	Security Capital	25,000,000	4.7625%*	Charles Wyly Loan	02/28/18 M
03/01/03	Security Capital	Charles Wyly	25,000,000	4.80%	Charles Wyly Loan	02/28/18 M
07/15/03	Newgale	Security Capital	10,000,000	4.1325%	Sam Wyly Loan	07/14/18 M
07/15/03	Security Capital	Sam Wyly	10,000,000	4.17%	Sam Wyly Loan	07/14/18 M

Exhibit A

When the Subcommittee attempted to question the offshore bank that formed Security Capital, Queensgate Bank responded that it could not answer any questions about Security Capital transactions, because disclosing client-specific information would violate Cayman law. Neither Security Capital nor Queensgate Bank were willing to produce documents to the Subcommittee, such as Security Capital's formation documents, the promissory notes between Security Capital and the Wyly-related offshore corporations, or wire transfers substantiating some of the transactions in which Security Capital is said to have participated. The Wyly case history illustrates the fact that corporate and financial secrecy laws and practices in the Cayman Islands – as well as those in the Isle of Man – make it extremely difficult to determine who is behind an offshore entity, how it functions, and who should be held accountable for its actions.

Despite the obstacles in obtaining complete information, the evidence accumulated about the Security Capital transactions depicts multi-million-dollar loans that, over a five-year period, supported Wyly-related personal and business interests. Eight Wyly-related offshore corporations loaned substantial assets to Security Capital, despite the fact that Security Capital was a shell offshore corporation with no assets, employees, or offices of its own. Security Capital used these funds to issue loans with generous, unsecured terms to Sam and Charles Wyly, a U.S. trust associated with Sam Wyly, and a Wyly-related business venture and its executive in the United States. One \$56 million transaction implemented a complex asset transfer plan, developed in consultation with Sam Wyly and legal counsel, to transfer specified assets to Cayman corporations associated with his children. Together, these facts suggest that the Wyls were not only benefiting from, but also directing the Security Capital transactions to advance their personal and business interests.

Documents show that Wyly employees were actively involved in the Security Capital transactions. The evidence suggests further that some of the promissory notes for these multi-million-dollar loans were prepared or altered after-the-fact. In the case of the \$56 million loan, for example, the relevant promissory notes were apparently executed nearly two years after the transfer itself took place. Key terms in the \$5 million Wrangler promissory note, such as the interest rate and annual payment amount, were apparently revised nine months after Security Capital provided the \$5 million, without showing those alterations on the loan document. Loan agreements for several of the loans related to Green Mountain have yet to be produced. The involvement of Wyly personnel and the casual treatment of the promissory notes offer cumulative evidence that the Security Capital transactions were directed by the Wyls and their representatives.

The economic reality behind the Security Capital transactions is that the Wyly-related offshore corporations were supplying the funds sent to the Wyly-related parties. A key question is why the Wyly-related parties did not simply obtain the funds directly from the offshore corporations instead of going through Security Capital. There are several possible explanations for inserting Security Capital in the middle of the borrowing chain. First, interposing Security Capital alleviated the need for direct wire transfers between the Wyly offshore and onshore interests that risked exposing the existence and dimensions of the Wyly offshore structure. Second, it helped disguise the fact that the Wyly offshore trusts were using their wholly-owned corporations to send large amounts of offshore cash to persons in the United States. Third, it

helped hide the fact that the Wylys were making use of the assets they had sent offshore years earlier. If the IRS had discovered that the funds loaned to the Wylys had originated with offshore trusts that named Wylys as beneficiaries, the transactions could have raised questions about the source of the offshore dollars, whether the original funds or subsequent income were taxable, whether the Wylys exercised control over the offshore trusts, and whether the trusts themselves should be treated as taxable grantor trusts or shams.

### **(5) Supplying Offshore Dollars to Wyly Business Ventures**

During the thirteen years examined in this Report, hundreds of millions of untaxed, offshore dollars were transferred to business ventures controlled by the Wylys and their business associates. The Subcommittee analyzed five such business ventures that, together, received Wyly-related offshore dollars in excess of \$500 million. Nearly \$300 million of these funds were transferred to hedge funds and a private investment fund founded by Sam and Charles Wyly. These funds were invested primarily in the U.S. stock market and U.S. business ventures. About \$20 million in offshore loans and equity contributions were supplied to an offshore insurance company while that company was under Wyly control, and another \$14 million placed in annuity policies using investment advisers chosen by the Wylys. Still another \$175 million in offshore dollars were transferred to a U.S. energy business acquired by the Wylys.

In each instance examined by the Subcommittee, the business venture was recommended by the trust protectors and agreed to by the trustees of the Wyly-related offshore trusts. The Subcommittee saw no instance in which an offshore trustee, on its own, initiated an investment in a business venture using Wyly-related offshore trust funds.<sup>910</sup> These five examples offer additional evidence that the offshore entities were taking direction from the Wylys and their representatives, supplying money and loans when asked and investing trust funds where told.

The five business ventures examined by the Subcommittee illustrate the issues involved.<sup>911</sup> From 1993 through 2004, these business ventures included two hedge funds, known as Maverick and Ranger, whose combined Wyly-related offshore investments totaled more than \$250 million; a private investment fund known as First Dallas, whose Wyly-related offshore investments exceeded \$43 million; an offshore insurance company known as the Scottish Annuity (Cayman), whose Wyly-related offshore investments exceeded \$20 million in loans and

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<sup>910</sup> In separate interviews, Mr. French, Ms. Hennington, and Ms. Robertson also told the Subcommittee that they knew of no such instance. Each told the Subcommittee that investments by the offshore entities had been initiated by Wyly family members. Subcommittee interviews of Mr. French (4/21/06 and 6/30/06), Ms. Hennington (4/26/06), and Ms. Robertson (3/9/06).

<sup>911</sup> The business ventures examined in this Report are limited to those that received a substantial amount of funding from Wyly-related offshore entities; the Report does not discuss Wyly-related business ventures that appear to have been funded substantially or wholly with domestic funds.

equity contributions and \$14 million in annuity assets; and a U.S. energy company known as Green Mountain, whose Wyly-related offshore investments totaled at least \$175 million.<sup>912</sup>

In each of these business ventures, legal, financial, tax, and other professionals helped to facilitate the investment of offshore dollars. For example, these professionals provided legal and financial advice and assistance to help the ventures get started, expand, borrow funds, resolve accounting issues, and go public. The complex transactions, paperwork, and offshore funding associated with the five business ventures could not have taken place without the many legal, financial, tax, and other professionals that advised the Wyllys and the offshore entities.

### **(a) Supplying Offshore Dollars to Hedge Funds**

The Wyly-related offshore entities' invested more than \$250 million in untaxed, offshore dollars in two hedge funds known as Maverick and Ranger. Both of these hedge funds were founded and managed for years by Wyly family members. By agreeing to transfer funds to the Wyly-related hedge funds, the Isle of Man (IOM) entities ensured that the funds would be further invested under the direction of the Wyllys.

#### **(i) Hedge Funds Generally**

In the United States, hedge funds are lightly regulated, private investment funds that pool investor contributions to trade in securities or make other investments. Most U.S. hedge funds are structured as limited partnerships, in which the general partner manages the fund for a fixed fee and a percentage of the fund's gross profits, and the limited partners function as passive investors.<sup>913</sup> Investors generally sign a "subscription agreement" specifying the investor's ownership interest in the fund, which may be in the form of shares, limited partnership interests, or ownership units, all of which are treated as unregistered securities.<sup>914</sup> Many U.S. hedge funds sponsor one or more offshore funds, which are administered offshore, keep their subscription agreements and other records offshore, and minimize contacts with the United States, other than typically using the same investment manager as their U.S. counterpart.

Unlike mutual funds, U.S. hedge funds typically are not required to register their securities with the SEC. Instead, as long as the hedge fund does not offer its securities to the public, and has fewer than 100 beneficial owners or accepts only sophisticated investors, such as individuals with at least \$5 million in investments, it is exempt from the Investment Company

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<sup>912</sup> Additional Wyly-related business ventures also appear to have been funded in whole or in substantial part with untaxed offshore dollars. However, detailed analysis will be confined to these five examples, which illustrate the issues involved.

<sup>913</sup> See Goldstein v. SEC, Case. No. 04-1434 (D.C. Cir. 6/23/06), slip opinion at 4-5; 12/31/02 Report to Congress by Treasury, Federal Reserve, and the SEC pursuant to Section 356(c) of the Patriot Act (hereinafter "Report to Congress"), at 19-24 (discussing hedge funds).

<sup>914</sup> See, e.g., 12/31/02 Report to Congress, at 20 in footnote 67, and 22.

Act of 1940 and the Securities Act of 1933.<sup>915</sup> The reasoning behind these exemptions is that “privately placed investment companies owned by a limited number of investors do not rise to the level of federal interest.”<sup>916</sup> In December 2004, the SEC issued a regulation requiring persons who direct a hedge fund’s investments to register with the SEC as an investment advisor and disclose a minimal amount of information about the hedge fund; however, this regulation was recently invalidated by the D.C. Circuit Court of Appeals.<sup>917</sup>

In addition to minimal SEC regulation, hedge funds are currently exempt from U.S. anti-money laundering laws. They are not required to institute an anti-money laundering program, know who their customers are, or report suspicious activity to law enforcement, despite significant money laundering vulnerabilities.<sup>918</sup> In 2002, the Treasury Department proposed a rule that would require hedge funds, among other types of unregistered investment funds, to institute anti-money laundering procedures, but four years later has yet to finalize that rule.<sup>919</sup>

With respect to U.S. taxes, most hedge funds are organized as partnerships, file 1065 informational tax returns with the IRS, and provide information about gains and losses to their partners for inclusion in the partners’ individual tax returns. Some hedge funds organized as corporations must file 1099 forms with the IRS reporting payments made to clients.<sup>920</sup> Hedge fund clients are then responsible for including any hedge fund gains in their taxable income. If a U.S. hedge fund sponsors an offshore investment fund, however, that offshore fund is typically structured as a foreign entity outside of U.S. tax law and does not file U.S. tax returns or report payments made to offshore clients. In 1999, the President’s Working Group on Financial Markets noted that a significant number of hedge funds operated in tax havens and may be associated with illegal tax avoidance.<sup>921</sup>

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<sup>915</sup> These exemptions appear in Sections 3(c)(1) and (c)(7) of the Investment Company Act of 1940, and Section 4(2) of the Securities Act of 1933. See also Section 2(a)(51) of the Investment Company Act for the definition of a “qualified purchaser” and Section 4(2) of the Securities Act for the definition of an “accredited investor.” See also Goldstein v. SEC, Case No. 04-1434, slip opinion at 3 (D.C. Cir. 6/23/06).

<sup>916</sup> “Implications of the Growth of Hedge Funds,” prepared by the SEC staff (9/03), at 1-2.

<sup>917</sup> See Goldstein v. SEC, Case. No. 04-1434 (D.C. Cir. 6/23/06). Hedge fund advisers had been required to register with the SEC by 2/1/06.

<sup>918</sup> See, e.g., proposal to make hedge funds subject to anti-money laundering requirements, 67 Fed. Reg. 60617 (9/26/02); 12/31/02 Report to Congress, at 23.

<sup>919</sup> See “Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies,” 67 Fed. Reg. 60617 (9/26/02); “Implications of the Growth of Hedge Funds,” prepared by the SEC staff (9/03), at 30-31.

<sup>920</sup> See 26 U.S.C. § 6042(a)(on reporting dividends), § 6049(a)(on reporting interest), and § 6045 (on reporting securities transactions).

<sup>921</sup> Report of the President’s Working Group on Financial Markets, “Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management,” (1999), at 41, cited in 12/31/02 Report to Congress, at 24.

## (ii) Maverick Hedge Fund

Sam and Charles Wyly founded their first hedge fund, Maverick, in April 1990, prior to the establishment of any of the Wyly-related offshore entities.<sup>922</sup> Maverick began as a Wyly family business venture, investing funds solely on behalf of family members.<sup>923</sup> Originally, it consisted of a single investment fund, organized as a Cayman corporation.<sup>924</sup> Over time, Maverick established multiple investment funds in the United States and Cayman Islands. In 1993, the Wyls decided to open the hedge fund to outside investors.<sup>925</sup> As a first step, Sam and Charles Wyly established Maverick Capital Ltd., a Texas limited partnership, to serve as the hedge fund's investment manager and general partner.<sup>926</sup> Maverick Capital hired Lee S. Ainslie III, a well-known hedge fund adviser, to invest Maverick funds. He began as co-investment manager with Sam Wyly, became the sole manager in 1995, and continues today to lead Maverick's investment strategies.<sup>927</sup> Sam Wyly's son, Evan Wyly, also became a principal of the hedge fund.

**Offshore Dollars.** The Wyly-related offshore entities began transferring funds to Maverick in 1993.<sup>928</sup> The offshore entities appear to have acted after receiving recommendations from the trust protectors, Mr. French, Ms. Robertson, and later Ms. Boucher.<sup>929</sup> Mr. French and Ms. Robertson each told the Subcommittee that the offshore entities did not invest trust assets

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<sup>922</sup> See, e.g., 4/12/94 "Maverick Overview" (PSI00121392-97).

<sup>923</sup> Id.

<sup>924</sup> This Cayman corporation was initially named First Dallas International Ltd. See, e.g., 10/10/93 letter from Ms. Robertson to Keith King (PSI00054717-18).

<sup>925</sup> 4/12/94 "Maverick Overview" (PSI00121392-97); Subcommittee interview of Maverick (2/2/06).

<sup>926</sup> 4/12/94 "Maverick Overview" (PSI00121392-97); 6/30/95 "Maverick Income Fund" private placement memorandum (PSI00117269-88, at 76). Maverick Capital Ltd. was originally named Dallas Asset Management Ltd. See 6/30/00 "Assignment of Partnership Interest" (PSI00025935-36). Maverick Capital Ltd. is registered with the SEC as the hedge fund's investment advisor.

<sup>927</sup> Id.

<sup>928</sup> See, e.g., 2/20/94 fax from Meespierson (Cayman) Ltd. to Lorne House (PSI00123693)(discussing East Baton Rouge's 1993 investment of about \$400,000 in Maverick Fund Ltd.).

<sup>929</sup> See, e.g., 3/28/95 fax from Lorne House to Ms. Robertson and Mr. French (PSI00120816)("Thank you for your overnight fax. There follows a copy of our fax to Michelle Boucher ... regarding the investment into the new Maverick Growth and Income Fund."); 12/16/96 fax from Ms. Boucher to Lorne House (PSI00121027)("The protectorate committee recommends that Little Woody Limited and Roaring Fork Limited redeem all of their holdings in Maverick Income Fund LDC, and invest the proceeds directly into Maverick Fund Ltd."); 9/29/00 email from Ms. Boucher to IFG (MAV008181)("It is expected that a recommendation will follow later this month for Little Woody Limited to acquire part of Moberly's investment in Precept Fund. ... In order to provide liquidity for this purchase, it is recommended that \$10Million be redeemed from Maverick Fund.").

without receiving a recommendation from them, and that they, as trust protectors, did not independently select trust investments but made their recommendations only after receiving instructions from Sam or Charles Wyly or one of their representatives.<sup>930</sup>

By September 2001, according to internal Wyly records, the offshore entities had invested more than \$125 million in Maverick's offshore funds.<sup>931</sup> Of this amount, seven IOM corporations, East Baton Rouge, East Carroll, Moberly, Morehouse, Richland, Tensas, and West Carroll, had placed about \$29 million in Maverick's offshore funds.<sup>932</sup> Another \$4 million had been placed in Maverick's offshore levered funds by East Carroll and the six Cayman LLCs associated with Sam Wyly's six children.<sup>933</sup> Another \$31 million was supplied to Maverick Fund Ltd. by Ranger Fund Ltd., an offshore fund sponsored by a second Wyly-related hedge fund.<sup>934</sup>

In addition, years before, the Lake Providence International Trust, an Isle of Man trust associated with Sam Wyly, had purchased an annuity policy from Scottish Annuity Company (Caymans) Ltd. (SAC) and then designated Maverick as the investment manager for the annuity assets. So had Castle Creek International Trust, an IOM trust associated with Charles.<sup>935</sup> Due to these designations, Maverick had assumed investment control of the annuity assets, which in 2001, totaled about \$52 million.<sup>936</sup>

By the end of 2004, internal Wyly financial records show that the investments of the offshore entities associated with Sam Wyly had grown to more than \$43 million in Maverick,

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<sup>930</sup> Subcommittee interviews of Mr. French (4/21/06 and 6/30/06) and Ms. Robertson (3/9/06). See also, e.g., 12/22/99 email from Ms. Boucher to Evan Wyly with copy to Ms. Robertson (PSI\_ED00069988) ("As you recall, due to tight cash constraints we are liquidating Maverick Fund shares at 1/1/00 to fund Greenmountain cash requirements. What is the timing of wanting to exercise the MIKE options - can we try for additional redemption from Maverick[?]"); 8/31/01 email from Ms. Boucher to Sam Wyly and Ms. Huebner with copies to Evan Wyly, Ms. Hennington, and Ms. Robertson (PSI\_ED00064869-71) (seeking Sam Wyly's reaffirmation of his earlier decision to cause Lake Providence International Trust to redeem \$30 million worth of Maverick shares for cash which could then be used on other matters of interest to the Wyls).

<sup>931</sup> See, e.g., 9/30/01 document including information on "Maverick Investments – Foreign" (PSI\_ED00019789-91).

<sup>932</sup> Id. at PSI\_ED00019790.

<sup>933</sup> Id. at PSI\_ED00019791.

<sup>934</sup> Id. at PSI\_ED00019789-90.

<sup>935</sup> See, e.g., 12/4/00 email from Ms. Boucher to Evan Wyly on "lake providence/castle creek – scottish annuity policy withdrawals" (MAV012080) (indicating both policies had funds invested in Maverick shares).

<sup>936</sup> See 9/30/01 document including information on "Maverick Investments – Foreign" (PSI\_ED00019789-91). A number of SAC annuity holders apparently designated Maverick as their investment manager, resulting in SAC's placing a total of more than \$212 million with the hedge fund in 2001. 3/23/06 letter from Maverick's legal counsel to the Subcommittee (hereinafter "Maverick letter"), at 3; Subcommittee interview of Maverick (2/2/06).

while the investments of the offshore entities associated with Charles Wyly had grown to more than \$87 million, for a combined total of more than \$130 million.<sup>937</sup>

**Wylys Directing Maverick Investments.** Maverick managed all of the offshore dollars supplied by the Wyly-related offshore entities. Maverick's investment decisions were made at first by Sam and Charles Wyly and, after 1993, by Maverick Capital Ltd., the Wyly hedge fund's SEC-registered investment advisor. From 1993 until about 2000, Maverick Capital Ltd. was owned and controlled by Sam and Charles Wyly, as explained below. Placing offshore funds in a hedge fund that they had founded and controlled was one more way the Wylys were able to maintain direction over the investment of the untaxed assets they had sent offshore.

Maverick told the Subcommittee that it invested most client funds in publicly traded stocks on the U.S. stock markets. Maverick told the Subcommittee that it rarely put money into nonpublic investments.<sup>938</sup> On several occasions, however, Maverick invested client funds in Wyly-related business ventures. For example, beginning in 1997, Maverick became a major shareholder of Green Mountain, a private energy company acquired by the Wylys, as explained further below. Maverick used about \$40 million to buy Green Mountain common and preferred stock, and another \$4.2 million to buy Green Mountain debt securities. It also accumulated capitalized interest and other fees totaling about \$1.7 million, for a combined total Green Mountain investment of about \$46 million.<sup>939</sup> Maverick continued to invest in this venture even though, every year from its inception, Green Mountain lost money. Today, Maverick holds about 12 percent of Green Mountain's outstanding stock. Despite its \$46 million investment, Maverick recently wrote down the market value of its Green Mountain stock to zero, due to the company's poor performance.<sup>940</sup> Absent Wyly interest in Green Mountain, it seems doubtful that Maverick would have invested such substantial funds over so many years in that company.

Maverick also invested client funds in the Scottish Re Group, the offshore insurance venture associated with Sam Wyly and Michael French.<sup>941</sup> In November 1998, Maverick used \$10 million to buy over 700,000 Scottish shares and 200,000 Scottish warrants from Scottish as part of the company's initial public offering. Over the next three months, Maverick spent another \$11 million in open market transactions to buy an additional 979,000 shares. From March 1999 through June 2001, Maverick sold virtually all of the Scottish shares for an aggregate sales price of about \$21 million. During May 2003, Maverick exercised the Scottish

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<sup>937</sup> 12/31/04 financial statement for "Global SW Family" (PSI\_ED00095232-33)(providing "Total Maverick" investments under "SW Foreign Total Family FMV") and for "Global CW Family" (HST\_PSI006887)(providing "Total Maverick" investments under "CW Foreign Total Family FMV").

<sup>938</sup> Subcommittee interview of Maverick (2/2/06). Maverick told the Subcommittee that, currently, less than one percent of its funds are in nonpublicly traded investments.

<sup>939</sup> 3/23/06 Maverick letter at 5. Presumably, these client funds were associated with the Wylys.

<sup>940</sup> Subcommittee interview of Ms. Robertson (3/9/06).

<sup>941</sup> 3/23/06 Maverick letter, at 3. Initially, the company was known as Scottish Annuity & Life Holdings.

warrants at an aggregate exercise price of \$3 million and sold the shares for about \$3.8 million. Maverick also appears to have allowed its Wyly-related offshore clients to “lend” their Maverick shares to Scottish Re to strengthen its balance sheet when it first got underway and again later when it prepared to go public, as explained further below.

By the end of 1997, the Scottish Annuity Company (Cayman) Ltd. (SAC) had become “the largest single investor in Maverick Fund.”<sup>942</sup> At its height in 2001, SAC had over \$200 million in client funds being managed by Maverick.<sup>943</sup> In 2004, however, some SAC investors withdrew their funds from Maverick and either switched to Ranger or placed their funds elsewhere. By the end of 2005, Scottish Re had only about \$14 million in client funds at Maverick.<sup>944</sup>

In addition to Green Mountain and Scottish Re, Maverick purchased 100,000 shares of Michaels Stores in 1993, and another 100,000 in 1994 and 1995, later selling all 300,000 shares in 1997.<sup>945</sup> It also purchased 300,000 shares of Sterling Software in 1993, and sold them in 1997.<sup>946</sup> Together these investments show how offshore funds placed with Maverick may have been used to help boost other Wyly-related businesses.

Today, Maverick has over \$11 billion in assets under management.<sup>947</sup> Mr. Ainslie and Evan Wyly continue as its principals.

**Maverick Ownership and Management.** Maverick began as a single Cayman corporation. In 1993, when the hedge fund was reorganized as a limited partnership and opened to other investors, Maverick Capital Ltd. became its general partner. At that time, Maverick Capital Ltd. was controlled by Sam and Charles Wyly who were its sole general partners and senior executives.<sup>948</sup> As of June 1996, Sam Wyly’s family held a 67 percent ownership interest

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<sup>942</sup> 11/7/97 “SAC 98 Plan,” authored by Mr. French (PSI\_ED00044927-28).

<sup>943</sup> See discussions of Maverick and Ranger above.

<sup>944</sup> “Scottish Re: Presentation to the Permanent Subcommittee on Investigations” (4/18/00) at 46, 52. All \$14 million appears to belong to an offshore entity associated with Charles Wyly. See 12/31/04 internal Wyly financial report entitled, “Family Offshore” (HST\_PSI006889)(including entries for “CW Foreign Total Family FMV,” and “SAC Policy – Maverick Levered”).

<sup>945</sup> See Schedules 13D filed by Maverick regarding Michaels Stores.

<sup>946</sup> See Schedules 13D filed by Maverick regarding Sterling Software.

<sup>947</sup> 3/31/06 Form ADV filed with the SEC by Maverick Capital Ltd. at 3. Maverick told the Subcommittee that it now has nearly 1,000 investors.

<sup>948</sup> Initially, Charles Wyly served as chairman of Maverick Capital Ltd., while Sam Wyly served as its president. See, e.g., 4/12/94 “Maverick Overview” (PSI00121392-97). Evan Wyly served as a managing director, as did Mr. French. Ms. Robertson, head of the Wyly family office, served as the treasurer of Maverick Capital, while the family’s tax director, Keith Hennington, served as Maverick’s tax manager. A number of employees,

and Charles' family held a 33 percent ownership interest.<sup>949</sup> Maverick Capital Ltd. exercised control over the hedge fund's investments.

Two years later, in 1998, Charles Wyly apparently sold his general partnership interest in Maverick Capital Ltd., and by the end of 2000, Sam and Charles Wyly had withdrawn from Maverick's management in favor of Evan Wyly and Mr. Ainslie.<sup>950</sup> Today, Maverick Capital Ltd.'s sole general partner is Maverick Capital Management LLC (formerly Maverick Capital General LLC), which is owned by Mr. Ainslie and Marmalade Ltd., a company that benefits Evan Wyly and his family.<sup>951</sup> Evan is the manager of Maverick Capital Management LLC.<sup>952</sup> Maverick Capital Ltd. also has a number of limited partners, all of whom are Wyly family members, Wyly or Maverick employees, or entities controlled by those persons.<sup>953</sup>

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including Mr. French, Ms. Robertson, and Mr. Hennington, were simultaneously on the payroll of Maverick, the Wyly family office, and other Wyly-related businesses, splitting their time among the various enterprises.

<sup>949</sup> 6/6/97 memorandum from Sam to Charles Wyly (PSI00109863-64). One document showing the extent of Wyly control over Maverick is a 6/6/96 memorandum from Sam to Charles Wyly entitled, "Maverick Discussion Sheet." (PSI00109863-64). In it, Sam discussed Charles' plan to reduce his Maverick ownership from a one-third share to a five percent share:

"Existing ownership of Maverick is 66.88% Sam's Family and 33.12% Charles' Family. Charles' Family will reduce to 5% ownership. ... In exchange for retaining 5% of Maverick a minimum balance of \$40 mm will be retained in the Hedge funds. Income may be distributed and losses do not need to be made up. Additionally, Charles' Family agrees to not pull out funds in excess of \$1,000,000 per quarter without a six month notice. Approximate balances at 5/31/96 are:

Maverick Funds USA – Entrepreneurs and Miller	3,264,254
Maverick Income Fund – Entrepreneurs and Aspen	2,966,025
Maverick Fund, LDC – IRA, Pension and Foreign	24,372,333
Maverick Income, LDC – Foreign	<u>9,525,113</u>
Total	<u>40,127,725</u> "

The bulk of Maverick "balances" at the time involved funds supplied by "Foreign" entities, presumably the Wyly-related offshore trusts and corporations. In this memorandum, Sam and Charles Wyly appear to have been making commitments on behalf of the offshore entities not to "pull out" more than \$1 million per quarter without notice.

<sup>950</sup> Subcommittee interview of Maverick (2/2/06).

<sup>951</sup> See 3/23/06 letter from Maverick's legal counsel, Shearman & Sterling, responding to questions from the Subcommittee (hereinafter "Maverick letter"), at 1-2.

<sup>952</sup> 3/31/06 Form ADV filed with the SEC by Maverick Capital Ltd. at signature page.

<sup>953</sup> Id. See also 3/23/06 Maverick letter.

### (iii) Ranger Hedge Fund

In August 2001, about one year after leaving Maverick's management, Sam Wyly founded a second hedge fund known as Ranger.<sup>954</sup> Ranger also began as a Wyly family investment fund, but within months was opened to other investors.<sup>955</sup> Sam Wyly's involvement with the hedge fund was well publicized and was apparently one of the marketing factors used to attract clients.<sup>956</sup> Like Maverick, Ranger sponsored investment funds both in the United States and Cayman Islands.

**Offshore Dollars.** Wyly-related offshore entities supplied millions of offshore dollars to Ranger from its inception. According to internal Wyly records, by August 31, 2001, the end of Ranger's first month of operation, Wyly-related offshore entities had apparently sent more than \$100 million to the hedge fund.<sup>957</sup> Nine IOM corporations, East Baton Rouge, East Carroll, Devotion, Greenbriar, Locke, Moberly, Sarnia Investments, Tensas, and West Carroll, had provided a total of more than \$81 million.<sup>958</sup> The six Cayman LLCs associated with Sam Wyly's children had supplied another \$21 million.<sup>959</sup>

In addition, in 2001, Scottish Re, the offshore insurance group associated with Sam Wyly and Michael French, invested at least \$30 million in client funds in Ranger.<sup>960</sup> These funds were provided through annuity policies issued by Scottish Re in which the policyholders supplied the

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<sup>954</sup> Some Ranger materials state that Charles Wyly was a co-founder of Ranger, but other evidence suggests he was not involved in the management of this hedge fund. See, e.g., December 2002 Private Placement Memorandum for Ranger Hedged Equity (Offshore) Ltd., Cayman fund of Ranger Investments (PSI\_ED00038917-80, at 33-34)(listing Charles Wyly as a co-founder with Sam Wyly of Ranger Capital Group).

<sup>955</sup> See, e.g., "Ranger Capital gets ready for October 1 launch," Infovest21 News (8/20/01).

<sup>956</sup> See, e.g., 9/10/03 emails exchanged between Ms. Hennington and Evan Wyly (PSI\_ED00003022-23)(Evan wrote: "Sam is asking about his idea of restructuring Ranger ownership"; Ms. Hennington responded in part: "Ranger may have a hard time not being able to use Sam's name as being behind Ranger because I think they rely on this heavily in marketing."); "Wyly bets boredom wins big," Dallas Morning News (12/26/03)(linking Sam Wyly with Ranger and admiring his investment "intuition"); "Ranger Capital Builds European Base," HedgeWorld Daily News (1/7/04)("Sam Wyly's Ranger Capital Group opened an office in Geneva, Switzerland"); "Hedge funds well-represented on billionaire list," Alternative Investment News (3/20/06)(listing Sam Wyly from Ranger Capital Group).

<sup>957</sup> See, e.g., 9/30/01 document including information on "Maverick Investments – Foreign" (PSI\_ED00019789-91).

<sup>958</sup> Id. at PSI\_ED00019790.

<sup>959</sup> Id. at PSI\_ED00019789-90.

<sup>960</sup> Subcommittee interview of Ranger (11/10/05). Later information provided by Ranger indicates that \$30 million is likely too low, but they did not have a precise amount. Information provided by Ranger (6/21/06).

annuity premiums and recommended Ranger as their investment manager. By the end of 2005, the amount of Scottish Re client funds in Ranger had increased to \$54 million.<sup>961</sup>

By the end of 2004, internal Wyly financial records show that funds invested by the offshore entities associated with Sam Wyly had grown to more than \$79 million in Ranger, while the funds invested by the offshore entities associated with Charles Wyly had grown to more than \$49 million, for a combined total of more than \$128 million.<sup>962</sup>

Like Maverick, the offshore dollars placed with Ranger appear to have been invested after the relevant offshore trust received a recommendation from the trust protectors who, in turn, had received direction from Sam or Charles Wyly or their representatives.<sup>963</sup> Ranger normally invested client funds in U.S. securities or in a fund of hedge funds. The Ranger Fund also placed about \$31 million with the Maverick Fund Ltd.<sup>964</sup> Today, Ranger has about \$370 million in assets under management.<sup>965</sup>

**Ranger Ownership and Management.** Ranger currently has three groups of investments funds, Ranger Investments, Ranger Advisors, and Ranger Family Fund, each of which has a complex ownership structure with entities ultimately traceable, in part, to Sam

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<sup>961</sup> “Scottish Re: Presentation to the Permanent Subcommittee on Investigations” (4/18/00) at 46, 52. In 2003, a Ranger employee asked Ms. Boucher “whether certain of the offshore Scottish [insurance] policies ... currently invested with Mav[erick] could be invested with Ranger ... without breaching the investor control issues currently in place.” This Ranger employee wrote: “[A]fter stripp[ing] out all references to any individual so as to keep you and Keeley calm ... I would think that [xxx] and certainly [xxxxxxx] would be able to invest in ... Ranger Multi Strategy.” 9/22/03 email from Robert Chambers of Ranger Capital to Ms. Boucher, with copy to Ms. Hennington (PSI\_ED00003108-09). This question apparently arose, because of U.S. tax rules related to annuitants controlling the investment of their annuity assets. See, e.g., Subcommittee interview of Mr. French (4/21/06) at 229-232. At issue was whether Sam or Charles Wyly “controlled” Ranger. Ultimately, it appears that offshore entities associated with Charles but not Sam Wyly moved their SAC funds from Maverick to Ranger. Compare, e.g., 12/31/04 internal Wyly financial report for “Global CW Family” (HST\_PSI006887)(listing \$19 million entry under “CW Foreign Total Family FMV” for “SAC Policy in RMS Class 1,” where “RMS” refers to the Ranger Multi-Strategy investment fund) with 12/31/04 internal Wyly financial report for “Global SW Family” (PSI\_ED00095232-33) (listing no SAC policy entry related to Ranger).

<sup>962</sup> 12/31/04 financial statement for “Global SW Family” (HST\_PSI006886)(providing “Total Ranger” investments under “SW Foreign Total Family FMV”) and for “Global CW Family” (HST\_PSI006887)(providing “Total Ranger” investments under “CW Foreign Total Family FMV”).

<sup>963</sup> See, e.g., 5/31/01 email from Ms. Boucher to IFG (CC012663)(“East Carroll should go to Ranger Fund LLC ... Locke’s money should go to Ranger Fund Ltd.”); 4/30/01 email from Ms. Boucher to Ms. Huebner for Sam Wyly (PSI\_ED00080054)(Ms. Boucher wrote: “I need to go out to the trustees tonight to request the additional \$2.5M investment in Ranger tonight.” Ms. Huebner responded: “I faxed his OKAY.”).

<sup>964</sup> 9/30/01 document on “Maverick Investments-Foreign” (PSI\_ED00019789-90). Apparently, about \$3 million of these offshore dollars had been supplied by Greenbriar and Sarnia Investments. *Id.* at PSI\_ED00019790.

<sup>965</sup> Information provided by Ranger (6/21/06).

Wyly, his son-in-law Jason Elliott, and Scott Cannon, who once worked as Green Mountain's chief financial officer.<sup>966</sup>

As with the offshore entities' investments with Maverick, Ranger illustrates how the Wyllys were able to exercise direction over the untaxed, offshore dollars held by the Wyly-related offshore entities. They did so by directing the offshore entities to transfer the funds to a Wyly-related hedge fund for further investment. Altogether, the offshore trustees invested more than \$250 million with Maverick and Ranger.

### **(b) Investing Offshore Dollars in a Private Investment Fund**

Hedge funds were not the only investment vehicles that received Wyly-related offshore dollars. Another was a private investment fund known as First Dallas, which received funds from offshore entities associated with Charles Wyly totaling at least \$43 million. First Dallas was established in early 2000, accepted funds only from parties related to the Charles Wyly family, and was never opened to outside investors.<sup>967</sup> It invested untaxed offshore dollars in a variety of U.S. securities and private equity ventures in the United States.

**Offshore Dollars.** From its inception, First Dallas was financed primarily with dollars from offshore entities associated with Charles Wyly. First Dallas International Ltd., a Cayman corporation, functioned as the gateway for IOM corporations associated with Charles Wyly to supply millions of dollars. For example, in March 2000, Elysium wired \$6.25 million to First Dallas International for its initial capitalization.<sup>968</sup> In June 2000, Roaring Fork wired \$2

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<sup>966</sup> With respect to Ranger Investments, for example, the SEC-registered investment manager is Ranger Investment Management LP, a Delaware limited partnership. 3/17/06 Form ADV for Ranger Investment Management LP, at 17-22. The general partner of Ranger Investment Management LP is Ranger Investment Group LLC, a Delaware limited liability corporation. Ranger Investment Group LLC is owned by Ranger Capital Group Holdings LP (RCGH), another Delaware limited partnership, and by David Anthony and Michael Durante. RCGH's general partner is Ranger Capital Group LLC, which was founded by Sam and Charles Wyly and apparently is currently owned by Mr. Elliott and Mr. Cannon. RCGH's limited partners include Sam Wyly and several Ranger employees. Ranger Advisors has a similar ownership structure. Its SEC-registered investment manager is Ranger Advisors LP (formerly named Ranger Capital Ltd.), whose general partner is RCGH and whose limited partner is Ranger Management LLC. 1/9/06 Form ADV for Ranger Advisors LP, at 21-22. As explained, RCGH's ultimate owners include Mr. Elliott, Mr. Cannon, and Mr. Wyly. In the case of the Ranger Family Fund, its SEC-registered investment manager is Ranger Fund Management LP, whose general partner is Ranger Fund Management LLC and whose limited partner is RCGH. 3/27/06 Form ADV for Ranger Fund Management LP, at 17-19.

<sup>967</sup> First Dallas was formed after Charles relinquished his ownership and management role in Maverick. See, e.g., 3/2/00 email from Ms. Robertson to Ms. Boucher regarding "CW" (PSI\_ED00047852)(indicating Charles was "[r]eady to start a fund in the Cayman Islands. Wants to seed with \$5 million.")

<sup>968</sup> 3/29/00 email projecting cash needs for \$6.25 million (HST\_PSI000053); 3/30/00 wire transfer of \$6.25 million (Mizuho001160-61).

million.<sup>969</sup> In July, Elegance wired \$4 million.<sup>970</sup> By January 2002, Ms. Boucher reported to Mr. Wyly and his son-in-law, Donald Miller, that the “IOM trusts have contributed a total of \$29.2 Million to date, of which \$24.2 Million was cash and \$5M was investments.”<sup>971</sup> Five months later, she reported that the total contributed by the IOM trusts had increased to \$32.2 million.<sup>972</sup> By the end of 2004, the combined offshore investment in First Dallas International exceeded \$43 million.<sup>973</sup>

This offshore funding was provided in varying amounts, every few months, in response to funding requests made by the Wyly family office, or in response to cash flow projections developed by Ms. Boucher, and the money was used to pay expenses, finance new investments, or satisfy capital calls made from existing investments.<sup>974</sup> After determining the amount needed by First Dallas in each instance, Ms. Boucher worked with the IOM trusts to identify available funds and arrange for one of the IOM corporations to wire the cash to First Dallas International.<sup>975</sup> First Dallas International then wired the offshore dollars to the United States, sending them either to First Dallas Ltd., which served as the fund’s investment manager, or First Dallas Ventures Ltd., which functioned as a venture capital investment fund, both of which were Texas limited partnerships.<sup>976</sup>

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<sup>969</sup> 6/22/00 email from Ms. Boucher (MAV008079)(“The protectors recommend that the trustees invest a further \$2M into First Dallas International”); 6/28/00 bank record (CC016678)(showing, on 6/28/00, Roaring Fork Ltd. wired \$2 million to First Dallas International).

<sup>970</sup> See 7/6/00 wire transfer (CC019562)(showing Elegance wired \$4 million to First Dallas International).

<sup>971</sup> 1/31/02 email from Ms. Boucher to Mr. Wyly and Mr. Miller (PSI00039590-91).

<sup>972</sup> 5/10/02 email from Ms. Boucher to Mr. Wyly and Mr. Miller (PSI00109206-07)(“The IOM trusts have contributed a total of \$32.2 Million to date, of which \$27.2 Million was cash and \$5M was investments.”).

<sup>973</sup> See, e.g., 12/31/04 financial statement for “Foreign Systems (CW)” (HST\_PSI006919)(showing combined “First Dallas International” investment from the Pitkin, Castle Creek International, Tyler and Red Mountain Trusts).

<sup>974</sup> See, e.g., 3/29/00 email projecting cash needs of \$6.25 million (HST\_PSI000053); 6/6/00 email requesting \$1.25 million (PSI00026310); 6/13/00 email requesting \$1 million (PSI\_ED00086616-17); 5/18/01 email requesting \$3 million (PSI\_ED00087333-34); 1/31/02 email projecting cash needs of \$3 million (PSI00039592); 5/10/02 email projecting cash needs of \$3 million (PSI00109206); 7/15/02 email requesting \$410,000 (PSI\_ED00010265-66); 12/3/02 email requesting about \$500,000 (PSI\_ED00005047); emails from July to September 2003 requesting over \$700,000 (PSI\_ED00005984-86); emails from January to February 2004 requesting funding (PSI\_ED00006339-41); 3/9/04 emails requesting about \$200,000 (PSI\_ED00013831-33); 7/23/04 email projecting immediate cash needs of \$500,000 to \$1 million and longer term cash needs totaling \$10 million (PSI\_ED00014804).

<sup>975</sup> See, e.g., 7/15/02 emails discussing where to obtain funding from IOM trusts (PSI\_ED00010265-66); 6/22/00 email identifying possible source of funding from Roaring Fork (MAV008079).

<sup>976</sup> See, e.g., bank records from 2000 to 2004, for First Dallas Ltd. (BA150280-387) and First Dallas Ventures Ltd. (BA PSI-W016499-620)(showing millions of dollars in deposits from First Dallas International).

First Dallas invested in a wide range of U.S. securities and private equity transactions in the United States.<sup>977</sup> All of the investments made by First Dallas appear to have been selected and managed by Charles Wyly and two of his sons-in-law, James Lincoln and Donald Miller. As a result, Charles Wyly was able to maintain control of the money he had placed offshore by having the untaxed funds sent to his own private investment fund, and then deciding where to further invest those funds.

The offshore dollars were also used for a second purpose. In addition to funding investments, some of the offshore dollars were used to pay management and performance fees charged by First Dallas Ltd.<sup>978</sup> First Dallas International paid, for example, an annual 2 percent management fee and supplied the funds used by First Dallas Venture to pay an annual 20 percent performance fee charged by First Dallas Ltd. The offshore entities' investments generated additional fees for the owners of First Dallas Ltd. – ultimately, Charles Wyly.

By providing in excess of \$43 million to First Dallas International to finance investments and generate fees in the United States, the IOM entities were, in effect, handing over direction of these offshore dollars to Charles Wyly and his family members so they could pursue their business interests.

**First Dallas Ownership.** The ownership structure of First Dallas was ultimately traceable to Charles Wyly and his family members. First Dallas consisted of three interlocking business entities, First Dallas International Ltd., a Cayman corporation; First Dallas Ventures Ltd., a Texas limited partnership, and First Dallas Ltd., another Texas limited partnership. First Dallas International supplied offshore funds to First Dallas Ventures, which functioned as a venture capital investment fund.<sup>979</sup> First Dallas Ltd. served as investment manager to both First Dallas International and First Dallas Ventures.<sup>980</sup> First Dallas Ltd. charged a fee for its services, requiring First Dallas International to pay an annual fee equal to two percent of the assets being invested, and requiring First Dallas Ventures to pay a 20 percent annual performance fee.<sup>981</sup>

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<sup>977</sup> See, e.g., document entitled, “Lehman Brothers Realized Gains and Losses ... First Dallas International Ltd From 01-01-00 Through 09-09-01” (BA165457-58)(listing securities transactions involving over two dozen companies); 5/10/02 “Summary of FDI cash flows since inception” (PSI00109206-07)(listing private equity investments involving over one dozen companies).

<sup>978</sup> See, e.g., 10/15/04 email from Irish Trust Company to Mr. Lincoln (PSI\_ED00009002)(indicating about \$110,000 in offshore dollars had been wired to pay management fees).

<sup>979</sup> See, e.g., 6/6/00 emails among Ms. Boucher, Ms. Hennington, and others (PSI00026310)(“FDI funds FDV, and FDV makes the investments. First Dallas, Ltd (FDL) acts as the investment advisor to both FDV and FDI.”).

<sup>980</sup> *Id.*, see also, e.g., 4/1/00 “Investment Management Agreement” (BA045267-77)(showing First Dallas Ltd. agreed to serve as investment manager for First Dallas International).

<sup>981</sup> See, e.g., 6/20/00 emails from Ms. Boucher to Ms. Hennington and others (PSI\_ED00004574-75, at 74)(discussing fees).

The Cayman corporation, First Dallas International, was apparently owned by the four IOM corporations that supplied its funding.<sup>982</sup> All four of these corporations were owned by IOM trusts that benefited the Charles Wyly family. The investment manager, First Dallas Ltd., was owned by its U.S. partners.<sup>983</sup> Its sole general partner was First Dallas GP LLC, a Texas limited liability corporation whose manager was Charles Wyly.<sup>984</sup> Its sole limited partner was Charles Wyly himself. The third entity, First Dallas Ventures, was owned by the other two: its sole general partner was First Dallas Ltd., and its sole limited partner was First Dallas International.<sup>985</sup>

**First Dallas Management.** Charles Wyly and his family members directed the First Dallas operations. Mr. Wyly was both the manager of the general partner and the sole limited partner of First Dallas Ltd.<sup>986</sup> The documents show that Mr. Wyly repeatedly made specific investment decisions for both First Dallas International and First Dallas Ventures.<sup>987</sup> In addition, his sons-in-law, James Lincoln and Donald Miller, played key management roles in the First

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<sup>982</sup> See 5/28/02 emails between Louis Schaufele of Bank of America and Ms. Hennington (PSI\_ED00006917)(Mr. Schaufele wrote: "Could you tell ... me whom the owners of 1<sup>st</sup> Dallas, I assume that it is IOM corps." Ms. Hennington responded: "[T]he companies are: Roaring Creek Limited, Roaring Fork Limited, Elysium Limited, Elegance Limited.").

<sup>983</sup> See 2/7/00 "First Dallas, Ltd. Limited Partnership Agreement" (BA045257-66).

<sup>984</sup> *Id.* See also MOPSI008564-67 (indicating FDG LLC is a single member LLC owned by Charles Wyly).

<sup>985</sup> See 3/10/00 "First Dallas Ventures, Ltd. Limited Partnership Agreement" (PSI\_ED00028561-70).

<sup>986</sup> See, e.g., "First Dallas Ltd. Limited Partnership Agreement" (BA045257-66) in which Charles Wyly signs the agreement twice, on behalf of both the general and limited partners. See also, e.g., 6/13/00 email from Mr. Lincoln to Ms. Hennington and others on "FDL Items" (PSI\_ED00086616-17)(indicating that First Dallas Ltd. will charge a management fee to First Dallas International and stating: "CJW would like for this to have started on April 1. So we need to invoice for the last quarter and ... upcoming quarter.").

<sup>987</sup> See, e.g., 3/29/00 email from Ms. Boucher to Charles Wyly, Mr. Miller, and others (HST\_PSI000053)(asking Mr. Wyly for information about particular investments to be made by First Dallas International and First Dallas Ventures, and containing his handwritten notations on specific amounts of funds to be invested in nine different companies); 10/16/00 memorandum from Ms. Boucher to Ms. Robertson, Mr. French, and others (MAV008220-21)("Charles has a planned investment in a new ... venture called 'Fresh Direct.' ... Charles would like to commit \$1Million through First Dallas International."); 1/31/02 email from Ms. Boucher to Charles Wyly, Mr. Miller, and others (PSI00039592)(Ms. Boucher wrote: "I have estimated that the protectors should recommend an additional investment of \$3Million dollars into First Dallas International." Mr. Wyly's handwritten notation responded: "Yes."); similar email dated 5/10/02 (PSI00109206)(recommending another \$3 million for First Dallas International to which Mr. Wyly again responded "yes"); 6/20/02 fax from Irish Trust Company to Charles Wyly (PSI00109208-14)(conveying financial information about First Dallas International); 7/15/02 email from Ms. Hennington to Ms. Boucher and others (PSI\_ED00010265-66)("Based on the last e-mail on 5/29 Charles approved \$210,000 per month for Transfinity and \$200,000 per month for Seranin. ... Michelle – you may want ... to have another discussion with Donnie and Charles on the remaining funding."); 11/26/02 email from Ms. Hennington to Andrea Westbrook and others (PSI\_ED00011228)("I just talked to Jim and Charles and Donnie have approved an additional funding for RLX.").

Dallas business venture. In June 2000, Ms. Boucher wrote to Ms. Hennington: “We look at FDV as a ‘venture capital fund’ and Donnie/Jim are managing it, making the investment decisions.”<sup>988</sup> The documents indicate that, from 2000 until 2004, both men were involved with First Dallas on a daily basis, but that Mr. Wyly also continued to participate in management decisions, apparently in a senior role.<sup>989</sup>

In the First Dallas business venture, the offshore trustees supplied funds when asked and provided a total of \$43 million, enabling Charles Wyly and his family members to direct use of these funds to pursue their business interests in the United States. Using offshore dollars to generate management fees charged by First Dallas Ltd. also provided a way to transfer these dollars directly into the United States for the Wylys’ personal use.

### **(c) Investing Offshore Dollars in Offshore Insurance**

In addition to providing offshore dollars to hedge funds and a private investment fund which enabled Wyly-controlled companies to decide when and how to further invest the money, the Wyly-related offshore entities directed millions of offshore dollars to specific business ventures favored by the Wyly family. One such business was an offshore insurance venture, the Scottish Annuity Company (Cayman) Ltd. (SAC). Investing their offshore assets in this offshore insurance venture produced multiple benefits for the Wylys, including providing another avenue of direction over the offshore funds, a means to boost other business ventures that interested them, and purportedly adding another layer of protection against U.S. taxes in the event that the underlying offshore trusts were deemed subject to U.S. taxation. Altogether, the Wyly-related offshore entities appear to have provided more than \$20 million in loans and equity contributions to SAC, as well as about \$14 million in annuity assets.

**Ownership and Management.** In 1994, Sam and Charles Wyly and the Wyly family legal counsel, Michael French, established a Cayman holding company called Scottish Holdings Ltd. This company was primarily owned by three offshore trusts. The Bessie Trust, associated with Sam Wyly, owned 38 percent, while the Tyler Trust, associated with Charles Wyly, owned 19 percent, for a combined total of 57 percent. The South Madison Trust, an Isle of Man trust associated with Mr. French, owned 38 percent. The final five percent was split among three

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<sup>988</sup> 6/20/00 email from Ms. Boucher to Ms. Hennington (PSI\_ED00004574-75).

<sup>989</sup> See, e.g., 6/13/00 email from Mr. Lincoln to Ms. Hennington (PSI\_ED00086616-17)(“Make sure that FDL’s financials are up to date. ... We will be reporting to CJW on standing as of the 2<sup>nd</sup> Qtr.”); 10/16/00 memorandum from Ms. Boucher to Ms. Robertson, Mr. French, and others (MAV008220-21)(“This is the venture cap fund that Donnie and Jim are managing. Charles has authorized investments up to \$10Million at this time. ... Jim and Donnie both appear to be really enjoying this venture.”); 9/17/03 letter from Charles Wyly to Mr. Lincoln (HST\_PSI036156)(using his personal stationery, Mr. Wyly awarded Mr. Lincoln a First Dallas bonus for selling certain assets: “First Dallas awards you a \$10,000 bonus .... While the amounts involved in this transaction and this bonus are not large, they are symbolically important.”).

individuals or offshore entities associated with them: Ms. Boucher, Ms. Robertson, and Lee Ainslie, head of Maverick investments.<sup>990</sup>

Scottish Holdings immediately established a wholly-owned subsidiary, SAC, which acquired a “Class B” or offshore insurer’s license allowing it to sell insurance and annuity policies to non-Cayman residents.<sup>991</sup> For its first four years of existence, from 1994 to 1998, SAC had two officers, Mr. French and Ms. Boucher.<sup>992</sup> Sam Wyly, who was not an officer, was nevertheless active in managing the company.<sup>993</sup>

**Offshore Dollars.** From its inception, Wyly-related offshore entities contributed or lent millions of offshore dollars and assets to capitalize SAC, strengthen its balance sheet, and purchase annuity policies from the company. Wyly-related offshore trusts provided, for example, the initial financing that got the offshore insurance venture underway. In 1994, two IOM trusts, the Bulldog Trust associated with Sam Wyly and the Pitkin Trust associated with Charles Wyly, issued a \$300,000 loan to SAC’s parent, Scottish Holdings Ltd.<sup>994</sup> The funds were apparently provided by Bulldog’s subsidiary Morehouse, which provided \$200,000, and Pitkin’s subsidiary Roaring Creek, which provided \$100,000.<sup>995</sup> In 1995, both trusts issued a second loan for \$200,000.<sup>996</sup> On both occasions, the trusts provided the financing in response to

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<sup>990</sup> “Scottish Re: Presentation to the Permanent Subcommittee on Investigations” (4/18/00) at 50; undated document (likely authored in 1997) entitled, “Scottish Holdings Recapitalization” (PSI\_ED00044949).

<sup>991</sup> 1999 annual report filed with the SEC by Scottish Annuity & Life Holdings, Ltd. at 35.

<sup>992</sup> Mr. French served as SAC’s chief executive officer throughout this period. “Scottish Re: Presentation to the Permanent Subcommittee on Investigations” (4/18/00) at 48; 6/9/98 minutes of Scottish Life Holdings Ltd. first corporate meeting (SR0000754-57). See also undated document (probably prepared in 1997) entitled, “Mike’s Deal” (PSI\_ED00044931)(stating without further explanation: “MCF is CEO of SAC. This may not be able to be formalized because of tax issues.”). Ms. Boucher served as SAC’s secretary and chief financial officer for five months, before moving to the Irish Trust Company. SAC’s directors were Mr. French; three Queensgate employees; and two persons associated with the Isle of Man, Ronald Buchanan and Keith King. “Scottish Re: Presentation to the Permanent Subcommittee on Investigations” (4/18/00) at 48. Mr. Buchanan was then managing director of Lorne House which served as trustee of the Bessie and Tyler Trusts that owned a majority interest in Scottish Holdings Ltd. Mr. King was also a director of Lorne House and served as the grantor of the Bessie and Tyler Trusts.

<sup>993</sup> See, e.g., 3/1/95 fax from Mr. Buchanan to Mr. French, in part, complaining about the management of SAC (PSI00120863-64)(Mr. Buchanan wrote: “Lorne House Trust, as trustee, is fighting the IRS in Northern California where the IRS is contending that a corporation owned by the (foreign) trust is the mere ‘alter ego’ of the Settlor, even though I can assure you that the settlor in question has been far more willing to leave us in genuine control – a fact which promises to win us the case – than S. appears to be.”). “S.” appears to refer to Sam Wyly.

<sup>994</sup> See 3/21/95 fax from Mr. French and Ms. Robertson to Ronald Buchanan of Lorne House Trust (PSI00121777-78); Subcommittee interview of Mr. French (4/21/06).

<sup>995</sup> 12/18/95 fax from Ms. Boucher to Lorne House (PSI00137814-17).

<sup>996</sup> Id.

a recommendation made by the trust protectors, Mr. French and Ms. Robertson, each of whom told the Subcommittee that they provided the recommendations on instruction from Sam Wyly.

In 1996, two more Wyly-related offshore trusts, the Bessie and Tyler Trusts, apparently assumed the \$500,000 in loans<sup>997</sup> and also provided Scottish Holdings with another \$720,000.<sup>998</sup> Again, the trusts acted on the basis of a recommendation from the trust protectors who told the Subcommittee that they would have acted on the instruction of Sam Wyly. In 1997, the two trusts apparently contributed \$2 million in additional capital.<sup>999</sup>

In addition to providing more than \$3.2 million in financing during the venture's early years, the Wyly-related offshore entities apparently "loaned" the business venture millions of dollars worth of shares in Maverick's offshore fund, so that these shares could be listed on SAC's balance sheet as part of its equity. In late 1995 or early 1996, for example, the offshore trusts "loaned" Scottish Holdings Ltd. a number of Maverick Fund LDC shares that collectively were worth about \$2 million.<sup>1000</sup> By 1997, the amount of "loaned" Maverick shares had increased to \$3.5 million.<sup>1001</sup> In 1998, another \$20 million in Maverick shares were apparently "loaned" to the insurance venture, for a combined total of about \$23.5 million.<sup>1002</sup> In each

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<sup>997</sup> See, e.g., 4/3/96 fax from Ms. Boucher to Barbara Wade of Lorne House (PSI-WYBR00370)(explaining the transactions needed for the Bessie and Tyler Trusts to assume the \$500,000 in loans from the Bulldog and Pitkin trusts). Both loans were apparently repaid around the same time. See, e.g., 8/22/96 fax from Ms. Boucher to Ms. Robertson (PSI00087607)(stating loans were repaid as of 3/31/96, but interest owing on them, \$182,000, remained outstanding).

<sup>998</sup> See 12/23/96 fax from Ms. Robertson to Mr. Buchanan of Lorne House (PSI00121018)(recommending that \$480,000 be contributed by the Bessie Trust through its wholly owned corporation, Fugue, later renamed Audubon Assets, and \$240,000 be contributed by the Tyler Trust through its wholly owned corporation, Soulieana). It is possible that the Tyler Trust lent additional funds to Scottish as well. See undated document entitled "Scottish Annuity" (PSI\_ED00044929)(listing "cash investments" from Tyler Trust on 6/7/94, 3/29/95, 11/1/95, and 12/31/96 totaling \$348,692).

<sup>999</sup> Undated document entitled, "Scottish Holdings Recapitalization," probably prepared in 1997 (PSI\_ED00044949)("Tyler needs to contribute the balance due (\$666,600) of the \$2m additional capital. Bessie contribution of \$1,333,4000 has been received.").

<sup>1000</sup> See, e.g., 8/22/96 fax from Ms. Boucher to Ms. Robertson (PSI00087607-10); 8/29/96 fax from Ms. Robertson to Sam, Charles and Evan Wyly and Don Miller (PSI00087605-06)("A reminder, that the Wyly's loaned \$2,008,013 of Maverick Fund LDC to Scottish Holdings [and] Scottish Holdings contributed the Fund investment to Scottish Annuity as APIC."); 11/7/97 "SAC 98 Plan" (PSI\_ED00044927-28)("Holdings has borrowed shares of Maverick Fund ... from Bessie/Tyler or related trusts."); Subcommittee interview of Mr. French (4/21/06).

<sup>1001</sup> See 11/7/97 "SAC 98 Plan" (PSI\_ED00044927-28); Subcommittee interview of Mr. French (4/21/06).

<sup>1002</sup> See 11/7/97 "SAC 98 Plan" (PSI\_ED00044927-28); undated document (likely authored in 1997) entitled, "Scottish Holdings Recapitalization" (PSI\_ED00044949)("Existing loan of shares of Maverick Fund from Bulldog and Pitkin to Holdings should be increased by shares having a current value of an additional \$20 million. These shares are to be contributed by Holdings to SAC as additional equity capital. Loan is a demand loan and must be satisfied by return of the shares. Like the existing arrangement, this will be equity on SAC's books and a loan payable on Holding's books."); Subcommittee interview of Mr. French (4/21/06).

instance, after the shares were “loaned” to Scottish Holdings, Scottish Holdings assigned the shares to its subsidiary, SAC, which then apparently included them on its balance sheet as part of its “equity.”

As Mr. French wrote at one point, the purpose of lending these shares was “to boost SAC equity” and provide it with a “competitive advantage” over other companies seeking to sell variable annuity products to high net worth individuals.<sup>1003</sup> Officials of Scottish Re, the company that acquired SAC in 1999,<sup>1004</sup> told the Subcommittee that the shares had helped to “build the balance sheet” and show that Scottish had the assets necessary to operate its business.<sup>1005</sup> Mr. French also wrote: “Since SAC is wholly owned by Holdings, the Fund shares can be withdrawn at any time and returned to the lenders, without documenting any obligation on SAC’s books.”<sup>1006</sup>

Scottish Re’s representatives told the Subcommittee that they had never seen this type of “loan” before, in which a hedge fund’s shares were “lent” but not contributed to a company and listed as an equity asset. Maverick’s representatives told the Subcommittee that they also found the “loan” unusual, but noted that hedge funds often allowed clients to assign their ownership interests in a hedge fund to a third party, such as, for example, a bank considering providing the client with financing.

In 1999, the “loan” of the Maverick shares came to an end, when SAC was formally purchased by Scottish Re for \$11.5 million.<sup>1007</sup> Prior to the closing, SAC returned \$23.6 million in capital to Scottish Holdings Ltd. – this returned “capital” apparently consisted of the Maverick shares.<sup>1008</sup>

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<sup>1003</sup> 11/7/97 “SAC 98 Plan,” authored by Mr. French (PSI\_ED00044927-28)(“It is proposed that another \$20 million of Fund shares be loaned to Holdings and contributed downstream to SAC to boost SAC equity to \$25 million. Since SAC engages only in the variable annuity business, there is no need for any of this capital from an operating standpoint. However, a balance sheet with \$25 million of equity will provide a significant competitive advantage over anyone else engaged in this type of business offshore, and possibly onshore.”).

<sup>1004</sup> See, e.g., 8/18/00 email from Paul Goldean to Scott Willkomm (SCREPSI014948) (“Scottish Holdings, Ltd. (a company owned by the Wyly’s and Mike French) sold all 250,000 shares of Scottish Annuity Company (Cayman) Ltd. to Scottish Annuity & Life Holdings, Ltd. for \$11,562,161.84 ... on 12/31/99.”). Scottish Re Group was incorporated on 5/12/98, under the name Scottish Annuity & Life Holdings, Ltd., and went public in November 1998. It briefly changed its name to Scottish Life Holdings Ltd. on 6/4/98, but returned to Scottish Annuity & Life Holdings, Ltd. on 9/9/98. The company took its present name, Scottish Re Group Ltd., on 8/28/03. 7/5/06 letter from the legal counsel for Scottish Re Group to the Subcommittee, at 2.

<sup>1005</sup> Subcommittee interview of Scottish Re (4/18/06).

<sup>1006</sup> 11/7/97 “SAC 98 Plan,” authored by Mr. French (PSI\_ED00044927-28).

<sup>1007</sup> SCREPSI014948.

<sup>1008</sup> “Scottish Re: Presentation to the Permanent Subcommittee on Investigations” (4/18/00) at 51; Subcommittee interviews of Scottish Re (4/18/06) and Mr. French (4/21/06). See also 12/31/99 Scottish Holdings Ltd. Balance Sheet (PSI00101644)(listing “Loans payable (Maverick shares)”). Scottish Re purchased SAC from its

**SAC Annuities.** In addition to investing in SAC itself, Wyly-related offshore entities provided at least \$14 million in offshore funds to purchase SAC annuity policies. SAC allowed its annuity policyholders to select who would invest and manage their annuity assets. The Wyly-related offshore entities initially directed that the funds in their annuities be placed with the Wyly-related hedge fund, Maverick; later, some moved funds to the second Wyly-related hedge fund, Ranger, or to other investment funds. By investing offshore dollars in SAC annuity policies and selecting Maverick or Ranger as the investment manager of those annuity assets, the offshore trusts had, in effect, enabled the Wyllys to direct the investment of those funds.

During SAC's early years, two Wyly-related offshore trusts were among its largest policyholders.<sup>1009</sup> In 1994, the Lake Providence International Trust, which was established by Sam Wyly, purchased a SAC annuity policy, apparently contributed about \$8.2 million in annuity assets, and selected Maverick as the investment manager for these funds.<sup>1010</sup> The Castle Creek International Trust, an IOM trust established by Charles Wyly, took similar action, purchasing a SAC annuity policy, apparently contributing about \$5.5 million in annuity assets, and also naming Maverick as the investment manager of those assets.<sup>1011</sup> Ms. Boucher later described these policies as "originally acquired, in part, to provide seed capital to Scottish's book of business."<sup>1012</sup>

The annuity assets, invested at Maverick, apparently grew rapidly in value. By September 2000, six years later, the Wyllys valued the Lake Providence assets at about \$45 million and the Castle Creek annuity assets at about \$30 million.<sup>1013</sup> In December 2000, Sam Wyly apparently instructed Ms. Boucher to withdraw the assets associated with the SAC

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parent, Scottish Holdings Ltd., which after receiving the \$11.5 million, issued a distribution to its shareholders, including about \$5.2 million to Audubon Assets, the corporation associated with Sam Wyly; \$2.6 million to Soulieana, the corporation associated with Charles Wyly; and \$3.8 million to Arakan Ltd., a corporation associated with Mr. French. See 1/20/00 "Scottish Holdings Cash reconciliation" (PS00101646).

<sup>1009</sup> Subcommittee interview of Mr. French (4/21/06).

<sup>1010</sup> See, e.g., 10/31/99 internal Wyly financial report for Lake Providence International Trust (PSI00109903)(showing the "book" value of "Scottish A. Policy" at about \$8.2 million and the fair market value at over \$36 million); 9/30/00 internal Wyly financial report for Lake Providence International Trust (PSI00071741)(showing the "book" value at about \$8.2 million and the fair market value at over \$45 million). The Subcommittee asked Scottish Re to confirm these figures and other details about the policy; Scottish Re said that it could not get permission from the client, presumably Lake Providence International Trust, to do so.

<sup>1011</sup> See, e.g., 10/31/99 internal Wyly financial report for Castle Creek International Trust (PSI00109912)(showing the "book" value of "Scottish Annuity Policy" at about \$5.5 million); 9/30/00 internal Wyly financial report for Castle Creek International Trust (PSI00071748)(showing the same "book" value). The Subcommittee asked Scottish Re to confirm these figures and other details about the policy; Scottish Re said that it could not get permission from the client, presumably Castle Creek International Trust, to do so.

<sup>1012</sup> 8/31/01 email from Ms. Boucher to Sam Wyly and others (PSI\_ED00064869-74).

<sup>1013</sup> See, e.g., 9/30/00 internal Wyly financial report for Lake Providence International Trust (PSI00071741); 9/30/00 internal Wyly financial report for Castle Creek International Trust (PSI00071748).

policies.<sup>1014</sup> After Scottish Re offered to lower its fees related to these annuities, the instructions were withdrawn and the SAC policies continued.<sup>1015</sup> Also in 2000, the Lake Providence trust was merged into a newly created IOM trust called “Bulldog II,” which was also associated with Sam Wyly. The Castle Creek trust was similarly merged into a new IOM trust called “Pitkin II.” During the time these new trusts were in existence, the SAC policyholders were Bulldog II and Pitkin II.<sup>1016</sup>

In 2001, Sam Wyly apparently decided to withdraw \$40 million from the Lake Providence SAC policy, with the initial \$30 million to be withdrawn by September 1, and another \$10 million by October 1.<sup>1017</sup> At the time, the funds were invested with Maverick, and the plan was for the offshore trust to redeem the Maverick investment “to raise cash” to be used “for various other purposes, such as ... investing in Ranger, Green Mountain and funding commitments to Red River and Winston Thayer and funding construction at Two Mile Ranch.”<sup>1018</sup> All of the mentioned uses for the cash involved businesses or real estate of interest to the Wyllys and indicate that Sam Wyly was directing the withdrawal of the Lake Providence annuity assets to generate cash for other businesses and properties of interest to him.

When the withdrawal request was communicated to SAC, Mr. French warned the Bulldog II trustee, then IFG, that “surrender[ing] a portion of the Bulldog annuity ... is not a wise

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<sup>1014</sup> See, e.g., 12/1/00 email from Ms. Boucher to Ms. Robertson on “SAC annuity policies” (PSI\_ED00044520-21)(“SW told us to go ahead and have the trustees make this withdrawal. ... SW also indicated that this is in keeping with the severing of the relationship.”); 12/4/00 email from Ms. Boucher to Evan Wyly on “lake providence/castle creek – scottish annuity policy withdrawals” (MAV012080)(“The trustees have not had satisfactory response from Scottish with trying to give effect to this transaction. ... I expect you and/or Sam, and maybe even Charles may hear from him [Mr. French]. ... I think that Scottish will want to negotiate to keep the policies in place through 12/31 for year end numbers. I think it is reasonable for the trustees to agree to this, provided SAC agrees to do a like-kind distribution and transfer the share of Maverick as opposed to having to redeem funds from Maverick & reinvest.”).

<sup>1015</sup> See, e.g., 12/14/00 email from Amy Castillo to Irish Trust on “Scottish Redemptions” (PSI\_ED00044136)(asking about “SAC P136-014 Castle Creek” and “SAC P136-015 Lake Providence” and describing the policies as “Wyly related”); 8/31/01 email from Ms. Boucher to Sam Wyly and others (PSI\_ED00064869-74); 11/15/01 email from Scott Willkomm, Scottish Re CEO, to Ms. Boucher (MAV012715-17)(“Sam had already agreed earlier this year not to redeem the annuities ... when we agreed to substantially lower the M&E fees.”).

<sup>1016</sup> Four years later, in 2004, both the Bulldog II and Pitkin II trust would be voided by their trustees, allegedly due to defects in how the trusts were established. See Appendix 1 and Report section on Directing Trust Assets. The trustees would also reconstitute the Lake Providence and Castle Creek International Trusts, and deem that their assets were returned to their custody as if they had never left, presumably including the SAC policies.

<sup>1017</sup> 8/31/01 email from Ms. Boucher to Sam Wyly and others (PSI\_ED00064869-74). See also 12/31/01 internal Wyly financial report on “Global Sam Family” (PSI00078955)(showing that a “Scottish Policy” in Maverick had a fair market value at that time of about \$53.5 million).

<sup>1018</sup> 8/31/01 email from Ms. Boucher to Sam Wyly and others (PSI\_ED00064869-74).

move.”<sup>1019</sup> Mr. French also warned Ms. Boucher of “grave negative tax implications,” explaining:

“The annuity exists because there is always a risk that the trust in question will be classified by US tax authorities as a grantor trust, thus subjecting the settlor to taxation on all of the trust income. ... Based on the history of this annuity and the amount of gain deferred, the entire amount proposed to be withdrawn would be classified as ordinary income for U.S. income tax purposes. If there is any action by the authorities in the next six years to classify the trust as a grantor trust, then the settlor will be subjected to a claim for taxes equal to 40% of the amount withdrawn plus interests and, possibly, penalties. ... Once a surrender takes place, the tax problem thus created cannot be cured, and will be there for the next six years. ... [M]y personal opinion is that it is a grave and unnecessary mistake.”<sup>1020</sup>

Ms. Boucher responded that “as was customary during your term of service as a protector to these trusts, legal counsel was in fact consulted with regard to this matter ... [and] this withdrawal [is] consistent with the advice obtained.”<sup>1021</sup> Ms. Boucher also sent a lengthy email to Sam Wyly and others, explaining the issues, conveying Mr. French’s warning, and stating “we need a quick reply” on whether to withdraw the \$40 million.<sup>1022</sup>

These email exchanges raise several issues. First, they demonstrate that Sam and Charles Wyly were the key decisionmakers for the annuity policies held in the name of the offshore trusts. In December 2000, for example, Ms. Boucher asked Sam Wyly, not the relevant offshore trustee, for a quick decision on withdrawing the \$40 million from the annuity policy. Second, the emails show a concern that the Wyly-related offshore trusts might be deemed by U.S. tax authorities as “grantor trusts” whose income would be attributed to Sam Wyly, and the annuity policies were purchased to provide added protection against potential U.S. tax liability. Finally, the emails show that the Wyls and their representatives considered the millions of dollars of offshore funds placed in the annuity policies as available, if redeemed, to fund other business ventures and personal properties of interest to the Wyls.

The documents suggest that, in the end, the \$40 million was not withdrawn from the Lake Providence annuity policy in 2001. The funds appear to have remained in the SAC policy, invested at Maverick, until 2004, when the funds were moved to the “LifeInvest Opportunity

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<sup>1019</sup> *Id.* at PSI\_ED00064871.

<sup>1020</sup> *Id.* at PSI\_ED00064872-73.

<sup>1021</sup> *Id.* at PSI\_ED00064873.

<sup>1022</sup> *Id.* at PSI\_ED00064869 (subject line of “URGENT email for Sam, we need a quick reply on this – thanks!”).

Fund,” an insurance-dedicated fund managed by Bermuda-based Tremont Advisers.<sup>1023</sup> By the end of 2004, the SAC annuity assets at the Lifeinvest Opportunity Fund were valued at about \$61.6 million.<sup>1024</sup> In addition, internal Wyly financial records show that, by the end of 2004, the Castle Creek International Trust held four SAC policies with assets totaling over \$43 million, of which about \$14 million was managed by Maverick and another \$19 million was managed by Ranger.<sup>1025</sup>

**IPO Stock Purchases.** In addition to the offshore dollars and assets contributed to SAC and SAC annuity policies, Wyly-related offshore entities provided capital for the initial public offering (IPO) of Scottish Annuity & Life Holdings, Ltd., the company later known as Scottish Re. As Scottish prepared for this initial public offering, the IPO vehicle, Scottish Annuity & Life Holdings Ltd., issued millions of shares and warrants to “related parties,” most of which were offshore entities associated with the Wyllys and Mr. French.<sup>1026</sup> In June and October 1998 (prior to the company’s initial public offering in November 1998), Scottish issued millions of shares and Class A warrants to “related parties.” Among the largest purchasers were Audubon Assets, an IOM corporation associated with Sam Wyly, which obtained over 470,000 shares and 1 million warrants; Soulieana, an IOM corporation associated with Charles Wyly, which obtained over 230,000 shares and 550,000 warrants; the Bessie Trust, an IOM trust associated with Sam Wyly, which obtained 152,000 shares; and the Tyler Trust, an IOM trust associated with Charles Wyly, which obtained 76,000 shares.<sup>1027</sup> Another 1.5 million shares were sold to Scottish Holdings Ltd., then owned in part by Wyly-related offshore entities, for \$500,000.<sup>1028</sup>

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<sup>1023</sup> Internal Wyly financial reports indicate that about \$54 million stayed in the SAC policy until 2004, when all but about \$14 million appears to have been withdrawn. See, e.g., 12/31/01 report on “Global Sam Family” (PSI00078955)(showing that a “Scottish Policy” in Maverick with a fair market value (FMV) of \$53.5 million); 12/31/02 report on “Global Family (SW & CW)” (PSI\_ED00092539)(showing that a “Scottish Policy” in Maverick with a FMV of \$54.9 million); 9/30/03 report on “Global Family (SW & CW)” (PSI\_ED00093878)(showing that a “Scottish Policy” in Maverick with a FMV of \$54.4 million); 12/31/04 report on “Global Family (SW & CW)” (PSI\_ED00095229)(showing no investment related to Sam Wyly in a Scottish Policy at Maverick, but \$61.6 million at Lifeinvest Opportunity Fund). See also 5/26/06 letter from Scottish Re’s legal counsel to the Subcommittee, at 2.

<sup>1024</sup> See, e.g., 12/31/04 internal Wyly financial report entitled, “Family Offshore” (HST\_PSI006889)(under entry for “SW Foreign Total Family FMV”); 12/31/04 internal Wyly financial report for Lake Providence (HST\_PSI006906).

<sup>1025</sup> See, e.g., 12/31/04 internal Wyly financial report entitled, “Family Offshore” (HST\_PSI006889)(under entry for “CW Foreign Total Family FMV”); 12/31/04 report on “Global Family (SW & CW)” (PSI\_ED00095229).

<sup>1026</sup> See, e.g., 1999 Scottish Annuity & Life Holdings Annual Report; “Scottish Re: Presentation to the Permanent Subcommittee on Investigations” (4/18/00) at 54; undated chart entitled “Scottish Annuity & Life Holdings, Ltd. Private Placement Transactions” (SCREPSI000423-25)(listing shares and warrants issued in June and October 1998).

<sup>1027</sup> See “Scottish Re: Presentation to the Permanent Subcommittee on Investigations” (4/18/00) at 54; undated chart entitled “Scottish Annuity & Life Holdings, Ltd. Private Placement Transactions” (SCREPSI000423-25)(listing shares and warrants issued in June and October 1998).

<sup>1028</sup> 3/30/99 10-K filed by Scottish Annuity & Life Holdings, at 11.

Another 460,000 shares were purchased by one of the Maverick offshore funds, Maverick Fund LDC. It is unclear how much the Wyly-related offshore entities paid in total for these shares and warrants.<sup>1029</sup> Mr. French and his IOM trust, South Madison, also received substantial shares, options, and warrants.

During the initial public offering itself, about 16.7 million shares were sold to the investing public.<sup>1030</sup> Maverick used \$10 million to buy over 700,000 shares and 200,000 warrants from Scottish.<sup>1031</sup> Over the next three months, Maverick spent another \$11 million in open market transactions to buy an additional 979,000 shares, for a combined total of \$21 million. By April 2000, Sam and Charles Wyly owned about 9.5 percent of the company directly and an additional 9.1 percent was held by Maverick.<sup>1032</sup> Mr. French became Chairman of the Board and Chief Executive Officer of Scottish Annuity & Life Holdings. From 1998 to 2000, Sam and Charles Wyly served as directors of that company, as did David Matthews, Sam Wyly's son-in-law, and Duke Buchan, then a managing director of Maverick Capital Ltd. These five individuals then formed a majority of the eight-person board.

In 2000, Mr. French and the Wyllys severed their business relationships.<sup>1033</sup> Mr. French continued as Chairman of the Board and Chief Executive of the Scottish Re Group, while resigning his positions as trust protector of the Wyly-related offshore trusts, director of Michaels Stores, and legal counsel to the Wyly family. He also gave up his ownership interest in Maverick. Sam and Charles Wyly had already resigned from the Scottish Re Group board earlier in 2000, and they stopped participating in Scottish Re's management.

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<sup>1029</sup> See, e.g., 3/30/99 10-K filed by Scottish Annuity & Life Holdings, at 11-15 (listing securities sales in October 1998 to Audubon, Soulieana, Maverick Fund LDC); 1999 Scottish Annuity & Life Holdings Annual Report, at 45 (showing Class A warrants to purchase a total of 1,550,000 shares at \$15 per share were issued to related parties in June 1998, in exchange for consideration totaling \$100,000; the report states: "The Class A warrants were issued ... at the initial stage of the development of our business plan when the feasibility of proceeding with the offering was uncertain. The consideration paid for the Class A warrants was determined to be fair value in the judgement of management in light of such uncertainty."); 6/17/98 fax from Ms. Boucher to Evan Wyly (SR0000752)(indicating 750,000 warrants to be purchased by the Bessie and Tyler Trusts would cost about \$48,000).

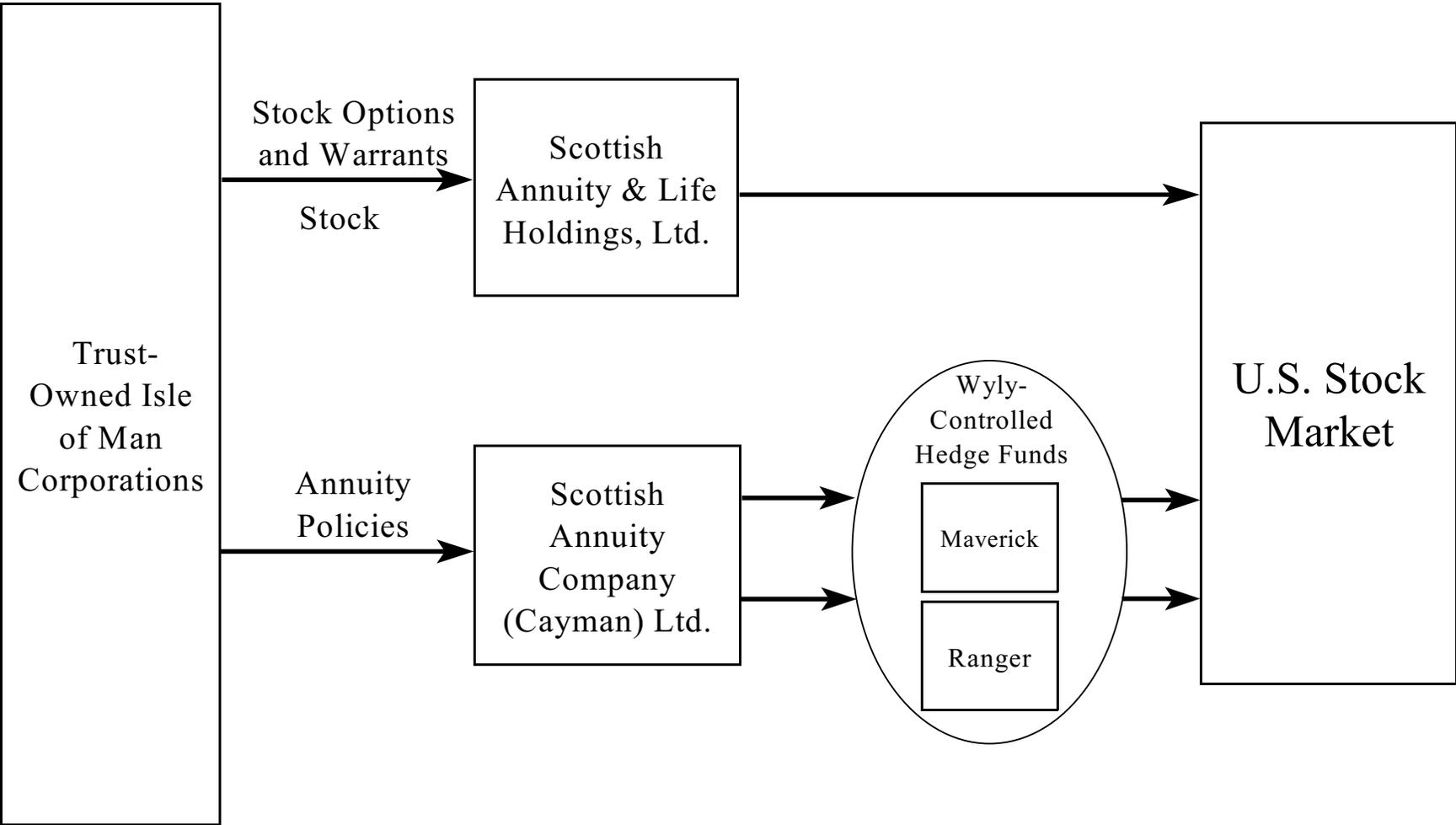
<sup>1030</sup> 1999 annual report filed with the SEC by Scottish Annuity & Life Holdings Ltd. at 45.

<sup>1031</sup> 3/23/06 Maverick letter to the Subcommittee, at 3. Presumably, all of these client funds were associated with the Wyllys. See also "Scottish Re: Presentation to the Permanent Subcommittee on Investigations" (4/18/00) at 54.

<sup>1032</sup> See, e.g., 5/1/00 DEF 14A filed with the SEC by Scottish Annuity & Life Holdings, at 7; 12/31/99 Schedule 13G/A filed with the SEC by Maverick Capital Ltd. relating to Scottish Annuity & Life Holdings.

<sup>1033</sup> The Wyllys and Mr. French signed an agreement to "sever all direct and indirect business and professional relationships between French and the Wyllys, to resolve all claims that French has asserted against the Wyllys, and to forever end all disputes between French and the Wyllys." See 12/21/00 "Settlement Agreement and Mutual Release" (F000282-89). The agreement did not explicitly mention Scottish Re.

# Using an Offshore Insurance Company to Invest Offshore Dollars in U.S. Securities



After the Wylys decided to withdraw from Scottish, the Wyly-related offshore entities began to sell their shares. Ms. Boucher kept Sam and Evan Wyly informed about these sales.<sup>1034</sup> In addition, by June 2001, Maverick sold virtually all of the Scottish shares it had purchased. During May 2003, Maverick exercised its clients' Scottish warrants at an aggregate exercise price of \$3 million and sold the shares for about \$3.8 million. By the end of 2004, offshore entities associated with Sam Wyly retained warrants to buy Scottish stock valued at about \$13.2 million, while offshore entities associated with Charles Wyly retained warrants to buy Scottish stock valued at about \$6.6 million, for a combined total of about \$19.8 million.<sup>1035</sup>

#### **(d) Investing Offshore Dollars in An Energy Company**

The final example of a business venture funded with Wyly-related untaxed, offshore dollars involves a specific U.S. corporation, rather than a hedge fund, investment company, or insurance venture that used the offshore funds to make other investments. Green Mountain Energy Company is a U.S. energy business, incorporated in Delaware, that captured the attention of the Wyly family in 1997, and is still in operation today.<sup>1036</sup> The company has lost money every year since its inception. Nevertheless, from 1997 when the Wylys first acquired an ownership interest in the company until the present time, Wyly-related offshore entities have supplied Green Mountain with at least \$175 million in offshore dollars.

Wyly family members, including Sam and Evan Wyly, actively participated in Green Mountain's management and directed millions of dollars from the Wyly-related offshore entities into this business venture. These funds continued to flow into Green Mountain even after audit reports questioned the viability of the venture, and the offshore trustees expressed concerns about the value of the investment. That the offshore trusts continued to transfer substantial sums to Green Mountain, despite years of loss, is added evidence of Wyly influence over the offshore dollars.

**Offshore Dollars.** Since August 1997, Wyly-related offshore entities have supplied the bulk of funds used to finance Green Mountain, sustaining the company through years of unprofitability. The total amount supplied from offshore is unclear, due to the complexity of the funding flows, several restructurings, and the fact that some investments have been written off. The evidence indicates that, at a minimum, the offshore entities financed most of the initial \$30

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<sup>1034</sup> See, e.g., 5/23/01 email from Ms. Boucher to Sam and Evan Wyly (PSI00088927).

<sup>1035</sup> See 12/31/04 internal Wyly financial report entitled, "Family Offshore" (HST\_PSI006889)(under entries for "SW Foreign Total Family FMV," "CW Foreign Total Family FMV," and "Total Scottish Annuity").

<sup>1036</sup> Green Mountain Energy Company has operated under several names since its inception. It began as Green Mountain Energy Resources, Inc.; became Green Mountain Energy Resources, LLC; briefly operated as Greenmountain.com Company; and then assumed its current name of Green Mountain Energy Company. For purposes of consistency, this Report will refer to this business venture simply as Green Mountain.

million funding commitment in 1997,<sup>1037</sup> as well as a little more than half of a second \$30 million funding commitment in 1998.<sup>1038</sup> They financed all of a \$22 million non-recourse loan to Green Mountain in 1999,<sup>1039</sup> and provided an additional \$7 million in capital in 2000.<sup>1040</sup> The offshore entities continued to supply funds to Green Mountain, even after an April 2002 Andersen audit questioned the company's ability to continue as a going concern. In the year following this audit, the offshore entities sent Green Mountain an additional \$19.3 million.<sup>1041</sup> By September 2003, internal Wyly financial records show that the Wyly-related offshore investments in Green Mountain totaled about \$175 million.<sup>1042</sup>

Using various financial records, the Subcommittee was able to trace about \$128 million in transactions that resulted in Wyly-related offshore funds being transferred to Green Mountain between August 1997 and June 2003. These offshore funds appear to have been provided either as capital contributions or as offshore "loans" to Green Mountain. About \$68 million of the \$128 million traced by the Subcommittee appears to have been provided as capital contributions, while the remaining \$60 million appears to have been transferred via pass-through loans from Security Capital or another Wyly-related entity, Green Funding I, explained below. These transactions help illustrate the magnitude of the offshore dollars provided to Green Mountain and the specific ways in which offshore funds were transferred into the United States.

The transactions traced by the Subcommittee show that offshore dollars provided to Green Mountain were routed through a complex funding structure that changed over time. Three

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<sup>1037</sup> See, e.g., Locke's transfer of \$18 million (CC022566) and \$3.7 million (CC022572); Roaring Creek's transfer of \$1.2 million (CC016377); and Roaring Fork's transfer of \$1.8 million (CC016626). These entities contributed a total of \$24.8 million in 1997.

<sup>1038</sup> See, e.g., East Carroll's transfer of \$2.2 million (CC20008); Roaring Fork's transfer of \$1.5 million (CC016765); and Dortmund's transfer of \$341,607 (CC018933). See also loans made by Richland (\$5.5 million), Morehouse (\$4.5 million), and East Carroll (\$1.5 million) to provide financing to Green Mountain Energy Resources, LLC, through Security Capital. In total, in 1998, these entities contributed \$15.5 million to Green Mountain, of which \$11.5 million was supplied through Security Capital loans. For more information about the Security Capital loans to Green Mountain, see Appendix 4.

<sup>1039</sup> See, e.g., 5/3/99 email from Elaine Spang to Ms. Hennington (HST\_PSI005574) ("Sam signed a letter authorizing Green Funding I to loan greenmountain.com \$22,000,000 under a non-recourse loan.... [A]n offshore entity will loan the funds to Green Funding I under a similar non-recourse loan, and GFI will turn the funds around to gm.com."). The funds were supplied to Green Mountain over the following seven months.

<sup>1040</sup> See, e.g., 3/29/00 email from Evan Wyly to Ms. Boucher and others (PSI00037501) ("Sam recommends fulfilling the Green Mountain request for \$7 million for April. ... Sam recommends investing whatever remaining balance that other investors do not take of the \$50 million. Charles will be contacting you regarding participation.").

<sup>1041</sup> See discussion below.

<sup>1042</sup> Of the \$175 million, about \$156 million was attributed to Sam Wyly's family and about \$18 million to Charles Wyly's family. See 9/30/03 financial statement entitled, "Global Family (SW & CW)" (PSI\_ED00093878-83)(including entries under "SW Foreign Total Family FMV," and "CW Foreign Total Family FMV" at PSI\_ED00093883).

interlocking companies played key roles: GMP Holdings Ltd., which appears to be a Cayman corporation; Green Funding I LLC (GFI), a Delaware limited liability company; and Green Funding II LLC (GFII), another Delaware limited liability company.

These three companies appear to have had complex ownership structures, all ultimately traceable to Wyly-related entities, primarily the Wyly-related offshore trusts and corporations. GMP Holdings, for example, appears to have been owned by more than ten Wyly-related IOM corporations, each of which supplied it with funds, including Elegance, Devotion, Dortmund, Greenbriar, Little Woody, Locke, Morehouse, Richland, Roaring Creek, Roaring Fork, and Rugosa.<sup>1043</sup> GFI originally had three owners: Maverick USA Corp., a Delaware corporation; EB&M Holdings, Ltd., a Cayman corporation; and GFII.<sup>1044</sup> Maverick USA Corp. was owned by Maverick Capital Ltd., the Texas limited partnership whose ownership was ultimately traceable to Sam and Charles Wyly.<sup>1045</sup> EB&M Holdings was owned by Maverick Fund LDC, one of Maverick's offshore funds in the Cayman Islands.<sup>1046</sup> In 2000, GFI's three owners resigned and were replaced by Moberly, an IOM corporation associated with Sam Wyly.<sup>1047</sup> Finally, GFII, which has been described as "an investment vehicle controlled by the Wyly family,"<sup>1048</sup> appears to have been owned by GMP Holdings and several domestic Wyly entities, including domestic trusts benefiting two of Sam Wyly's children<sup>1049</sup> and Green Funding Corporation.<sup>1050</sup> Green Funding Corporation is a Delaware corporation whose directors have included Sam and Evan Wyly. (HST\_PSI005363)

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<sup>1043</sup> See 4/13/99 fax from Chris Butner of Jones Day to Ms. Robertson on "Unit Distribution" of Greenmountain.com Company (PSI-WYBR00516-19)(listing the number of "units" that GMP Holdings would distribute to these IOM corporations)(hereinafter "Jones Day letter").

<sup>1044</sup> 8/6/97 Operating Agreement of Green Funding I, LLC (BA060725-45).

<sup>1045</sup> See discussion of Maverick Capital Ltd., above.

<sup>1046</sup> Subcommittee interview of Maverick (2/2/06).

<sup>1047</sup> See 6/8/00 Third Amendment to the LLC Agreement for Green Funding I LLC (BA PSI-W013658-62) (enabling GFI members to resign at any time and providing that no member that resigns may withdraw any of its capital contributions to Green Mountain); 6/9/00 Fourth Amendment to the LLC Agreement of Green Funding I LLC (BA PSI-W013653-57)(adding Moberly as a member and allowing GFII, Maverick USA, and EB&M Holdings to resign). Moberly sent \$14 million to Green Funding I on 6/15/00 (See BA PSI-W016710-11).

<sup>1048</sup> See 1999 Greenmountain.com prospectus (HST\_PSI066481).

<sup>1049</sup> See Jones Day letter (PSI-WYBR00516)(listing number of "units" that GFII would distribute to two of the trusts of Sam's children).

<sup>1050</sup> See Jones Day letter (PSI-WYBR00516-18)(listing number of "units" that Green Funding Corp. would distribute to Sam Wyly, Evan Wyly, and five trusts belonging to his wife and three children).

The majority of the offshore funds sent to Green Mountain flowed through Green Funding I (GFI), according to the bank records reviewed by the Subcommittee.<sup>1051</sup> According to GFI's operating agreement, "the business and affairs of the Company shall be managed under the direction of, the Managers," who are identified as Sam and Evan Wyly. This agreement enabled Sam and Evan Wyly, as GFI managers, to exercise control over the majority of the offshore funds sent to Green Mountain, since the bulk of those funds flowed through GFI first.

The offshore funds followed several paths, which simplified over time. In the earliest and most complex pathway, the offshore funds were transferred by offshore corporations to GMP Holdings, which, in turn, transferred them to GFII, which then transferred them to GFI, which finally transferred them to Green Mountain. The Subcommittee was able to trace about \$29 million that flowed in this manner between August 1997 and November 1998.<sup>1052</sup> In the second pathway, the funds went from offshore corporations to GMP Holdings, then to GFII, and then to Green Mountain, bypassing GFI. The Subcommittee identified \$10 million flowing in this manner during February 1999.<sup>1053</sup> In the third variation, funds went from offshore corporations, directly to GFI, and then to Green Mountain. The Subcommittee identified about \$74 million that was transferred in this manner from June 1999 to June 2003.<sup>1054</sup> Also during this time period, the Subcommittee identified two offshore corporations which transferred funds totaling about \$4 million directly to Green Mountain.<sup>1055</sup> Finally, in three transactions that took

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<sup>1051</sup> Out of the \$128 million traced by the Subcommittee, for example, about \$107 million or 80 percent passed through GFI before reaching Green Mountain Energy Company.

<sup>1052</sup> Specifically, during this time period, GMP Holdings received about \$21.8 million from Locke, \$3.3 million from Roaring Fork, and a total of about \$3.7 million from East Carroll, Roaring Creek, and Dortmund. See, e.g., account statements relating to these transactions (CC016377, CC016626, CC016765, CC018933, CC020008, CC022566-67, CC022572).

<sup>1053</sup> Specifically, in February 1999, GMP Holdings received \$3 million from Little Woody, \$2 million from Rugosa, and \$5 million from Greenbriar. See, e.g., account statements relating to these transactions (CC016545, CC021711, CC022330).

<sup>1054</sup> For example, from June 1999 through February 2000, GFI received about \$13.8 million from Richland. See account statements relating to these transactions (CC022948, CC023469, BA PSI-W016700-02). From June 1999 through June 2003, GFI received about \$8.26 million from Morehouse. See account statements relating to these transactions (CC023360, CC023373, CC023465, BA PSI-W016744). From March 2000 through June 2003, GFI received about \$39.5 million from Moberly. See account statements relating to these transactions (CC023670, BA PSI-W016706, CC023630, BA PSI-W016731, BA PSI-W016738, BA PSI-W016738, 42, 44). From November 2002 through December 2002, GFI received about \$3.6 million from Devotion. See documents relating to these transactions (BA042538 and PSI00038936).

<sup>1055</sup> East Carroll wired about \$1.6 million and Quayle wired about \$2.5 million directly to Green Mountain Energy Company. See account statements relating to these transactions (CC024015, CC020002-03).

place during 1998, about \$11.5 million in offshore funds traveled from offshore corporations to Security Capital to Green Mountain.<sup>1056</sup>

Several of these transactions involved the provision of loans by the Wyly-related offshore entities, either directly to Green Mountain or through back-to-back wire transfers involving GFI or Security Capital. In 2003, for example, an internal Wyly financial record listed five loans to GFI totaling about \$53 million, including a \$42 million loan from Morehouse, a \$3.7 million loan from Moberly, another \$3.7 million loan from Morehouse, and \$3.7 million in loans from Devotion.<sup>1057</sup> All five loans apparently carried interest rates of 9 percent. By the end of 2004, the outstanding loans to GFI totaled about \$66 million.<sup>1058</sup> According to another internal Wyly record, after receiving these loans, GFI appears to have subsequently made corresponding loans to Green Mountain.<sup>1059</sup>

These offshore dollars were provided in response to funding needs identified by Wyly family members, such as Evan Wyly who worked on the Green Mountain venture; funding requests made by Wyly representatives; or cash flow projections developed by Green Mountain.<sup>1060</sup> Sam Wyly also made funding decisions and commitments in his capacity as a manager of GFI.<sup>1061</sup> After being informed of the amount of money needed in each instance, the trust protectors worked with the IOM trusts to identify available funds and arrange for one or more of the IOM corporations to wire cash to Green Mountain.<sup>1062</sup>

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<sup>1056</sup> Specifically, in August 1998, Richland loaned \$5.5 million and Morehouse loaned \$4.5 million to Security Capital which made a \$10 million loan to Green Mountain Energy Company. In October 1998, East Carroll loaned \$1.5 million to Security Capital, which loaned the money to Green Mountain. For more information about these transactions, see Appendix 4.

<sup>1057</sup> See 1/1/03 chart listing loans to GFI (PSI\_ED00033156-63).

<sup>1058</sup> Id.

<sup>1059</sup> See undated chart entitled, “Green Mountain Energy Company Accrued Interest - Long Term Loan - Green Funding” (PSI\_ED00035472-75)(listing loans from GFI to Green Mountain Energy Company).

<sup>1060</sup> See, e.g., 2/23/00 email from Evan Wyly to Ms. Boucher, Ms. Robertson, and IFG (PSI\_ED00046890)(forwarding projected cash flow needs from Scott Cannon, Green Mountain chief financial officer); 3/29/00 email requesting \$7 million (PSI00037501); 6/28/01 email from Evan Wyly to Ms. Hennington and Ms. Boucher on “Green Mountain” (PSI\_ED00006169-70)(Evan wrote: “Sam is considering a \$5 million investment .... How do his sources of cash look?”; to which Ms. Boucher responded: “Assuming it will come from offshore, we should be okay.”).

<sup>1061</sup> See, e.g., 5/3/99 email from Elaine Spang of the Wyly family office to Ms. Hennington (HST\_PSI005574)(“I just learned that Sam signed a letter authorizing Green Funding I to loan greenmountain.com \$22,000,000 under a non-recourse loan. My understanding is that an offshore entity will loan the funds to Green Funding I under a similar non-recourse loan, and GFI will turn the funds around to gm.com.”).

<sup>1062</sup> See, e.g., 11/19/98 fax from Mr. French and Ms. Robertson to IFG (PSI\_ED00042897); 3/6/00 email from Ms. Boucher to IFG with copy to Ms. Robertson (MAV007958)(“As per the recent cash flow projections, the protectors recommend that you make arrangements for the \$6.5M funding for March to be paid over to Green

**Financial Losses.** Despite the millions of dollars supplied by Wyly-related parties and others, Green Mountain was not a profitable venture. According to an SEC filing, for example, during 1998, the company generated revenues of \$1.5 million and incurred net losses of \$46 million, and expected to “incur net losses in 1999 and subsequent fiscal periods.”<sup>1063</sup> In April 2002, a financial audit report issued by the Arthur Andersen accounting firm determined that Green Mountain had “not generated positive cash flows from operations since inception,” and expressed “substantial doubt about the Company’s ability to continue as a going concern.”<sup>1064</sup> In October 2004, another audit report, this one by PricewaterhouseCoopers, echoed the Arthur Andersen report, saying that Green Mountain has continued to incur “losses and negative cash flows from operations since inception and has a net capital deficiency which raise substantial doubt about the Company’s ability to continue as a going concern.”<sup>1065</sup>

At one point, one offshore trustee, IFG, expressed concern about sending funds to a company that kept losing money. In 1999, Ms. Robertson wrote: “D. Harris [managing director of IFG] has been raising hell about the money going into Green Mountain[.] It’s not that I don’t think he should be, just adds one more stress level. Currently he has agreed to fund through Sept[ember.] ... Surprisingly, Sam did not explode, but it actually seemed to cause him to step back and re-think the money is [sic] spending. We’ll see what happens.”<sup>1066</sup> Sam and Evan Wyly apparently spoke personally with IFG.<sup>1067</sup> Afterward, the offshore trusts administered by IFG continued to transfer funds to Green Mountain year after year. In the year following the negative 2002 Andersen audit report, for example, the Wyly-related offshore corporations sent Green Mountain an additional \$19.3 million.

Not all Wyly-related interests, however, continued to invest. In 2001, Quayle, an IOM corporation associated with Charles Wyly, apparently stopped sending funds and instead indicated a desire to sell its Green Mountain interests. A May 2001 email from Charles Wyly to

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Funding 1 at your earliest convenience. I suggest that you make arrangements to utilize funds on hand at Moberly Limited with Bank of Bermuda, as well as those that were realized on the recent SSW swap reset.”); 3/17/00 email from Ms. Boucher to IFG and Trident (PSI\_ED00047907)(requesting offshore funds to enable GMP Holdings to pay director fees and legal expenses).

<sup>1063</sup> 3/29/99 S-1 filed with the SEC by Greenmountain.com, at 4.

<sup>1064</sup> “Green Mountain Energy Company Financial Statements as of December 31, 2001 Together with Auditors’ Report” (PSI\_ED00014537-56).

<sup>1065</sup> “Green Mountain Energy Company Financial Statements as of December 31, 2003 and 2002” (MAV013233-60).

<sup>1066</sup> 8/18/99 email from Ms. Robertson to Ms. Boucher (PSI-WYBR00529).

<sup>1067</sup> See, e.g., 1/4/00 email from Evan Wyly to Ms. Robertson (PSI\_ED0070074)(stating that Sam and Evan Wyly would like to meet with David Harris of IFG about Green Mountain when Mr. Harris was in Dallas the following week); 4/25/00 email from Evan Wyly and IFG (PSI\_ED00048130-32)(showing Evan Wyly answering IFG questions about Green Mountain); 4/1/03 emails among Evan Wyly, David Harris, and Ms. Boucher (PSI\_ED00011922-26)(showing Evan Wyly answering IFG questions about Green Mountain).

Dennis Kelly, then Green Mountain CEO, stated: “Quayle Limited would like to proceed with the sale of all or any portion of its investment. I would appreciate your contacting existing shareholders to see if they have an interest now. Alternatively, Quayle would like to be a selling shareholder in the next planned financing. We are pleased with the growth and progress and outlook for Green Mountain. This simply is no longer a strategic holding for Quayle.”<sup>1068</sup> This email shows that Charles Wyly was making investment decisions for Quayle. It also shows that he was, in effect, directing the use of untaxed funds that he had placed offshore, brought back onshore to invest in Green Mountain, and then wished to deploy elsewhere.

In addition to the Wyly-related offshore entities, from the inception of this undertaking in 1997, Maverick also contributed substantial funds to Green Mountain, using both domestic and offshore dollars. Maverick spent about \$40 million to purchase both common and preferred stock in Green Mountain, becoming a major shareholder. It also purchased Green Mountain debt securities totaling about \$4.2 million. Altogether, by the end of 2004, Maverick’s contributions to Green Mountain totaled about \$46 million.<sup>1069</sup> Ms. Robertson, Maverick’s chief financial officer, told the Subcommittee that, by the end of 2004, Maverick had stopped investing in Green Mountain, but retained substantial shares and promissory notes. She indicated that, at that time, Maverick had marked down the market value of Green Mountain’s stock to zero.<sup>1070</sup>

The Wylys also invested domestic dollars in Green Mountain, reported substantial investment losses to the IRS, and used those losses to offset other U.S. income.<sup>1071</sup> It is unknown what role, if any, was played by the offshore dollars that provided the bulk of Green Mountain’s financing.

**Green Mountain Ownership and Management.** Wyly-related ownership of Green Mountain began in 1997 and continues to the present time. In 1997, Green Mountain Power Corporation, a Vermont electric utility, sought investors to inject capital into a business venture undertaken to establish an energy distribution company that would buy electricity from environmentally friendly, renewable sources, and sell it to residential customers. In August 1997, the Wylys provided \$30 million in exchange for 67 percent of Green Mountain’s

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<sup>1068</sup> 5/11/01 email from Charles Wyly to then Green Mountain CEO, Dennis Kelly (PSI\_ED00084054).

<sup>1069</sup> 3/23/06 Maverick letter at 5.

<sup>1070</sup> Subcommittee interview of Ms. Robertson (3/9/06). Maverick told the Subcommittee that, today, it holds about 12 percent of Green Mountain Energy Company’s outstanding stock. 3/23/06 Maverick letter at 6.

<sup>1071</sup> See, e.g., Wyly v. Commissioner, No. 122-04 (U.S. Tax Court, March 8, 2005).

shares.<sup>1072</sup> According to Ms. Robertson, this investment was “Sam’s idea.”<sup>1073</sup> In 1998, the Wyls invested another \$30 million, gaining control over 99 percent of the stock.<sup>1074</sup> In January 1999, the Wyls bought the final 1 percent of Green Mountain’s stock from the Vermont utility for \$1 million.<sup>1075</sup> In late January, Green Mountain was converted from an LLC into a corporation called Greenmountain.com Company, and management announced plans to take the company public.<sup>1076</sup>

Despite this announcement, Green Mountain never actually went public. According to a subsequent SEC filing, the company ceased all activities in connection with the proposed public offering in late June 1999, due to negative “market conditions,” but did not notify the SEC at that time in the hope that market conditions would improve. On May 8, 2000, Green Mountain formally withdrew its registration statement, indicating to the SEC that it did not anticipate going forward with a public offering in the immediate future.<sup>1077</sup>

In June 1999, the three largest shareholders of Green Mountain were Locke, an IOM corporation associated with Sam Wyly, which held 6.5 million shares or 25 percent of Green Mountain’s common stock; Maverick Capital Ltd., which held 4.2 million shares or about 16 percent of the common stock (plus 78,000 stock options); and Sam Wyly, who held about 2

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<sup>1072</sup> See, e.g., 8/14/97 10-Q filed with the SEC by Green Mountain Power Corporation (“[O]n 8/6/97, GMRI entered into an agreement with Green Funding I, LLC, an affiliate of the Sam Wyly Family, which acquired a 67 percent membership interest in [Green Mountain].” “Green Funding I, LLC (the Investor) ... has agreed to invest up to \$30 million in [Green Mountain] in exchange for an equity interest of 67 percent.”).

<sup>1073</sup> Subcommittee interview of Ms. Robertson (3/9/06). See also Subcommittee interviews of Michael French (4/21/06)(an investment banker had brought the company to Sam Wyly’s attention; Sam and Evan Wyly led initial negotiations), and Maverick (2/2/06)(“Sam Wyly helped launch the company”).

<sup>1074</sup> See, e.g., 3/27/98 10-K filed with the SEC by Green Mountain Power Corporation (“An affiliate of the Sam Wyly Family, Green Funding I, LLC... agreed to invest... an additional \$10 million in [Green Mountain], increasing its ownership percentage to 74.3 percent.”); 3/29/99 S-1 filed with the SEC by Greenmountain.com (“On 11/20/98, Green Funding I committed to an additional \$20 million to the LLC... raising Green Funding I’s total equity interest to approximately 99 percent.”).

<sup>1075</sup> 1/8/99 8-K filed with the SEC by Green Mountain Power Corporation (“GMP has agreed ... [to] the sale of GMRI’s interest in [Green Mountain] in return for payment of \$1 million.”); 3/29/99 S-1 filed with the SEC by Greenmountain.com (“As of January 1999, Green Funding I owned 100 percent of the equity interests in [Green Mountain].”).

<sup>1076</sup> 3/29/99 S-1 filed with the SEC by Greenmountain.com (“Since 8/97, entities controlled by the Wyly Family have invested more than \$70 million in our company.” “Between 8/97 and 12/98, Green Funding I, LLC, an investment vehicle controlled by the Wyly Family, contributed to us a total of \$60 million.”). See also 10/15/99 draft settlement agreement and mutual release related to the employment of David White as Green Mountain CEO (PSI-WYBR00561)(discussing, in part, the structure of Green Mountain).

<sup>1077</sup> 5/8/00 RW (Registration Withdrawal Request) filed with the SEC by Greenmountain.com (“As a result of market conditions, the Company ceased all activities in connection with the proposed public offering in late June 1999.”). Apparently, Green Mountain Energy Company was unable to arouse sufficient interest in the investing public to purchase its shares.

million shares or 8 percent of the common stock (plus 200,000 stock options).<sup>1078</sup> Together, these three blocks of shares represented more than 47 percent of the company's common stock. As of early 2005, about 36 percent of the shares of Green Mountain are held by Wyly-related domestic and offshore interests and another 12 percent by Maverick.<sup>1079</sup>

In addition to gaining control of Green Mountain's shares and providing it with substantial capital, Wyly family members were ongoing, active participants in Green Mountain's management. Green Mountain's 1999 filing with the SEC, for example, in which it signaled its intent to go public, stated that, "Our management team is led by Sam Wyly, our Chairman." The filing listed not only Sam as chairman and a director, but also his son, Evan, as vice-chairman and a director, and his daughter, Lisa Wyly, as another director.<sup>1080</sup> Over the years, Sam and Evan played key roles in obtaining financing for Green Mountain, not only from the offshore entities as explained earlier, but also from Maverick,<sup>1081</sup> and two major energy companies, BP Amoco and Nuon, a Dutch utility.<sup>1082</sup>

#### **(e) Analysis of Issues**

The five business ventures examined by the Subcommittee show how more than \$500 million in untaxed, offshore dollars were transferred by the Wyly-related offshore entities to business ventures of interest to Sam and Charles Wyly. In these instances, more than \$250 million was invested in the Wyly-related hedge funds, Maverick and Ranger. About \$43 million went to First Dallas, a private investment fund controlled by Charles Wyly and his sons-in-law. Another \$20 million in capital contributions and loans went to the offshore insurance company, Scottish Annuity (Cayman), which was then controlled by the Wyllys. Another \$14 million was placed in SAC annuity policies and turned over to Maverick or Ranger for investment. More than \$175 million in offshore funds was transferred to Green Mountain, a U.S. energy company acquired by the Wyllys.

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<sup>1078</sup> See 6/1/99 draft prospectus for Green Mountain's initial public offering (HST\_PSI066378, 454-55).

<sup>1079</sup> 1/3/05 chart entitled, "Green Mountain Equity Structure" (PSI00079618); 3/10/06 Green Mountain "Information and Proxy Statement" (PSI00138719); 3/23/06 Maverick letter at 6.

<sup>1080</sup> 3/29/99 S-1 filed with the SEC by Greenmountain.com. See also, e.g., "The View from Green Mountain: Financier Mixes Business, the Environment, and Politics," New York Times (3/16/00).

<sup>1081</sup> See, e.g., 11/1/02 email from Evan Wyly, asking whether Maverick is able to provide a \$1 million guarantee for Green Mountain Energy Company (PSI\_ED00011174-75).

<sup>1082</sup> See, e.g., emails between Evan Wyly and David Harris of IFG on 11/23/99 (PSI\_ED00069565) and 12/20/99 (PSI\_ED00069934), and between Sam Wyly, Evan Wyly, and Matt Cheney of Nuon USA on 5/22/02 (MAV012945) (discussing the negotiations).

The general pattern presented by these business ventures is additional evidence that the Wyls and their representatives were directing the use of offshore assets. In each instance, Sam and Charles Wyly initiated the investment, the trust protectors communicated funding needs to the offshore trustees, and the offshore trustees complied. The trust protectors identified no instance in which a trustee initiated a business investment on its own, and no instance in which a trustee actually declined to supply requested funding. Moreover, the businesses that received the offshore funds were ones in which the Wyls exercised significant management control which allowed them to further direct the use of the offshore dollars.

## **(6) Funneling Offshore Dollars Through Real Estate**

During the thirteen years examined in this Report, tens of millions of untaxed, offshore dollars were used to acquire, improve, and operate U.S. real estate properties used by the Wyls for personal residences or business ventures. The Subcommittee analyzed in detail five real estate properties that received offshore dollars totaling about \$85 million. In the case of new real estate, Wyly family members chose the properties, initiated construction or renovation efforts to render the property suitable to their needs, and made personal use of the real estate. In other instances, Sam or Charles Wyly used real estate they already controlled to arrange sham real estate sales or loans that brought millions of offshore dollars into the United States for the personal use of Wyly family members. In each instance examined by the Subcommittee, the real estate transactions were initiated by the Wyls and agreed to by the offshore trustees. Two trust protectors told the Subcommittee that they could recall no instance where an offshore trustee had initiated a real estate transaction or had declined to carry out a real estate transaction recommended to them.<sup>1083</sup> These real estate transactions offer additional proof of the extent to which the Wyls were directing the use of trust assets.

The five real estate properties also demonstrate the key role played by legal, financial, and other professionals in bringing untaxed, offshore dollars into the United States to advance Wyly-related interests. In each instance, legal advisers designed complex structures, involving layers of Isle of Man and U.S. shell entities, trusts, and financial accounts, to acquire, improve and operate the real estate. These structures were used to finance 90 percent or more of the U.S. real estate costs with offshore dollars. In some instances, offshore dollars were funneled through sham real estate sales or loans to supply funds for the personal use of Wyly family members. In every instance, U.S. financial institutions facilitated the transactions by authorizing frequent, multi-million-dollar wire transfers from offshore jurisdictions into the United States.

### **(a) Real Estate Transactions in General**

From 1992 to 2005, multiple U.S. real estate properties used by Sam and Charles Wyly for personal residences or business ventures were funded in whole or in substantial part with

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<sup>1083</sup> Subcommittee interviews of Mr. French (4/21/06) and Ms. Robertson (3/9/06). Ms. Hennington had the same recollection. Subcommittee interview of Ms. Hennington (4/26/06).

offshore dollars.<sup>1084</sup> The properties examined here include a \$45 million 244-acre ranch near Aspen, Colorado, known as Rosemary's Circle R Ranch, containing a half dozen residences built for the Sam Wyly family; a \$9 million 26-acre ranch near Aspen, sometimes referred to as the LL Ranch, containing an 8,000 square foot residence used by the Charles Wyly family; a \$13 million set of condominiums in downtown Aspen operating as Cottonwood Ventures and containing, in part, art galleries run by Sam Wyly's daughter; a \$12 million 95-acre ranch near Dallas, Texas, known as Stargate Horse Farms, run by Charles Wyly's daughter; and an \$8 million oceanside property in Malibu, California, owned by Sam Wyly until 2002.<sup>1085</sup> While each of these real estate transactions had unique characteristics, all had common elements regarding the property's ownership structure and the financial mechanisms used to obtain offshore funding.

The structures used to acquire and finance the five real estate transactions were designed by legal counsel, in particular Rodney Owens, a partner at Meadows, Owens, Collier, Reed, Cousins & Blau LLP (Meadows Owens), a Texas law firm that provided tax and real estate advice to the Wyly family.<sup>1086</sup> Meadows Owens told the Subcommittee that the structures were the result of an indepth research effort by Mr. Owens and others to design an innovative means to ensure Wyly access to properties being financed primarily with offshore funds.<sup>1087</sup> Numerous emails discussing the real estate transactions refer to Mr. Owens or Meadows Owens, and indicate that legal counsel was being consulted with respect to the real estate transactions.<sup>1088</sup> To

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<sup>1084</sup> The real estate properties examined in this Report are limited to those funded in whole or substantial part with offshore dollars; the Report does not discuss Wyly-related real estate properties that appear to have been funded primarily with domestic funds.

<sup>1085</sup> Additional properties used by the Wyly family also appear to have been funded primarily with offshore dollars. Due to resource constraints, however, detailed analysis will be confined to the five properties to illustrate the issues involved in offshore funding of U.S. real estate. Two of these examples, involving Rosemary's Circle R Ranch and the LL Ranch, are examined here; the remaining three, involving Cottonwood Ventures, Stargate Horse Farm, and the oceanside property in Malibu, are presented in Appendix 5.

<sup>1086</sup> Subcommittee interviews of Meadows Owens (4/27/06 and 7/7/06); Ms. Robertson (3/9/06); discussions with legal counsel currently representing the Wylys. Mr. Owens provided legal advice to the Wyly family from 1997 until 2001. In 2003, Mr. Owens died of ill health. Other Meadows Owens lawyers who helped to advise the Wyly family include Charles Pulman, Alan Stroud, and Tray Cousins.

<sup>1087</sup> Subcommittee interview of Meadows Owens (7/7/06). Meadows Owens told the Subcommittee that a lengthy legal memorandum was produced describing the real estate structure, but declined due to attorney-client privilege to provide the Subcommittee with a copy.

<sup>1088</sup> See, e.g., 9/10/99 telephone message for Charles Wyly (HST\_PSI001136) ("Shari said NationsBank is ready to go on Little Woody and Lambda project as soon as we can get answers out of Owens."); 11/2/99 email from Ms. Boucher to Ms. Robertson (MAV007771) ("I've been thinking about the email this morning from Meadows Owens."); 11/17/99 emails promising to seek advice from Mr. Owens related to the 1 and 99 percent contributions for real estate costs (PSI00134652-53); 4/18 and 4/19/00 emails exchanged between Ms. Boucher and Ms. Hennington about Cottonwood (PSI-WYBR00577) ("[T]hey are waiting on Rodney's comments on the offer documents .... I called Rodney, and, with respect to the structure - they are still working on it."); 10/16/00 memorandum from Ms. Boucher to Ms. Robertson, Mr. French and others on Stargate horse farm (MAV008220-

date, despite Subcommittee requests, the Wyls have not provided a detailed explanation of the legal reasoning behind these real estate structures, and have not provided any legal opinions or analysis, instead asserting the attorney-client privilege.

The common elements in the ownership and funding structures used for the five properties involve a tiered set of shell entities in offshore jurisdictions and the United States. They can be summarized as follows.

The apparent initial step was for one of the Wyly-related offshore trusts to form a new Isle of Man (IOM) shell corporation whose sole function was to serve as a funding gateway for offshore dollars to be spent on a designated real estate property in the United States. Next, this IOM corporation and one or more Wyly family members typically established a trust in the United States to manage the designated property. The management trust was established by a trust agreement signed by the IOM corporation and Wyly family members. This agreement specified that the trust grantors, meaning the IOM corporation and the Wyly family members who signed the trust agreement, were allowed “full and complete Usage” of the property owned by the trust without any obligation by the trustee to monitor such use.<sup>1089</sup> These provisions explicitly authorized Wyly family members to make personal and unfettered use of the real estate.

The trust agreement also assigned to each grantor a so-called “Trust Share” reflecting the grantor’s proportional contributions to the trust’s assets.<sup>1090</sup> For example, a grantor who contributed ten percent of the trust’s assets acquired a ten percent “trust share.” The agreement further obligated each grantor to pay a portion of the real estate costs reflecting that “trust share,” such as mortgage payments, utilities, operating expenses, and construction costs. In other words, a grantor with a ten percent trust share had to pay ten percent of the real estate costs.

In the five examples examined by the Subcommittee, the IOM corporation typically made a cash contribution to the U.S. management trust resulting in its acquiring a 98 or 99 percent trust share, while Wyly family members made a much smaller contribution resulting in a 1 or 2 percent trust share. Real estate costs were then split on the same basis, with 98 to 99 percent of the costs attributed to the offshore corporation and only 1 to 2 percent attributed to a Wyly family member. This arrangement was apparently intended to enable Wyly family

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21)(“Keeley and I are consulting Rodney to see if we can use a structure similar to that which was used for the gallery in Aspen, thus utilizing foreign assets for the cash injection”); 6/20/01 email showing Mr. Owens was consulted about methods to pay for residences being built on Rosemary’s Circle R Ranch (PSI\_ED00013928).

<sup>1089</sup> See, e.g., 10/1/99 Woody Creek Ranch Management Trust, section 2.2 (BA120713-40, at 21-22); 8/1/00 Cottonwood Ventures II Management Trust, section 2.3 (BA163416-44, at 25).

<sup>1090</sup> See, e.g., 10/1/99 Woody Creek Ranch Management Trust, sections 1.3 and 2.3 (BA120713-40, at 18 and 22); 8/1/00 Cottonwood Ventures II Management Trust, sections 1.3 and 2.4 (BA163416-44, at 21 and 26). Meadows Owens told the Subcommittee that this approach, using “trust shares,” was an innovation designed by Mr. Owens. Subcommittee interview of Meadows Owens (4/27/06 and 7/7/06). The Subcommittee consulted other real estate and tax experts, who indicated they had not seen this approach in other real estate transactions.

members to obtain full usage of the trust's real estate, while paying a minimal percentage of the costs.

After the U.S. management trust was established and funded, the final step was for the trust to form a new U.S. partnership or limited liability corporation. This U.S. entity, using funds supplied from the Wyls and from offshore, then acquired the designated property and served as the owner of record for the U.S. real estate.<sup>1091</sup>

Most of the funds spent to acquire, improve, and operate the real estate moved from an offshore entity to a U.S. entity. The funds typically moved from one of the 58 Wyly-related offshore trusts or corporations in the Isle of Man, to the newly created IOM shell corporation created to serve as the funding gateway for the particular real estate, to the U.S. management trust, and finally to the U.S. entity serving as the owner of record for the property. The property owner then used the offshore funds to pay the acquisition, construction, and operating costs associated with the real estate. On some occasions, Wyly-related offshore entities ignored this funding pathway and wired funds directly to the U.S. management trust or directly to the U.S. property owner. More often, however, perhaps to avoid direct wire transfers from Wyly-related offshore entities to the U.S. property owner, the offshore funds took the longer route, which often required three or more wire transfers to move funds from the originating offshore entity to the final U.S. entity. This multi-step process also made it more difficult for anyone examining the real estate to trace the origin of the funds and determine that they came from an offshore trust related to the Wyly family.

U.S. and offshore financial institutions played a vital role in making these real estate structures work effectively. Lehman Brothers, Bank of America, Bank of Bermuda (IOM), Queensgate Bank and Trust, and other financial institutions routinely authorized the offshore trusts and corporations to wire substantial funds into the United States, with few questions asked. In these five examples, hundreds of thousands and sometimes millions of dollars moved through multiple accounts, across international lines, within days. Securities accounts often functioned as bank accounts, allowing millions of dollars to pass through them without any securities transactions. Without the cooperation of the banks and securities firms that controlled the financial accounts, these complex real estate structures could not have effectively been used to pay the U.S. real estate bills.

Also critical to the functioning of these complex real estate structures were the financial professionals who processed the paperwork, tracked the real estate costs, and identified available offshore funds. Key players included Ms. Robertson and Ms. Hennington from the Wyly family office, Ms. Boucher from the Irish Trust Company, and the IOM offshore service providers who

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<sup>1091</sup> In instances where the property was being purchased for a business venture, rather than a personal residence, a Nevada corporation was sometimes inserted into the ownership chain. This Nevada corporation then typically functioned as an intermediary between the Wyly-related offshore entities and the U.S. entities that owned the U.S. property. According to representatives of the Wyls, the reason for this substitution was that it was easier for a corporation than a trust to operate a business. Subcommittee interview of Ms. Robertson (4/21/06) and Meadows Owens (7/7/06). See real estate examples for more information.

administered the offshore trusts and corporations. Together, they moved tens of millions of offshore dollars into the United States through real estate transactions benefitting the Wyly family.

The five examples examined in this Report show how these complex structures, designed by lawyers and implemented by bankers, brokers, and other financial professionals, were used to supply millions of offshore dollars to pay U.S. real estate costs and, through sham real estate sales and loans, provide additional millions of offshore dollars for the personal use of Wyly family members in the United States. Two of the examples are explained here; the other three appear in Appendix 5.

### **(b) Rosemary's Circle R Ranch**

Rosemary's Circle R Ranch is a 244-acre ranch near Aspen, Colorado, that was purchased in 1999. Ninety-nine percent of its purchase price, \$11.3 million, was paid for with offshore dollars. Offshore funds also paid for 99 percent of the cost of building multi-million-dollar, customized homes on the ranch for the personal use of Wyly family members. They also paid for 99 percent of the ranch's operating costs. By early 2005, total offshore funds spent on this property exceeded \$45 million.<sup>1092</sup>

The property was purchased in October 1999. Sam Wyly appears to have initiated the idea of buying the property, and the trust protectors recommended the purchase to the LaFourche Trust, an Isle of Man trust benefitting the Sam Wyly family.<sup>1093</sup> The documentation indicates that the LaFourche Trust was given little time to evaluate the purchase, and the trustee, Trident, was pushed to quickly provide the funds needed for the \$11.3 million purchase price. In an email about one month after the purchase, Ms. Boucher wrote to Ms. Robertson: "Francis [Webb of Trident] has not yet seen any original Trust documents for execution regarding the Woody Creek Ranch Management Trust .... Francis commented after the fact on being very rushed on moving forward with the Woody Creek Ranch closing. Which he was, but that's

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<sup>1092</sup> See chart entitled "Rosemary's Circle R Ranch Offshore Funding," prepared by the Subcommittee Minority Staff (listing 35 wire transfers from IOM entities that, from 10/4/99 to 2/4/05, transferred over \$47 million into the United States to be spent on this real estate). See also 12/31/04 financial statement for Rosemary's Circle R Ranch Ltd. (PSI00026595)(showing that \$45,685,260 had been invested in Rosemary's Circle R Ranch Management Trust); 12/31/04 chart entitled, "Rosemary's Circle R Ranch Budget/Cost to Date & Projected," (PSI\_ED00037498) (listing "Costs to Date Dec 31/04" of \$46,299,906).

<sup>1093</sup> See, e.g., 8/19/99 email from Ms. Robertson to Ms. Boucher (PSI-WYBR00529)("Sam still has a contract pending on one property. It is up to him to determine whether he wants to counter. I'm not sure what he's going to do. He ... wasn't too sure he should be spending \$10-\$14 million to purchase the property and then spending money on building houses."); 3/28/00 email from Ms. Boucher to Ms. Robertson (PSI\_ED00047995). Because Sam Wyly asserted his Constitutional rights and did not participate in an interview, the Subcommittee was unable to ask him about the documents suggesting he initiated this real estate transaction or describing other information related to this matter. The same is true for the other real estate transactions.

life.”<sup>1094</sup> Initially referred to as the Woody Creek Ranch, Sam Wyly renamed the property in 2000 as Two Mile Ranch, and renamed it again in 2003 as Rosemary’s Circle R Ranch, which is how the property is currently known.<sup>1095</sup>

Over the following six-year period from 1999 to 2005, multiple residences were built on the property, with particular houses designated for particular branches of the Sam Wyly family.<sup>1096</sup> Additional sums were spent on other structures, as well as roads, water and power systems, and landscaping. Wyly family members worked with the architects and builders to design the homes and other structures.<sup>1097</sup> As residences became available for occupancy, Wyly

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<sup>1094</sup> 11/4/99 email from Ms. Boucher to Ms. Robertson (PSI\_ED00043836-37).

<sup>1095</sup> See, e.g., 11/4/03 email from Ms. Hennington discussing the name changes, among other matters (PSI\_ED00003352); 6/6/03 email from Ms. Hennington to Ms. Boucher (PSI\_ED00012211)(“Just got off the phone with Sam and they are changing the name of the Ranch to Rosemary’s ranch – i have a call in to confirm with Kelly before I start the whole process. ?????”). The fact that Mr. Wyly twice renamed the ranch is evidence of his involvement with and influence over this property.

<sup>1096</sup> See, e.g., 11/1/00 email from Ms. Boucher to IFG (MAV008239)(“each family group should fund construction of their specific houses,” while “the common development costs should be split by everyone”); 4/10/01 email from Ms. Hennington to Ms. Boucher (PSI\_ED00005778-80)(“help me remember that as we start to build other houses, those individuals will need to contribute to the Management trust”); 5/8/01 memo from Ms. Boucher to Sam Wyly (PSI00078291-93)(“Kelly will need liquidity to fund construction costs of their home on Two Mile Ranch.”); 4/30/01 email from Ms. Boucher to Kristin Yeary (PSI\_ED00013764-66)(requesting “break down of cost allocations” for “individual houses”; Kristin responds on 5/9/01: “The last I heard, mine and Jay’s house will be built first, then Kelly’s and Rosemary’s simultaneously will start soon after mine ....”); 6/6/01 email from Ms. Hennington to Ms. Boucher (PSI\_ED00005972)(“Based on the 4 lots as they stand now, they would be allowed to build 7 houses [but] ... [t]hey would like to build 8”); 6/11/01 email from Ms. Yeary to Ms. Boucher (PSI\_ED00013849-50)(“Sam has informed Kelly that he has set up accounts for each child’s house.”); 6/17/01 email from Ms. Elliott to Ms. Hennington (PSI\_ED00013929)(“You will soon be receiving bills for work on Mom’s site at the ranch.”); 11/7/01 email from Ms. Hennington to Ms. Boucher (PSI\_ED00006516)(providing costs for houses being built for “Rosemary,” “Kelly and Jason,” “Lisa & John,” “Kristin and Jay”); 3/14/03 email from Ms. Hennington to Ms. Boucher (PSI\_ED00013731)(providing status report on ranch, including construction of houses for “Kelly” and “Rosemary”); 7/31/03 document allocating “Ranch Costs” (PSI00026229)(allocating costs for “Lisa & John,” “Acton House,” “CP Wyly House,” “E&B Wyly,” “Elliott House,” “Family Barn,” “Matthews,” and “S&C Wyly”); 9/2/03 email from Ms. Boucher to Ms. Yeary (PSI\_ED00003203-04)(“I was speaking with Sam & Evan today, and we would like to get an idea of budget going forward at the Ranch” including “[c]osts to complete individual houses on the property.”); 8/25/04 email from Margot MacInnis to Ms. Hennington and Ms. Boucher (PSI\_ED00015013) (providing “updated July Budget” for the ranch, including costs related to Elliott, Graham, and Matthews residences); undated document, likely prepared in 2004 (PSI\_ED00012468-69)(providing status report on various projects, including “Two Mile” which projects total construction costs of \$55 million and completion of residences for Elliott, Graham, Matthews, and Sam and Cheryl Wyly in 2004 and 2005); 12/31/04 chart entitled, “Rosemary’s Circle R Ranch Budget/Cost To Date & Projected,” (PSI\_ED00037498)(listing “Costs to Date Dec 31/04” including for residences for Elliott, Acton, “S&C” [Sam and Cheryl Wyly], Graham, “E&B Wyly” [Evan and Barbara Wyly], and Matthews); 12/31/04 “SUMMARY: Rosemary’s Ranch Allocation of assets” (PSI\_ED00037501) (allocating ranch costs among the Bessie Trust and the six Cayman LLCs associated with Sam Wyly’s six children).

<sup>1097</sup> See, e.g., 11/4/99 email from Bob Witek of RJW to Wyly family office employee, Rena Alexander (PSI00025486)(“I spoke with Cheryl & Sam[.] They approved the purchase of the required [Transfer Development Rights] for the ranch.”); 3/17/00 document naming Cheryl Wyly and Kelly Wyly Elliott as agents for the U.S.

family members made personal use of them on a rent-free basis. There is no evidence that any part of the property was ever rented to a third party.

Two Colorado limited liability corporations (LLCs) served as the owners of record for the property.<sup>1098</sup> Both were wholly owned by a U.S. management trust, established to manage the ranch.<sup>1099</sup> This U.S. management trust had two grantors, Sam Wyly and an IOM corporation now known as Rosemary's Circle R Ranch Ltd.<sup>1100</sup> Sam Wyly's "trust share" was 1 percent, while the IOM corporation's "trust share" was 99 percent.

When the U.S. management trust was first established in 1999, Sam Wyly contributed \$110,000 in cash and his interests in the two Colorado LLCs which he valued at \$5,000; while the IOM corporation contributed ten times as much via a cash contribution of \$11,385,000.<sup>1101</sup>

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management trust to handle permits for the ranch (PSI\_ED00036411); 4/3/01 "Two Mile Ranch Memo" from Kelly Wyly Elliott to Gary Beach who handled environmental issues during construction, with copies to Sam Wyly and others (PSI00039972)(discussing possible installation of a natural gas line and other utilities); 5/26/01 email from Ms. Elliott to Ms. Hennington, with copies to Sam Wyly and others (PSI\_ED00013774)(discussing contract related to building residences on the ranch); 8/24/01 "Negative Covenant Prohibiting Subdivision of Property" executed by Ms. Elliott (PSI00039975-78); 11/7/01 email from Ms. Hennington to Ms. Boucher (PSI\_ED00006516) (advising on the costs of five houses and a barn); 3/14/03 email (PSI\_ED00013731)(providing status report on ranch construction); 10/3/03 email from Ms. Yeary to Ms. Boucher (PSI\_ED00003203-08) (forwarding a draft letter from the construction consultant to Sam Wyly detailing remaining construction projects on the ranch); 4/5/04 email from Ms. Boucher to Jana Frederick (PSI\_ED00014742)(conveying information from Ms. Elliott about construction projects on the ranch).

<sup>1098</sup> See chart entitled, "Rosemary's Circle R Ranch Funding Structure," prepared by the Subcommittee Minority Staff. The property consists of 4 parcels of land in Pitkin County, Colorado. Each LLC owned two of the four parcels of land. The two LLCs were initially named Rocky Mountain Serenity Ranch I LLC and Rocky Mountain Serenity Ranch II LLC. Later they were renamed Two Mile Ranch I LLC and Two Mile Ranch II LLC. In 2003, they were renamed Rosemary's Circle R Ranch East LLC and Rosemary's Circle R Ranch West LLC. See, e.g., Colorado Department of State reports on Rosemary's Circle R Ranch East LLC and West LLC (S4562-66). Sam Wyly's daughter, Kelly Wyly Elliott, has served as the manager of both LLCs. (PSI00039975-78)

<sup>1099</sup> See 10/1/99 U.S. trust agreement (BA120713-40); 12/31/03 financial statement of U.S. management trust (PSI00040012). This U.S. management trust was initially named the Woody Creek Ranch Management Trust, renamed in 2000 as Two Mile Ranch Management Trust (BA062067-69), and renamed in 2003 as Rosemary's Circle R Ranch Management Trust (BA062051-54). Its initial trustees were Mr. French and Ms. Robertson, later replaced by Sam Wyly's daughters, Kelly and Lisa (SR0001069-71; PSI\_ED00018641).

<sup>1100</sup> See U.S. trust agreement (BA120713-40). The trust agreement characterizes it as a U.S. grantor trust whose grantors are Sam Wyly and the IOM corporation. *Id.* at BA120718-19. The IOM corporation was initially named Woody Creek Ranch Ltd., later renamed Two Mile Ranch Ltd., and renamed still later as Rosemary's Circle R Ranch Ltd. See 9/30/99 Certificate of Incorporation No. 97427C; BA062052, 68; IOM Certificates of Change of Name.

<sup>1101</sup> See U.S. trust agreement (BA120713-40, at 40)(initial contributions to trust); 1999 financial statement for the U.S. management trust (PSI00045614).

This pattern of parallel 1 and 99 percent contributions continued over the following years.<sup>1102</sup> By the end of 2004, for example, internal Wyly documents show that Sam Wyly had contributed a total of about \$434,000 to the U.S. management trust or 1 percent of its assets, while the IOM corporation had contributed 99 percent, or a total of more than \$43 million.<sup>1103</sup>

Rosemary's Circle R Ranch Ltd., the IOM corporation that acted as the funding gateway for offshore dollars spent on the property, was initially owned by Devotion.<sup>1104</sup> Devotion, in turn, was owned by the 1992 LaFourche Trust. After legal counsel advised the Wyly family that U.S. real estate should be owned by the 1994 trusts instead of the 1992 trusts, the Wyly family office apparently asked the LaFourche Trust to transfer the property to the 1994 Bessie Trust associated with Sam Wyly.<sup>1105</sup> The LaFourche Trust complied. In 2000, three months after acquiring it, Devotion "sold" the IOM corporation to the Bessie Trust, giving up all ownership interest in the ranch for no apparent profit.<sup>1106</sup> In 2001, the six Cayman LLCs associated with

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<sup>1102</sup> See, e.g., 12/31/00 financial statement for the U.S. management trust (PSI\_ED00063562-64) (showing Sam Wyly's contributions totaled \$130,625, while the IOM corporation's contributions totaled \$12,933,919); 1/31/01 Two Mile Ranch Management Trust (PSI00043783); 2002 "Wyly Family Capital Account Activity Report" (PSI00040032) (showing Sam Wyly's contributions totaled \$287,528, while the IOM corporation's contributions totaled \$27,495,245); 12/31/03 "Working Trial Balance" for Rosemary's Circle R Ranch Management Trust (misdated as 12/31/02)(PSI\_ED00055675-79)(showing Sam Wyly's contributions totaled \$380,808, while the IOM corporation's contributions totaled \$36,711,442).

<sup>1103</sup> See 2004 "Working Trial Balance" for Rosemary's Circle R Ranch Management Trust (PSI\_ED00050943-47, at 47).

<sup>1104</sup> See, e.g., 10/31/99 financial statement for the "Foreign Systems" (PSI00109903) (showing LaFourche Trust owned Woody Creek Ranch); 2/15/00 financial report indicating Devotion owned the ranch (PSI\_ED00046873-75); IOM corporation's "Annual Return" as of 9/30/00, filed in the Isle of Man, "List of Past and Present Members" (showing Devotion had owned the corporation); emails stating that Woody Creek Ranch Limited was owned by Devotion (PSI\_ED00043836-37, 47995, 72001).

<sup>1105</sup> See, e.g., 11/4/99 email from Ms. Boucher to Ms. Robertson (PSI\_ED00043836-37)(discussing acquisition by Bessie Trust "of Woody Creek Ranch Limited from La Fourche using note"); 11/9/99 document entitled, "Trustee Meetings" (MAV007783-85) ("Per Rodney all U.S. real estate should be purchased from 1994 Trusts."); 12/9/99 email from Ms. Boucher to Ms. Robertson (MAV007788)("I went back to Rodney again yesterday on the Devotion/La Fourche/Little Woody Creek Ranch Funding, and await an answer."); 11/2/00 email from Ms. Boucher to Ms. Robertson (PSI\_ED00044455)(discussing need to speak to trustees about "the crossover between the 1992's and the 1994 trusts"). The trustee of the LaFourche Trust was then Trident. The trustee of the Bessie Trust was then IFG.

<sup>1106</sup> See, e.g., PSI\_ED00024963, 43836, 44244, 47995 (discussing potential bookkeeping for sale), 47999 (discussing final structure of sale), 72001 (discussing obtaining funds for sale). Yurta Faf, an IOM corporation owned by the Bessie Trust, appears to have paid Devotion for the initial cost of purchasing the property, but did not provide it with any profit. See, e.g., PSI\_ED00046873-75 (showing Yurta Faf cash outflow of \$11.7 million as of 2/15/00, due to "LWCRL sale"); PSI\_ED00006055 (showing Yurta Faf with an "inter-trust" receivable of \$12.2 million as of 4/30/01).

Sam Wyly's six children acquired one share each in the IOM corporation from the Bessie Trust, becoming partial owners along with the trust itself.<sup>1107</sup>

The LaFourche Trust provided the initial funding to purchase the Colorado ranch. Bank documents show that, on November 4, 1999, Devotion wired \$10.2 million in offshore funds to the U.S. management trust which, in turn, wired \$5 million to each of the Colorado LLCs to buy the property.<sup>1108</sup> Another \$1.1 million, in a separate "earnest money" payment by Devotion, brought the total purchase price of the property to about \$11.3 million.<sup>1109</sup> There is no record of any mortgage.

Over the next five years, a number of offshore entities associated with Sam Wyly and his family provided an additional \$34 million in offshore funds to improve and operate Rosemary's Circle R Ranch. In some cases, the Wyly family representative handling the bills for the ranch had requested the offshore funds by sending an email to Ms. Boucher.<sup>1110</sup> In other cases, Ms. Boucher appears to have used cost projections to anticipate the ranch's funding needs. Ms. Boucher then worked with the trust protectors and the offshore trusts to supply the offshore funds. All funding requests appear to have been met within days.

The offshore entities typically provided amounts ranging from \$200,000 to \$4 million at a time. They typically wired the funds to the U.S. management trust which then forwarded the funds to the LLCs to spend on the ranch. For example, in March 2000, Devotion of the LaFourche Trust wired \$500,000 to the IOM corporation which, in turn, wired the funds to the U.S. management trust.<sup>1111</sup> In April 2001, Sarnia Investments of the Lake Providence International Trust wired \$2 million to the IOM corporation which then wired the funds to the U.S. management trust for use on the property.<sup>1112</sup> In September 2001, Sarnia wired another \$3.6

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<sup>1107</sup> PSI00078959-64, 71494-97.

<sup>1108</sup> See, e.g., PSI\_ED00043681, PSI00025492, 496-503 (bank records, internal Wyly financial records, and related email messages documenting the \$10.2 million transfer by Devotion to the United States to buy the property).

<sup>1109</sup> See, e.g., CC011842 (showing that, on 8/30/99, Devotion wired \$1.1 million to Alpine Bank and Trust); PSI00025489, 97 (discussing separate earnest money payment of \$1.1 million by Devotion).

<sup>1110</sup> Wyly family office personnel, as well as Kristin Yeary who handled some of the ranch bills, directed offshore funding requests to Ms. Boucher. See, e.g., 3/3/00 email requesting \$500,000 (PSI\_ED00047857); 9/20/00 email requesting an unspecified amount of funds (PSI00037025); 9/21/00 email requesting \$750,000 (PSI\_ED00048761); 10/2/00 email requesting \$200,000 (PSI00037011); 11/2/00 email requesting \$250,000 (PSI00036997); 4/10/01 email requesting \$2 million (PSI\_ED00005774); 8/14/01 email requesting \$1 million (PSI\_ED00006347); 9/3/01 email requesting \$3.6 million (PSI\_ED00014220); 2/11/04 email requesting \$1 million (PSI\_ED00012605); 4/26/04 email requesting \$300,000 (PSI\_ED00014247-48); 1/19/05 email requesting \$2 million (PSI\_ED00052880-81).

<sup>1111</sup> See PSI\_ED00047857, CC011870, PSI00037113 (showing the request for and movement of the funds).

<sup>1112</sup> See CC004168 (showing, on 4/18/01, Sarnia wired \$2 million to Two Mile Ranch Ltd.); and BA144515-16 (showing, on 4/19/01, Two Mile Ranch Ltd. wired \$2 million to the U.S. management trust).

million to the IOM corporation which, in turn, wired it to the U.S. management trust.<sup>1113</sup> In June 2001, Audubon Assets, a subsidiary of the Bessie Trust, wired \$1 million to the IOM corporation which then sent it to the U.S. management trust.<sup>1114</sup> In May 2002, the IOM corporation wired another \$4 million to the U.S. management trust.<sup>1115</sup> In October 2002, Yurta Faf of the Bessie Trust wired \$2.5 million directly to the U.S. management trust.<sup>1116</sup> In December 2003, Pops LLC, a Cayman corporation owned by the Bessie Trust and associated with one of Sam Wyly's daughters, wired \$1.5 million directly to the U.S. management trust, while Bubba LLC, a Cayman corporation associated with another of his daughters, wired \$900,000.<sup>1117</sup> These and other offshore funds were spent to purchase development rights for the property; construct multiple residences, roads, power and water systems, landscaping, and other improvements; as well as pay for maintenance and other operational costs associated with the ranch.

Rosemary's Circle R Ranch is an example of U.S. real estate that was bought and paid for primarily with offshore dollars, and used additional offshore funds to provide Wyly family members with rent-free, customized, multi-million-dollar homes for their personal use. The millions of offshore dollars spent on this property, the fact that the funds requested by a trust protector were invariably provided within days of a request, and the contribution of multiple offshore trusts associated with Sam Wyly to the financing of these real estate costs, provide additional evidence of the extent of Wyly influence over the offshore trusts.

### **(c) LL Ranch**

The LL Ranch is a 26-acre Colorado property that was transferred in a sham "sale" from one Wyly-related entity to another, in order to bring \$4.29 million in offshore dollars into the

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<sup>1113</sup> See CC027320 (showing, on 9/6/01, Sarnia wired \$3.6 million to Two Mile Ranch Ltd.); and BA144524 (showing, on 9/11/01, Two Mile Ranch Ltd. wired \$3.6 million to the U.S. management trust).

<sup>1114</sup> See CC009849 (showing, on 6/22/01, Audubon Assets wired \$1 million to Two Mile Ranch Ltd.); BA144519 (showing, on 6/25/01, Two Mile Ranch Ltd. wired \$1 million to the U.S. management trust); and BA144519; PSI\_ED00022592 (showing, on 6/25/01, the U.S. management trust wired \$1 million (\$500,000 each) to the Colorado LLCs).

<sup>1115</sup> See BA\_PSI-W016896 (showing, on 5/30/02, Two Mile Ranch Ltd. wired \$4 million to the U.S. management trust); and BA\_PSI-W016898 (showing, on 6/4/02, the U.S. management trust wired \$4 million (\$2 million each) to the Colorado LLCs). It is unclear where the IOM corporation acquired these funds; possibly they were provided by Yurta Faf.

<sup>1116</sup> See BA\_PSI-W016902 (showing, on 10/22/02, Yurta Faf wired \$2.5 million to the U.S. management trust); and BA\_PSI-W016904 (showing, on 11/6/02, the U.S. management trust wired \$2.5 million (\$1.25 million each) to the Colorado LLCs).

<sup>1117</sup> See BA\_PSI-W016924 (showing, on 12/23/03, Pops LLC wired \$1.5 million to the U.S. management trust); BA\_PSI-W016925 (showing, on 12/23/03, the U.S. management trust wired \$1.5 million (\$750,000 each) to the Colorado LLCs); BA\_PSI-W016925 (showing, on 12/24/03, Bubba LLC wired \$900,000 to the U.S. management trust); and BA\_PSI-W016926 (showing, on 1/26/04, the U.S. management trust wired \$850,000 (\$425,000 each) to the LLCs).

United States for the personal use of Charles Wyly family members. After this sham sale was completed in 2001, another \$1.9 million in offshore funds paid for 98 percent of the property's operating and construction costs. Altogether, from 2001 to 2004, about \$6.2 million in offshore dollars were transferred to the United States in connection with this property.<sup>1118</sup>

The LL Ranch is a 26-acre wooded site in a prestigious neighborhood near Aspen, Colorado.<sup>1119</sup> It was purchased in 1996, from a third party, for \$2.4 million by a Texas partnership, Little Woody Ltd., whose partners were Charles Wyly and his four children.<sup>1120</sup> Working with architects and builders, the Wyly family extensively remodeled the residence, expanding it to more than 8,000 square feet.<sup>1121</sup> There is no evidence that the property was ever rented to a third party.

In late 1999, Charles Wyly apparently began to consider selling several real estate properties used by his family to the Wyly "offshore system" in order to bring offshore funds into the United States.<sup>1122</sup> For example, an October 8, 1999 email from Ms. Boucher to Ms. Hennington on "CW property acquisition" stated: "My understanding is that shortly we are

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<sup>1118</sup> See chart entitled, "LL Ranch Offshore Funding," prepared by the Subcommittee Minority Staff (listing eight wire transfers from IOM entities that, from 3/2/01 to 11/5/04, transferred \$6.2 million into the United States to be spent on this real estate).

<sup>1119</sup> See, e.g., 3/22/99 Uniform Residential Appraisal Report (BA143744-45). This property is sometimes referred to in the documentation as "Little Woody" or "Little Woody Creek Ranch," but to avoid confusion with another 1999 purchase of what was then known as the Woody Creek Ranch (now known as Rosemary's Circle R Ranch), this property will be referred to by another name sometimes used for it, the LL Ranch. See, e.g., PSI\_ED00000053.

<sup>1120</sup> See, e.g., 1996 General Warranty Deed (BA143746); 2000 appraisal report (BA143715); PSI00045950-54 (11/96 financial statements of Mr. Wyly and his four children listing realty purchase); PSI00117308-09, 117305 (describing 1996 purchase). The general partner of Little Woody Ltd. (Texas) was the Charles J. Wyly, Jr. Revocable Trust (BA143988), while the limited partners were the domestic trusts of his four children (PSI00043790, 30649). Mr. Wyly's domestic trust had a 10 percent ownership interest in the partnership, while each of the children's domestic trusts had a 22.5 percent interest. See, e.g., PSI00012101, 03, 05, 06, 07, 09, 11, 12, 14; 25341-44; 25417, 20, 24-27; 30648-49; 43790; 45951-54. It is possible that \$1.5 million in offshore funds were used to help purchase the property in 1996, and pay for some of its construction costs. See, e.g., August 1996 emails discussing offshore trustee approval of a \$1.5 million loan and second mortgage on the property (PSI00117305, 117308-09, 129440).

<sup>1121</sup> See, e.g., HST\_PSI000643-44 (8/12/99 list of property improvements from 10/24/96 until 4/15/99, at a total cost of \$3.8 million); BA144023 (identifying construction variances); BA143745 (3/22/99 appraisal report states: "The subject is in effectively new condition following its total remodeling and expansion."); BA143718 (11/28/00 appraisal report states: "Mr. Wyly has largely gutted, remodeled, and expanded the home.").

<sup>1122</sup> Because Charles Wyly asserted his Constitutional rights and did not participate in an interview, the Subcommittee was unable to ask him about the documents suggesting the existence of this plan, indicating he initiated this real estate transaction, or describing other information related to this matter. The same is true for the other real estate transactions.

looking to sell four properties to the offshore system.”<sup>1123</sup> The documentation shows that Mr. Wyly personally selected the properties to be “sold” and determined the timing of the “sales,” postponing the LL Ranch transaction several times until 2001.<sup>1124</sup> On February 28, 2001, Ms. Hennington wrote to Ms. Boucher:

“I was talking to Charles yesterday and he was kind of thinking out loud on some stuff. He was talking about use of off-shore cash and was using the following for planning – thought I would pass it along even though he was just thinking.

First Dallas –	\$10.5 future commi[t]ments (Brazos, FDV, ?)
955 Little Woody –	\$10.2 (Charles and Dee home in Aspen)
Little Woody –	\$4.5 (next week deal)
Sport Horses –	\$3.0 (capital improvements)
Jennifer and Jim –	\$4.0 (new house)
Charity –	??? ...

He was saying that these things would use about half of his current available cash off-shore.”<sup>1125</sup>

The statement that Mr. Wyly was discussing uses for “his” available offshore cash is added evidence of the ability of the Wylys to direct use of the offshore dollars.

The actual “sale” of the LL Ranch took place about one month later on March 30, 2001, but was made effective as of March 5, 2001.<sup>1126</sup> The transaction was handled by the private banking department of Bank of America. Little Woody Ltd. (Texas) “sold” the LL Ranch to another Wyly-related entity, Little Woody LLC, for \$7.5 million. When asked why the property was transferred from one Wyly-related entity to another, Ms. Hennington answered with one

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<sup>1123</sup> PSI\_ED00000266. See also, e.g., 11/9/99 document entitled, “Trustee Meetings,” (MAV007783)(listing three “Real Estate acquisitions planned for 1<sup>st</sup> quarter 2000,” all of which involved properties controlled by the Charles Wyly family).

<sup>1124</sup> See, e.g., 10/11/99 email from Ms. Hennington to Ms. Boucher (PSI\_ED00000266)(“In my discussions with Charles last week, he said due to the option sale earlier this month that the sale of the properties was not as time sensitive.”); 10/12/99 email on “CW real estate” discussing where to obtain the funds for the transactions (PSI\_ED00000267)(“Shari – Do you think we should sit down with Charles again and make sure he wants to go forward with everything”); PSI\_ED00000296-99, 317-19 (additional planning for the LL Ranch sale which does not, in the end, take place in 1999 or 2000); 10/16/00 email from Ms. Boucher to Ms. Robertson and others (MAV008220-21)(“We put together all documentation to sell this property to an IOM company last November/December. Charles has asked us to proceed once again and effect the sale.”); PSI\_ED00005218, 5295, 5361, 5390-91, 30527 (additional 2001 planning for LL Ranch sale).

<sup>1125</sup> (PSI\_ED00005370). The reference to “Little Woody” and the “next week deal” was to the property also known as the LL Ranch.

<sup>1126</sup> See closing documentation (BA143962-67); Pitkin County Assessor/Treasurer online Parcel Detail Information.

word: “Liquidity.” She indicated that the purpose of the transaction was to provide the Wyls with cash to use in domestic endeavors during 2001.<sup>1127</sup>

The entity that became the owner of record for the property, Little Woody LLC, was a Colorado limited liability corporation.<sup>1128</sup> This LLC was wholly owned for the first month by Little Woody Creek Ranch Ltd. (LWCRL), the Isle of Man corporation established to serve as the funding gateway for the LL Ranch.<sup>1129</sup> LWCRL was wholly owned by the 1994 Tyler Trust associated with Charles Wyly.<sup>1130</sup> A month after Little Woody LLC was established, LWCRL contributed the corporation to a newly established U.S. management trust set up to manage the LL Ranch.<sup>1131</sup>

This U.S. management trust, called the Little Woody Management Trust, had three grantors, Charles Wyly’s daughter Emily, his daughter Jennifer, and LWCRL.<sup>1132</sup> Emily obtained a “trust share” of 1 percent, Jennifer obtained another 1 percent, and LWCRL, the IOM corporation, obtained a “trust share” of 98 percent.<sup>1133</sup> In accordance with this arrangement, from 2001 until 2004, the documents show that LWCRL contributed 98 percent of the funds transferred to the U.S. management trust, while the Wyly daughters together contributed 2 percent.<sup>1134</sup> By the end of 2004, for example, internal Wyly records indicate that the LWCRL

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<sup>1127</sup> Subcommittee interview of Ms. Hennington (4/26/06).

<sup>1128</sup> See 10/22/99 Colorado certificate of incorporation and articles of organization (BA060702-03) (showing Little Woody LLC was formed with a single manager, Charles Wyly).

<sup>1129</sup> See, e.g., BA060700-01 (showing the single original owner of Little Woody LLC was the IOM corporation, LWCRL).

<sup>1130</sup> See, e.g., Sept. 2003 Cash Report (PSI00040534)(listing Tyler Trust’s subsidiaries); 10/31/02 financial report for the Tyler Trust (PSI00078301)(listing its subsidiaries); PSI\_ED00024964.

<sup>1131</sup> See, e.g., BA060700-01 (showing the single original owner of Little Woody LLC was the IOM corporation, LWCRL, later replaced by the U.S. management trust). See also 11/30/99 U.S. management trust agreement (BA\_PSI-W011806-33). The initial trustees were Mr. French and Ms. Robertson, later replaced by Charles Wyly’s son-in-law, Donald Miller.

<sup>1132</sup> See U.S. trust agreement (BA PSI-W011806-33). At the time of the transaction, these two daughters apparently made personal use of the house. See 10/16/00 email from Ms. Boucher to Ms. Robertson and others (MAV008220-21)(“This is the house that Emily and Jennifer use.”)

<sup>1133</sup> See trust agreement (BA PSI-W011806-33). Initially, the two daughters each contributed \$200 to obtain a 1 percent trust share, while LWCRL contributed \$19,600 for a 98 percent trust share.

<sup>1134</sup> See, e.g., 12/31/02 “Working Trial Balance” for the U.S. management trust (PSI\_ED00062247) (showing the IOM corporation had contributed \$4.6 million or 98 percent of the trust’s capital, while Charles Wyly’s two daughters had each contributed about \$47,000); 9/30/02 financial statement for the U.S. management trust, LWMT (PSI00051138)(showing similar figures); 12/31/03 “Working Trial Balance” for the U.S. management trust (PSI\_ED00059481)(showing the IOM corporation had contributed \$4.7 million or 98 percent of the trust’s capital, while Charles Wyly’s two daughters had each contributed about \$48,000).

had contributed a net total of \$4.8 million to the U.S. management trust, while each daughter had contributed about \$48,000.<sup>1135</sup>

To purchase the LL Ranch for \$7.5 million, Little Woody LLC agreed to assume an existing mortgage of \$3.8 million on the property, and to pay Little Woody Ltd. (Texas) the remaining “sales price” of \$3.65 million. The LLC also agreed to pay \$646,000 for furnishings and artwork already in the house, for a total cash payment of about \$4.29 million.<sup>1136</sup> Little Woody LLC obtained the necessary funds from offshore. Bank documents show that, on March 2, 2001, a few weeks before the “sale,” the IOM corporation, LWCRL, wired \$4.5 million to the U.S. management trust which then wired \$4.5 million to Little Woody LLC.<sup>1137</sup>

On the day of the closing, March 30, 2001, Little Woody LLC issued wire transfers totaling about \$4.29 million to “purchase” the house, its furnishings, and artwork.<sup>1138</sup> A few weeks later, Little Woody Ltd. (Texas) transferred the same amount, \$4.29 million, to the personal, domestic trusts of Charles Wyly and his four children, in amounts reflecting their proportionate ownership interests in the partnership.<sup>1139</sup>

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<sup>1135</sup> 12/31/04 “Working Trial Balance” for U.S. management trust (PSI\_ED00019967). See also chart entitled, “LL Ranch Funding Structure,” prepared by the Subcommittee Minority Staff.

<sup>1136</sup> See, e.g., 1/31/01 Wyly Partnerships financial statement for this property, referred to as “Little Woody” (PSI00043790) (showing real estate had a book value of \$6.5 million, and furnishings and art with a book value of \$646,339, resulting in an overall total book value of \$7.2 million); Loan Assumption Agreement (BA143981-93, at 88)(showing Little Woody LLC assumed \$3.8 million mortgage, and Charles Wyly signed the Loan Assumption Agreement on behalf of both entities, as manager of the LLC and as trustee of the general partner of Little Woody Ltd.).

<sup>1137</sup> See, e.g., PSI00025359, 68 (showing, on 3/2/01, LWCRL wired \$4.5 million to the U.S. management trust); PSI00025359, 37309; BA PSI-W004464 (showing, on 3/2/01, the U.S. management trust wired \$4.5 million to Little Woody LLC). It is unclear how LWCRL itself obtained these funds.

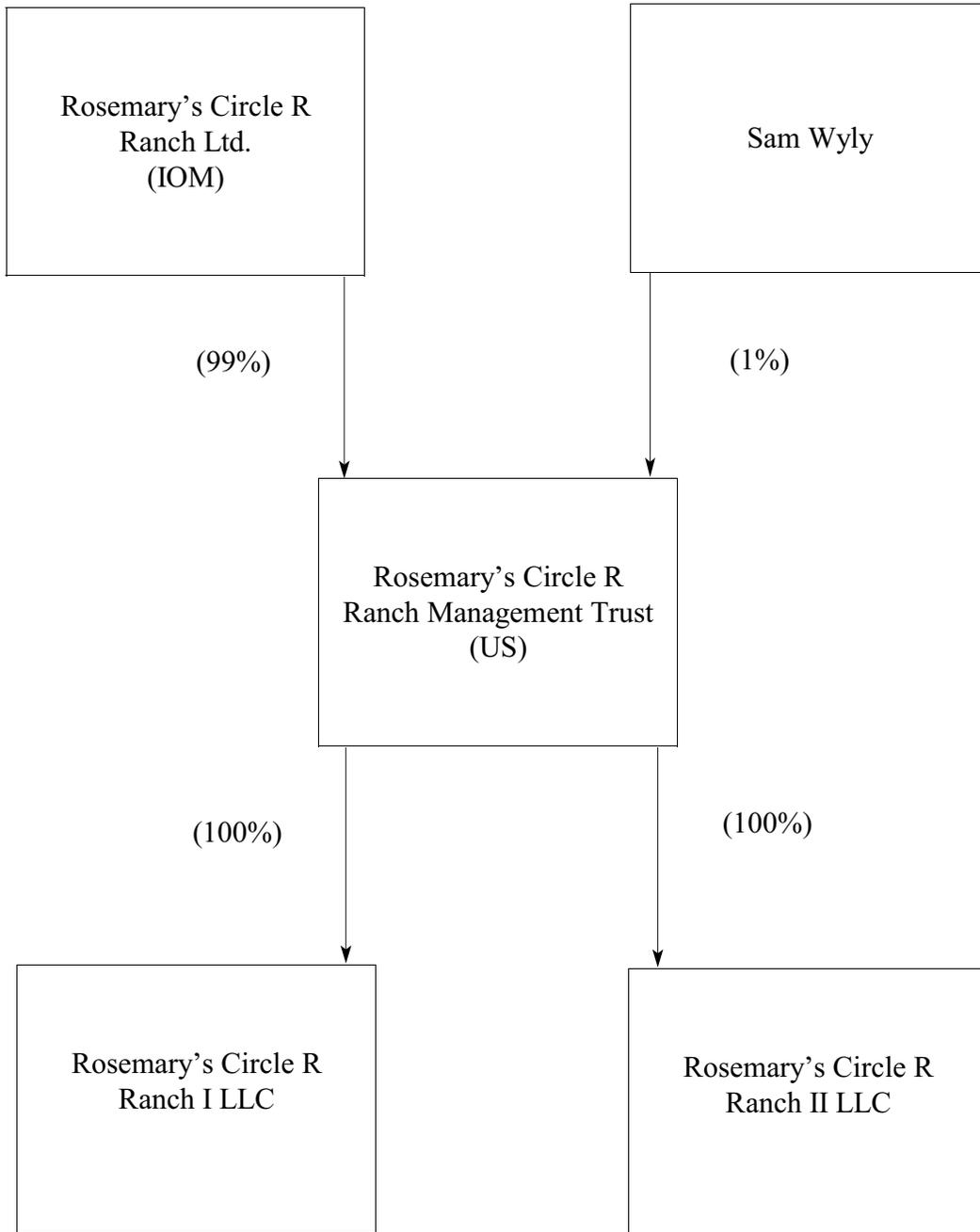
<sup>1138</sup> See wire transfer records (BA PSI-W004464)(showing Little Woody LLC wired \$3,650,823 to Steward Title of Aspen, presumably as part of the closing, and wired \$646,339 to Little Woody Ltd. (Texas), an amount exactly equal to the value of the existing furnishings and artwork in the house, for a total of about \$4.29 million); BA150424-25, PSI00024367, PSI00013498 (showing that Little Woody Ltd. (Texas) received a credit of \$3,643,227, presumably from the closing, and a credit of \$646,339 from Little Woody LLC).

<sup>1139</sup> See BA150428; PSI00025341-44 (showing that, on 4/17/01, Little Woody Ltd. (Texas) wired the following amounts totaling \$4,290,000:

\$429,000 wired to Charles Wyly CP  
\$865,250 wired to Martha Wyly Trust  
\$965,250 wired to Charles Wyly III Trust  
\$965,250 wired to Emily Wyly Trust  
\$965,250 wired to Jennifer Wyly Trust”);

BA150425; and PSI00025363 (showing that, on 3/22/01, Little Woody Ltd. (Texas) had wired \$100,000 to the Martha Wyly Trust).

## Rosemary's Circle R Ranch Funding Structure



## Rosemary's Circle R Ranch Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
10/4/1999	Devotion, Ltd	\$10,200,000	Rosemary's Circle R Ranch Mgmt Trust	10/5/1999	\$5,000,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	10/5/1999	\$5,000,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	11/5/1999	\$50,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	11/5/1999	\$50,000	Rosemary's Circle R Ranch II, LLC
12/1/1999	Rosemary's Circle R Ranch, Ltd	\$85,000	Rosemary's Circle R Ranch Mgmt Trust			
12/1/1999	Rosemary's Circle R Ranch, Ltd	\$300,000	Rosemary's Circle R Ranch Mgmt Trust			
3/7/2000	Rosemary's Circle R Ranch, Ltd	\$500,000	Rosemary's Circle R Ranch Mgmt Trust	4/7/2000	\$50,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	4/7/2000	\$50,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/5/2000	\$50,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/5/2000	\$50,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/9/2000	\$400,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/9/2000	\$400,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/11/2000	\$50,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/11/2000	\$50,000	Rosemary's Circle R Ranch II, LLC
9/28/2000	Rosemary's Circle R Ranch, Ltd	\$750,000	Rosemary's Circle R Ranch Mgmt Trust	10/2/2000	\$100,000	Rosemary's Circle R Ranch I, LLC

## Rosemary's Circle R Ranch Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
			Rosemary's Circle R Ranch Mgmt Trust	10/2/2000	\$100,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	11/2/2000	\$125,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	11/2/2000	\$125,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	12/12/2000	\$125,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	12/12/2000	\$125,000	Rosemary's Circle R Ranch II, LLC
1/16/2001	Rosemary's Circle R Ranch, Ltd	\$300,000	Rosemary's Circle R Ranch Mgmt Trust	1/16/2001	\$150,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	1/16/2001	\$150,000	Rosemary's Circle R Ranch II, LLC
2/16/2001	Rosemary's Circle R Ranch, Ltd	\$1,200,000	Rosemary's Circle R Ranch Mgmt Trust	2/20/2001	\$200,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	2/20/2001	\$200,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	3/9/2001	\$180,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	3/9/2001	\$180,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	3/19/2001	\$50,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	3/19/2001	\$50,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	4/5/2001	\$200,000	Rosemary's Circle R Ranch I, LLC

## Rosemary's Circle R Ranch Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
			Rosemary's Circle R Ranch Mgmt Trust	4/5/2001	\$200,000	Rosemary's Circle R Ranch II, LLC
4/19/2001	Rosemary's Circle R Ranch, Ltd	\$2,000,000	Rosemary's Circle R Ranch Mgmt Trust	4/19/2001	\$250,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	4/19/2001	\$250,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/8/2001	\$600,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/8/2001	\$600,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/11/2001	\$100,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/11/2001	\$100,000	Rosemary's Circle R Ranch II, LLC
6/25/2001	Rosemary's Circle R Ranch, Ltd	\$1,000,000	Rosemary's Circle R Ranch Mgmt Trust	6/25/2001	\$500,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	6/25/2001	\$500,000	Rosemary's Circle R Ranch II, LLC
8/17/2001	Rosemary's Circle R Ranch, Ltd	\$1,000,000	Rosemary's Circle R Ranch Mgmt Trust	8/20/2001	\$510,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	8/20/2001	\$510,000	Rosemary's Circle R Ranch II, LLC
9/11/2001	Rosemary's Circle R Ranch, Ltd	\$3,600,000	Rosemary's Circle R Ranch Mgmt Trust	9/13/2001	\$350,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	9/13/2001	\$350,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	10/4/2001	\$1,250,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	10/4/2001	\$1,250,000	Rosemary's Circle R Ranch II, LLC

## Rosemary's Circle R Ranch Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
5/30/2002	Rosemary's Circle R Ranch, Ltd	\$4,000,000	Rosemary's Circle R Ranch Mgmt Trust	6/4/2002	\$2,000,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	6/4/2002	\$2,000,000	Rosemary's Circle R Ranch II, LLC
10/22/2002	Yurta Faf, Ltd	\$2,500,000	Rosemary's Circle R Ranch Mgmt Trust	11/6/2002	\$1,250,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	11/6/2002	\$1,250,000	Rosemary's Circle R Ranch II, LLC
4/2/2003	Rosemary's Circle R Ranch, Ltd	\$900,000	Rosemary's Circle R Ranch Mgmt Trust	4/3/2003	\$450,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	4/3/2003	\$450,000	Rosemary's Circle R Ranch II, LLC
5/9/2003	Rosemary's Circle R Ranch, Ltd	\$900,000	Rosemary's Circle R Ranch Mgmt Trust	5/16/2003	\$450,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/16/2003	\$450,000	Rosemary's Circle R Ranch II, LLC
7/14/2003	Rosemary's Circle R Ranch, Ltd	\$900,000	Rosemary's Circle R Ranch Mgmt Trust	7/14/2003	\$450,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	7/14/2003	\$450,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust			Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust			Rosemary's Circle R Ranch II, LLC
8/14/2003	Rosemary's Circle R Ranch, Ltd	\$720,000	Rosemary's Circle R Ranch Mgmt Trust	8/18/2003	\$360,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	8/18/2003	\$360,000	Rosemary's Circle R Ranch II, LLC

## Rosemary's Circle R Ranch Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
8/22/2003	Rosemary's Circle R Ranch, Ltd	\$180,000	Rosemary's Circle R Ranch Mgmt Trust	9/3/2003	\$100,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	9/3/2003	\$100,000	Rosemary's Circle R Ranch II, LLC
9/19/2003	Rosemary's Circle R Ranch, Ltd	\$350,000	Rosemary's Circle R Ranch Mgmt Trust	9/24/2003	\$175,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	9/24/2003	\$175,000	Rosemary's Circle R Ranch II, LLC
10/2/2003	Rosemary's Circle R Ranch, Ltd	\$2,000,000	Rosemary's Circle R Ranch Mgmt Trust	10/7/2003	\$1,000,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	10/7/2003	\$1,000,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	11/12/2003	\$50,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	11/12/2003	\$50,000	Rosemary's Circle R Ranch II, LLC
11/20/2003	Rosemary's Circle R Ranch, Ltd	\$500,000	Rosemary's Circle R Ranch Mgmt Trust	11/20/2003	\$250,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	11/20/2003	\$250,000	Rosemary's Circle R Ranch II, LLC
12/3/2003	Rosemary's Circle R Ranch, Ltd	\$500,000	Rosemary's Circle R Ranch Mgmt Trust	12/9/2003	\$250,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	12/9/2003	\$250,000	Rosemary's Circle R Ranch II, LLC
12/19/2003	Rosemary's Circle R Ranch, Ltd	\$500,000	Rosemary's Circle R Ranch Mgmt Trust	12/23/2003	\$250,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	12/23/2003	\$250,000	Rosemary's Circle R Ranch II, LLC
12/23/2003	Pops, LLC	\$1,500,000	Rosemary's Circle R Ranch Mgmt Trust	12/23/2003	\$750,000	Rosemary's Circle R Ranch I, LLC

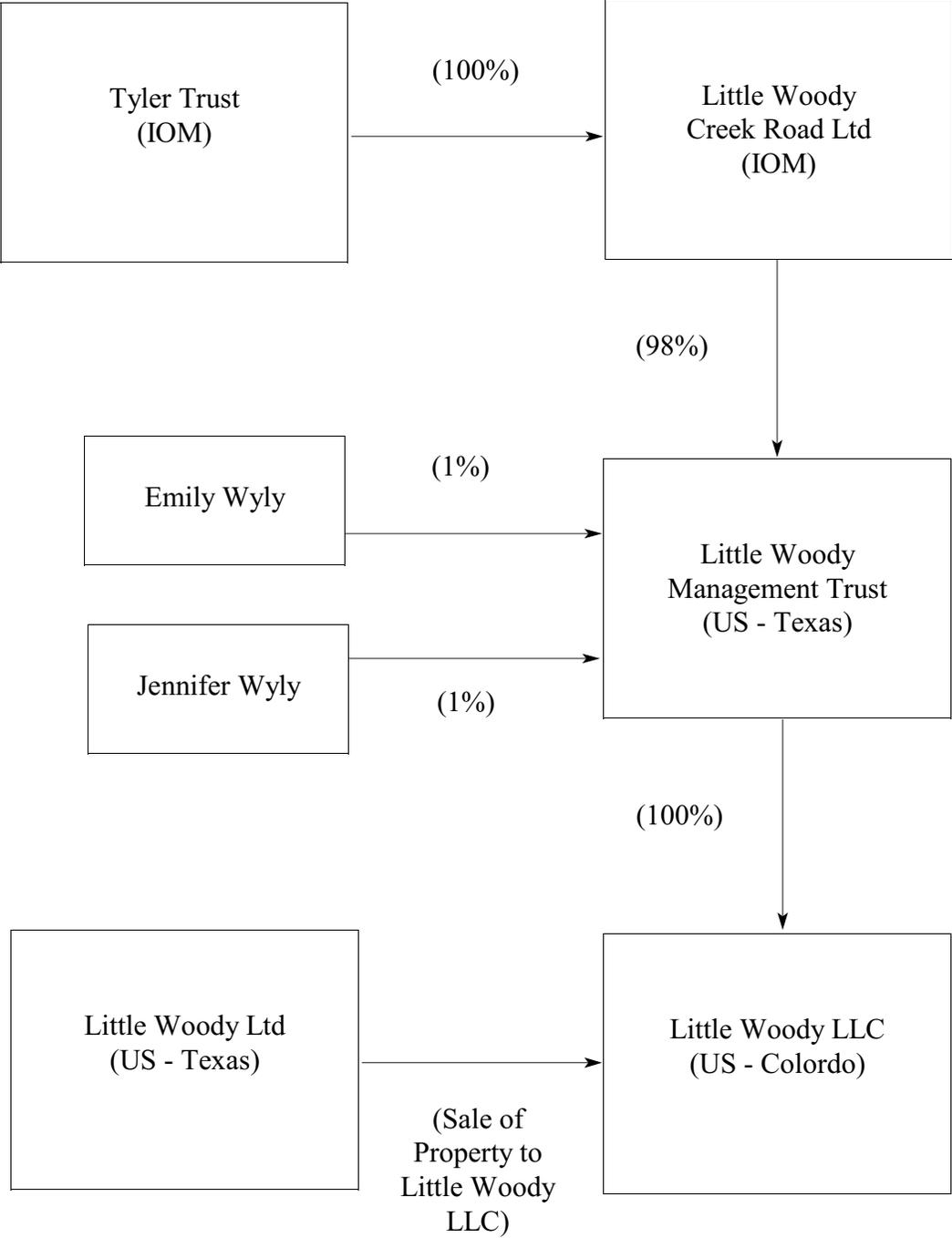
## Rosemary's Circle R Ranch Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
			Rosemary's Circle R Ranch Mgmt Trust	12/23/2003	\$750,000	Rosemary's Circle R Ranch II, LLC
12/24/2003	Bubba, LLC	\$900,000	Rosemary's Circle R Ranch Mgmt Trust	1/26/2004	\$425,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	1/26/2004	\$425,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	2/11/2004	\$50,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	2/11/2004	\$50,000	Rosemary's Circle R Ranch II, LLC
2/23/2004	Rosemary's Circle R Ranch, Ltd	\$900,000	Rosemary's Circle R Ranch Mgmt Trust	2/27/2004	\$450,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	2/27/2004	\$450,000	Rosemary's Circle R Ranch II, LLC
3/17/2004	Rosemary's Circle R Ranch, Ltd	\$600,000	Rosemary's Circle R Ranch Mgmt Trust	3/31/2004	\$300,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	3/31/2004	\$300,000	Rosemary's Circle R Ranch II, LLC
4/23/2004	Rosemary's Circle R Ranch, Ltd	\$300,000	Rosemary's Circle R Ranch Mgmt Trust	4/27/2004	\$150,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	4/27/2004	\$150,000	Rosemary's Circle R Ranch II, LLC
5/6/2004	Rosemary's Circle R Ranch, Ltd	\$800,000	Rosemary's Circle R Ranch Mgmt Trust	5/6/2004	\$400,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	5/6/2004	\$400,000	Rosemary's Circle R Ranch II, LLC
5/16/2004	Rosemary's Circle R Ranch, Ltd	\$900,000	Rosemary's Circle R Ranch Mgmt Trust	5/20/2004	\$450,000	Rosemary's Circle R Ranch I, LLC

## Rosemary's Circle R Ranch Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
			Rosemary's Circle R Ranch Mgmt Trust	5/20/2004	\$450,000	Rosemary's Circle R Ranch II, LLC
6/23/2004	Rosemary's Circle R Ranch, Ltd	\$300,000	Rosemary's Circle R Ranch Mgmt Trust	6/25/2004	\$150,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	6/25/2004	\$150,000	Rosemary's Circle R Ranch II, LLC
7/15/2004	Rosemary's Circle R Ranch, Ltd	\$500,000	Rosemary's Circle R Ranch Mgmt Trust	7/16/2004	\$250,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	7/16/2004	\$250,000	Rosemary's Circle R Ranch II, LLC
8/3/2004	Rosemary's Circle R Ranch, Ltd	\$3,000,000	Rosemary's Circle R Ranch Mgmt Trust	8/4/2004	\$500,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	8/4/2004	\$500,000	Rosemary's Circle R Ranch II, LLC
			Rosemary's Circle R Ranch Mgmt Trust	8/5/2004	\$1,000,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	8/5/2004	\$1,000,000	Rosemary's Circle R Ranch II, LLC
1/27/2005	Rosemary's Circle R Ranch, Ltd	\$2,000,000	Rosemary's Circle R Ranch Mgmt Trust	2/4/2005	\$1,000,000	Rosemary's Circle R Ranch I, LLC
			Rosemary's Circle R Ranch Mgmt Trust	2/4/2005	\$1,000,000	Rosemary's Circle R Ranch II, LLC
<b>Circle R Total</b>		\$46,585,000			\$46,400,000	

# LL Ranch Funding Structure



## LL Ranch Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
3/2/2001	Little Woody Creek Road, Ltd.	\$4,500,000	Little Woody Management Trust	3/2/2001	\$4,500,000	Little Woody, LLC
8/16/2001	Little Woody Creek Road, Ltd.	\$200,000	Little Woody Management Trust	8/28/2001	\$200,000	Little Woody, LLC
<b>2001 TOTAL</b>		<b>\$4,700,000</b>			<b>\$4,700,000</b>	
2/12/2002	Little Woody Creek Road, Ltd.	\$200,000	Little Woody Management Trust	2/22/2002	\$200,000	Little Woody, LLC
7/25/2002	Little Woody Creek Road, Ltd.	\$300,000	Little Woody Management Trust	7/30/2002	\$300,000	Little Woody, LLC
<b>2002 TOTAL</b>		<b>\$500,000</b>			<b>\$500,000</b>	
3/13/2003	Little Woody Creek Road, Ltd.	\$250,000	Little Woody Management Trust	3/13/2003	\$250,000	Little Woody, LLC
9/11/2003	Little Woody Creek Road, Ltd.	\$250,000	Little Woody Management Trust	9/11/2003	\$250,000	Little Woody, LLC
<b>2003 TOTAL</b>		<b>\$500,000</b>			<b>\$500,000</b>	
3/10/2004	Little Woody Creek Road, Ltd.	\$250,000	Little Woody Management Trust	3/18/2004	\$10,000	Little Woody, LLC
				3/31/2004	\$50,000	Little Woody, LLC
				4/22/2004	\$200,000	Little Woody, LLC
11/5/2004	Little Woody Creek Road, Ltd.	\$250,000	Little Woody Management Trust	9/22/2004	\$45,000	Little Woody, LLC
				12/2/2004	\$200,000	Little Woody, LLC
<b>2004 TOTAL</b>		<b>\$500,000</b>			<b>\$505,000</b>	
<b>GRAND TOTAL</b>		<b>\$6,200,000</b>			<b>\$6,205,000</b>	

After the purchase in March 2001, every six months or so, the Wyly family office requested additional offshore funds to operate the property.<sup>1140</sup> In response, the IOM corporation, LWCRL, wired at least \$200,000 to the U.S. management trust, LWMT. LWMT, in turn, wired the funds to Little Woody LLC, which then used the funds to pay for construction projects, furnishings, utilities, real estate taxes, and other expenses related to the LL Ranch. In a little over 3 years, from August 2001 to December 2004, more than \$1.9 million in offshore funds were spent on the upkeep and improvement of the LL Ranch.<sup>1141</sup>

The LL Ranch provides an example of a sham real estate “sale” used to bring \$4.29 million in offshore cash into the United States for the personal use of Wyly family members. Although the ranch changed hands on paper, moving from one Wyly-related entity to another, in reality, the property apparently continued to be used by the same Wyly family members in the same way both before and after the sales transaction. Another \$1.9 million in offshore money was used to pay the real estate’s operating expenses, providing Wyly family members with an almost cost-free, multi-million-dollar residence for their personal use. Altogether, about \$6.2 million in offshore dollars was spent on this property. The fact that the offshore trustees were willing to wire millions of dollars to be spent on this property and complied with funding requests within days provides additional proof that the Wyllys were able to direct the use of offshore dollars to advance their personal interests.

Analysis of three additional real estate transactions, involving Cottonwood Ventures, Stargate Horse Farm, and oceanside property in Malibu, California, raise commercial as well as residential property issues. These real estate transactions are examined in Appendix 5.

#### **(d) Analysis of Issues**

The five real estate examples examined by the Subcommittee show how \$85 million in untaxed, offshore dollars were used to buy residential and commercial property in the United States; pay real estate maintenance, operating, and construction costs; and enable Wyly family members to enjoy, at minimal personal expense, residential and business properties costing millions of dollars. In these instances, offshore dollars paid for 90 percent or more of the real estate costs. For example, of the \$45 million spent on Rosemary’s Circle Ranch, all but \$434,000 was supplied from offshore. The examples also show how, in some instances, properties were used to justify sham real estate sales and loans that brought millions of offshore dollars into the United States for the Wyllys’ personal use.

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<sup>1140</sup> See, e.g., 8/10/01 email requesting \$200,000 (PSI\_ED00006355-57, 67); 2/11/02 email requesting \$200,000 (PSI\_ED00004611); 7/15/02 email requesting \$300,000 (PSI\_ED00010261); 2/27/03 email requesting \$250,000 (PSI\_ED00005247); 9/8/03 email requesting \$250,000 (PSI\_ED00005974); 3/2/04 email requesting \$250,000 (PSI\_ED00006373); 4/26/05 email requesting \$200,000 (PSI\_ED00003251).

<sup>1141</sup> See chart entitled, “LL Ranch Offshore Funding,” prepared by the Subcommittee Minority Staff (listing wire transfers).

These real estate transactions provide additional proof that the Wyls and their representatives were directing the use of the offshore assets. In the instances examined by the Subcommittee, the Wyls chose the properties to be purchased or sold, determined the timing of the transactions, supervised construction and renovation projects, and made personal use of the real estate. They built homes, art galleries, and a state-of-the-art equestrian facility. Wyly representatives routinely requested offshore funds to pay the real estate costs, and the Wyly-related offshore trustees routinely complied. The Subcommittee saw no instance in which a trustee refused a request for funds; most funding requests were supplied within days. The Subcommittee also saw no instance in which an offshore trustee initiated a real estate transaction on its own. Instead, the offshore trustees routinely deferred to Wyly representatives, supplying funds whenever asked.

### **(7) Spending Offshore Dollars on Artwork, Furnishings, and Jewelry**

During the thirteen years examined in this Report, at least \$30 million in untaxed, offshore dollars were spent to purchase furnishings, artwork, and jewelry for the apparent personal use of Wyly family members.<sup>1142</sup> Although the nominal owners of virtually all of these items were two offshore corporations, the evidence indicates that the artwork, furnishings, and jewelry were actually selected, held, and used by individual Wyly family members. These purchases are further evidence that the Wyls were directing the use of trust assets, and that the offshore trusts were benefitting U.S. persons.

**Background.** From 1992 until 2005, numerous expensive works of art, rare documents and books, furniture, and jewelry were purchased with Wyly-related offshore dollars. These purchases included, for example, a \$937,500 portrait of Benjamin Franklin,<sup>1143</sup> a \$13,000 French

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<sup>1142</sup> The Subcommittee has identified 67 transactions in which a Wyly-related offshore entity paid for one or more items of furnishings, art, rare documents, books, or jewelry, using wire transfers which together total about \$29.9 million. See also 12/31/04 financial statement for “Global SW Family” (PSI\_ED00095232-33)(listing under “SW Foreign Total Family,” an asset described as “Investments in Art, Jewelry, Collectibles & Furniture,” with a fair market value of about \$20.9 million); and 12/31/04 financial statement prepared for “Global CW Family” (HST\_PSI006887)(listing the same asset and showing a fair market value of about \$7.2 million).

<sup>1143</sup> See Senate00135 (invoice for “The Portrait of Benjamin Frankin” by David Martin); HG0213 (dating portrait to 1772). This painting was purchased in 1999, invoiced to Audubon Assets Ltd. (Senate00135), paid for by an offshore corporation, Richland Ltd. (Senate00150), and delivered to Cheryl Wyly in Aspen (Senate00138).

bronze chandelier,<sup>1144</sup> a \$162,000 bureau cabinet,<sup>1145</sup> \$721,000 in official documents from the presidency of Abraham Lincoln,<sup>1146</sup> a \$622,000 ruby,<sup>1147</sup> and a \$759,000 emerald necklace.<sup>1148</sup>

Although a number of Wyly-related offshore entities supplied funds for these purchases, almost all of the items were nominally owned by either Audubon Assets Ltd. (Audubon) or Soulieana Ltd. (Soulieana). Audubon, formerly named Fugue Ltd., is wholly owned by the Bessie Trust, a 1994 foreign grantor trust set up to benefit Sam Wyly and his family. Soulieana is wholly owned by the Tyler Trust, a 1994 foreign grantor trust set up to benefit Charles Wyly and his family. Both corporations are shell operations, with no employees or offices of their own. Since 1995, many of their transactions have been handled for a fee by the Irish Trust Company, working in tandem with the Wyly family office. The documents show that the key persons who handled these matters for Audubon and Soulieana during the period under examination were Ms. Boucher and Ms. MacInnis from the Irish Trust Company, and Ms. Hennington, Ms. Robertson, Ms. Alexander, and Ms. Westbrook from the Wyly family office.

Over the years, several other companies also provided the Wyly family with assistance in purchasing and transporting artworks and furnishings. One is a Texas corporation called Marguerite Theresa Green and Associates, Inc. (Green & Associates), an interior design firm which handled purchases associated with the Charles Wyly family.<sup>1149</sup> Another is Michelangelo Investors LDC, a Cayman corporation which, on occasion, acted as an intermediary in some purchases associated with the Charles Wyly family.<sup>1150</sup> A third is the Elliott Yeary Gallery, the

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<sup>1144</sup> See PSI00078562 (invoice for 18-light French bronze chandelier). This light fixture was purchased in 1997, by Marguerite Theresa Green and Associates, for “Mr. Wyly’s bedroom,” and paid for by an offshore corporation, Soulieana Ltd.

<sup>1145</sup> See PSI00078568 (invoice for “George I Walnut ... Bureau Cabinet”). This cabinet was purchased in 1997, by Marguerite Theresa Green and Associates, and paid for by Soulieana Ltd.

<sup>1146</sup> See PSI-CHRIST00295 (invoice for “resolution for Amendment 13”). This document was purchased in 2002, as part of a larger collection of American historical documents. It was invoiced to Sam Wyly (PSI-CHRIST00295), paid for by Audubon Assets Ltd. (PSI-CHRIST00296), and delivered to Highland Stargate in Dallas (PSI-CHRIST00297-98).

<sup>1147</sup> See PSI\_ED00002658, 70 (emails describing ruby). The ruby is apparently held in the name of Audubon Assets Ltd.

<sup>1148</sup> See PSI-JEWEL00065 (invoice for necklace and matching ring). The necklace was purchased in 2000, described as “Sold to: Mr. Charles Wyly,” and paid for by Soulieana Ltd.

<sup>1149</sup> See, e.g., Green & Associates invoices from 1997 to 1999 (PSI00078475-573).

<sup>1150</sup> See, e.g., Michelangelo invoice on 12/20/00 for multiple purchases of art and furnishings (PSI\_ED00005035-38); emails discussing this invoice (PSI\_ED00005039-41). See also 5/3/01 emails between Ms. Hennington and Ms. Boucher on Michelangelo’s role (PSI\_ED00012663)(Ms. Hennington wrote: “Charles sent me an invoice for a painting he commissioned for \$30,000 with a note as to whether Souli[e]ana should pay. Someone put down a \$15,000 deposit .... Is it a problem to pay \$15,000 to a domestic entity and the rest to the gallery?” Ms. Boucher responded: “I don’t like to pay direct to the domestic entity from offshore, but we have a company here

Colorado art gallery run by Sam Wyly's daughter, Kelly Wyly Elliott, and her business partner, Kristin Yeary. In 2002, Audubon named the Gallery as the "curator" of its art collection.<sup>1151</sup> In 2004, perhaps to forestall an argument that no legitimate business would allow a multi-million-dollar collection of art, rare documents, furnishings, and jewelry to reside at multiple locations with no tracking system, Audubon entered into formal "Possession Agreements" with Sam Wyly, his wife and children, identifying which Wyly family members had possession of which Audubon-owned pieces and stating that these persons were holding the items as "an agent" of Audubon.<sup>1152</sup> It is unclear whether Soulieana has an equivalent tracking system and set of custody agreements.<sup>1153</sup>

**Audubon and Soulieana Purchases.** On paper, the artwork, furnishings, and jewelry purchased by Audubon and Soulieana were held as investments intended to benefit the Bessie and Tyler Trusts. In reality, many of these purchases appear to have been made at the direction of Wyly family members and to have been treated not as trust investments, but as personal possessions intended for the use and enjoyment of particular Wyly family members. The following examples illustrate these points.

**Investing in Art.** A painting purchased in 1996, called Noon Day Rest, demonstrates that some purchases of artwork were made at the insistence of Wyly family members despite trustee concerns. On July 10, 1996, Sotheby's issued an invoice to Cheryl Wyly for the purchase of Noon Day Rest for £155,500 or about \$240,000. (PSI00119266) Two weeks later, on July 15, 1996, the Bessie Trustee, then Lorne House, asked Sotheby's to change the invoice to charge Audubon for the cost of the painting. (PSI00119255, 57).

The story behind this invoicing change is as follows. On July 18, 1996, one week after the original invoice was issued naming Cheryl Wyly as the purchaser of the painting, Michael French and Sharyl Robertson, as trust protectors for the Wyly offshore trusts, wrote to Lorne House, then the Bessie Trust trustee, recommending that its subsidiary, Audubon, sell certain Treasury Bills, use the funds to purchase the painting, and ship it to Dallas. (PSI00119258).

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called Michelangelo LDC that we can use as an intermediary to refund the deposit. We can assign or sell the commissioned work to Michelangelo and then assign it onto Soulieana Limited.”).

<sup>1151</sup> 5/22/02 letter agreement between Audubon and Elliott Yeary Gallery (PSI00039349-50). See also HST\_PSI000001(referring to 5/22/02 agreement). Audubon may have also appointed the Gallery and Sam Wyly as "art consultants" authorized to assist in its purchases. See 12/14/04 letter from the law firm of Herrick, Feinstein, representing Hammer Galleries, to the Manhattan District Attorney's Office. (HG0005-06).

<sup>1152</sup> See, e.g., (PSI00078338-42)(possession agreement with Paragon Building/Kelly Wyly Elliott); (PSI00078361-67, 87-88)(possession agreement with Sam and Cheryl Wyly); (PSI00078418-22)(possession agreement with Kelly and Jason Elliott); (PSI0078428-32)(possession agreement with Laurie and David Mathews); (PSI00078439-43)(possession agreement with Lisa Wyly and John Graham).

<sup>1153</sup> See, e.g., 3/27/01 meeting agenda (PSI00110232-33)(discussing Soulieana possession agreements and completion of "schedules"). The Subcommittee has been unable, however, to locate any such agreements, and Ms. Hennington reported that she had no copies of them.

The managing director of Lorne House, Ronald Buchanan, did not immediately agree. Instead, in an email sent the next day, he wrote: “[W]e would draw to the Committee of Protectors’ attention that they are recommending the substitution of a very safe, income-producing asset by one which might be difficult to sell at a profit at short notice and which generates no income.” He observed that Audubon was also being asked to buy the painting at “222% of the pre-auction estimated price.” He asked the protectors to confirm that they “do not believe that the beneficiaries will need the income which the proposed purchase price could have generated in the near or medium-term future,” and “the painting will gain appreciably more in value than would Treasury Bills.” (PSI00119265).

Mr. French responded the same day, July 19, 1996, with a sharply worded email. He stated that the Bessie Trust agreement “clearly authorizes a purchase of personal property for personal use or enjoyment in specie by any beneficiary.”<sup>1154</sup> (PSI00119259; emphasis in original). He continued:

“Unless there is a clear and unequivocal requirement of IOM law (which I doubt), that any such purchase that is specifically authorized by the trust agreement must nevertheless be weighed against the investment returns that could otherwise be obtained on the funds, then I must assume that this transaction is authorized and lawful. If you wish to search for such a legal prohibition, you should do so at your own expense and not that of the Trust. ... We need to resolve this issue at once.”

On July 22, 1996, Mr. Buchanan wrote to Ms. Boucher requesting “written confirmation that the Committee of Protectors have considered the points raised ... and ... continue to recommend that the Trustees should buy the ... painting.” (PSI00117450; see also 117449). On July 24, 1996, Mr. French wrote to Mr. Buchanan proposing that Sam Wyly provide the Trustees with a letter stating that, with respect to the £155,500 needed to buy the painting, “neither I, nor my spouse nor any of my issue has any foreseeable need for such funds or any such income thereon.” (PSI00119263-64) Mr. Buchanan replied on July 25, 1996, that the proposed letter would “do very well” and apologized if the trustees had “appeared excessively obdurate on this matter but, as you know, the legal responsibilities of a trustee are more onerous than those of a banker or portfolio manager.” (PSI00119262). Later the same day, Lorne House sent a letter to Sotheby’s confirming that the painting should be invoiced to Audubon. (PSI00119257). Three days after that, on July 29, 2006, the Trustees formally approved the purchase of the painting by the Bessie Trust “in accordance with the wishes of the ... Protectors.” (PSI00117548).

The Noon Day Rest documents show that it was the Wyllys who made the initial decision to purchase the painting and, only after purchasing it, asked Audubon to become the nominal owner and pay the cost. The email exchange shows further that the Bessie Trustee had

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<sup>1154</sup> Mr. French sent a copy of the trust agreement language which states: “The Trustees shall have power at their absolute discretion ... to invest in the purchase of ... chattels for use or occupation or otherwise for enjoyment in specie by any Beneficiary.” (PSI00119260-61).

reservations about buying the painting, due to concerns that it was overpriced, might be difficult to sell at a profit, and would not appreciate in value compared to other investments. It was only after the protectors pressed for approval and presented a letter from Sam Wyly, that the Trustee agreed to buy the painting. The painting was shipped to Dallas.<sup>1155</sup>

**Gifting An Audubon Painting.** Another painting, Off in the Distance, provides further evidence that the Wyly family, rather than the Bessie Trust, exercised true direction over the Audubon art collection.

On December 23, 2004, Ms. Alexander of the Wyly family office informed Ms. Boucher that Sam Wyly had “just gifted” Off in the Distance “to a friend,” and asked whether the painting was owned by Audubon. (PSI00038425). On December 28, 2004, Ms. Boucher responded that the painting was, in fact, owned by Audubon and the original cost was \$2,520. She asked whether there was a “similarly valued piece owned domestically that the trustees could consider swapping” for the painting that had been given away. (*Id.*). On January 5, 2005, Ms. Alexander identified two paintings that together had a similar value to the painting that Mr. Wyly had given away. Ms. Boucher replied “sounds good – I think Elliott Yeary Gallery as curator for the collection should write a letter or give a notice to Audubon Assets of the exchange” by sending an email to the current Trustee of the Bessie Trust, IFG International. (*Id.*).

Later the same day, Ms. Alexander told Ms. Boucher that she needed to obtain more information on the two paintings she had identified. Ms. Boucher replied that she had “cleared the concept on my end so we are good to go when we find substitution.” (PSI\_ED00034877). About two weeks later, on January 18, 2005, Ms. Alexander identified two different paintings that could be provided to the Trust in place of the painting that had been given away. (PSI00038423). Ms. Boucher responded, “I think this will work.” Two weeks later, on February 2, 2005, Ms. Alexander wrote to Ms. MacInnis at Irish Trust Company “about an exchange of art that Sam gifted at Christmas. I just want to follow up and make sure it works for you and the Trustees as well. ... Please let me know if this works for you, so we can book as an December exchange.” Ms. MacInnis responded the same day: “We are booking the art exchange ... in December.” (PSI00038422).

The documentation related to Off in the Distance shows that no one associated with the Wyly family office, the Irish Trust Company, or the Bessie Trust questioned or objected to Mr. Wyly’s giving away the Trust’s property. That his staff came up with an after-the-fact way to compensate the Trust for the painting’s loss does not alter the evidence showing that Sam Wyly was making the decisions on the content of the Audubon art collection.<sup>1156</sup>

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<sup>1155</sup> See also 11/25/96 fax from Mr. French to Mr. Buchanan (PSI00121101-03)(providing similar assurances to convince the Bessie Trust to purchase five additional paintings at a total cost of about \$1.4 million).

<sup>1156</sup> See also 2002 instance in which the Elliott Yeary Gallery sold a painting without prior notice to or consultation with Audubon. (HST\_PSI000001; PSI00078328; HG0051).

**Green & Associates Invoices.** Another set of documents, related to artwork and furnishings handled by Green & Associates on behalf of the Charles Wyly family, provides evidence that items nominally owned by Soulieana were, in fact, purchased at the direction of Charles Wyly's family members and intended for the family's personal use.

On April 21, 1999, Ms. Robertson sent a fax to Ms. Boucher with copies of 16 invoices from Green & Associates, dated April 1 through April 4, 1999, itemizing specific furnishings and works of art that had been purchased for the Charles Wyly residence. Ms. Robertson wrote:

“As in the past, the protectorate committee recommends that Tyler Trust (Soulieana Limited) consider the purchase of collectibles and artwork. I am attaching invoices from Marguerite Theresa Green and Associates, Inc. totalling \$224,298.26. I am obtaining insurance on behalf of Soulieana, as requested. Pictures of these collectibles will come by courier with the original invoices. If possible, could these funds be wired **AS SOON AS POSSIBLE** since vendors need to be paid immediately.”<sup>1157</sup>

Each of the 16 invoices billed Soulieana, described a particular item, identified its cost, and identified the room in which the item was intended to be placed in the Wyly home. For example, Invoice 234890 described a “mid-19th century Chinese pottery figure” costing about \$9,300, intended to go in the “upstairs sitting room.” (PSI00078482) Invoice 23500 described a “set of 2 ‘Parian’ wall shelves” costing about \$2,100, intended for “Mrs. Wyly’s bath.” (PSI00078493). Invoice 23502 described a “bronze and crystal lamp base” costing \$600, for “Mrs. Wyly’s closet.” (PSI00078495).

An earlier fax, dated January 21, 1997, sent by a Wyly family office employee to Green & Associates, informed the company that Mr. Wyly wanted these types of purchases to be billed to Soulieana: “Pursuant to Mr. Wyly’s telephone conversation, please invoice future purchases of collectibles” to Soulieana Ltd. (PSI00078559). A fax dated February 10, 1997, from the same Wyly family office employee to the Huntsman Gallery of Fine Art in Aspen, Colorado, was even more explicit: “[P]lease invoice the recent purchase by Dee Wyly” to Soulieana. “The Wyly name should not be noted on the invoices.” (PSI00078558).<sup>1158</sup> A fax dated two days later, on February 12, from Ms. Robertson to Lorne House recommended that “Tyler Trust (Soulieana)” purchase all of the items described in invoices provided by Green & Associates, for a total of about \$450,000. The fax states: “The property is presently in storage but will eventually reside at ... Deloache, Dallas, Texas,” giving the address of the residence of Charles

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<sup>1157</sup> PSI00078481 (emphasis in original). The same wording appears in other invoices as well. See, e.g., PSI00078475 (fax dated 6/29/99); PSI00078478 (fax dated 3/7/99); PSI00078498 (fax dated 1/30/99); PSI00078506 (fax dated 12/23/98); PSI00078505 (fax dated 8/13/98); PSI00078507 (fax dated 1/29/98).

<sup>1158</sup> An undated handwritten letter from Paul Klinerman of the Huntsman Gallery states: “Enclosed are copies and documentation for art purchased on 2 invoices by Dee Wyly. ... The 1/2/97 invoice was paid by Dee[.] The 2/4/97 invoice was sent to Soulieana Limited.” Notations on the side of the letter in another person’s handwriting state: “Shari – When Soulieana pays, Huntsman will reimburse Mrs. Wyly.” (PSI00078515)

Wyly and his wife. (PSI00078517). Five days later, on February 17, the Trustee sent \$450,000 in offshore dollars from Soulieana to Green & Associates to buy the items. (PSI00078556).

Together, these documents suggest that Green & Associates routinely purchased art and furnishings for the Charles Wyly family home, that some of the items were selected by his wife, and, at the direction of Charles Wyly, the purchases were often billed to Soulieana. The protectors, in turn, routinely asked the Tyler Trust to approve the purchases as soon as possible.<sup>1159</sup> It appears from the documentation that the Trustee played no role in selecting or evaluating specific items as suitable trust investments; rather the Trustee was informed of the purchases after the fact and asked to make immediate payment to the vendors. Soulieana or its parent trust then supplied the funds requested. The Subcommittee is unaware of any evidence showing that Lorne House ever declined to pay a Green & Associates invoice.

**Jewelry.** In addition to artwork and home furnishings, Audubon and Soulieana expended significant sums on jewelry. One set of documents shows that, while the jewelry was held in the name of the two IOM corporations, individual pieces were treated as if they were the personal possessions of particular Wyly members who kept the pieces in their homes and directed their use.

In 2003, when renewing a jewelry insurance policy, the Wyly family office was apparently asked to identify the single most expensive piece owned by Audubon and Soulieana, and to describe how often Wyly family members wore insured jewelry.<sup>1160</sup> On July 15, 2003, Ms. Boucher wrote in response: “[C]an get it to you today – I think the new necklace might be the largest for Soulieana ... [and] Cheryl’s \$600K ruby is the most expensive on Audubon but will confirm.” (PSI\_ED00002658) Later the same day, Ms. Hennington sent the following information to the insurance company: “[H]ere are the answers to your questions:

“Sam family – \$600,000 earrings bought for Cheryl Charles family – \$100,000 ... [for] a ring purchased by Donnie for Martha – all of the very expensive pieces are owned by Soulieana Audubon – \$622,000 ruby in Cheryl’s possession Soulieana – \$759,000 necklace in Dee Wyly’s possession ....” (PSI\_ED00002670).

The wording of these emails indicates that individual jewelry pieces nominally owned by Audubon or Soulieana were treated as if they were the property of individual Wylys, such as the “ruby in Cheryl’s possession” and “necklace in Dee Wyly’s possession.” The Subcommittee

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<sup>1159</sup> One of the trust protectors, Mr. French, told the Subcommittee that he had not been informed of and did not participate in the recommendations for these purchases, and first learned of them when the Subcommittee showed him the documentation. Subcommittee interview of Mr. French (4/21/06). Mr. French said that the recommendations must have been made solely by Ms. Robertson, despite his understanding that both protectors had to act together for a recommendation to be made.

<sup>1160</sup> See 7/15/03 email from Ms. Hennington, head of the Wyly family office, to Ms. Boucher on “insurance” (PSI\_ED00002658)(“For the insurance renewal’s on the jewelry policy the company needs to know the most expensive piece owned by both Audubon and Soulieana.”).

saw no evidence that the Bessie or Tyler trustees played any role in selecting, evaluating as trust investments, or controlling the use of the jewelry purchased by Audubon and Soulieana.<sup>1161</sup>

**Reinvoicing.** On a number of occasions, either Sam or Charles Wyly requested that items which they or other family members had purchased personally be re-invoiced so that the cost would be paid by either Audubon or Soulieana. For example, in 2002, after receiving invoices for jewelry purchases totaling about \$37,000, the Wyly family office sent an email to the merchant on behalf of Charles Wyly as follows: “I just received a note from Mr. Wyly requesting that a couple of the invoices be charged to Soulieana. The invoice numbers are 19951A and 19951C. Can these please be addressed and re-billed to Soulieana? I hate to burden you with this again, but your help is appreciated as always.” (PSI\_ED00004943; see also PSI-JEWEL00166-68). On July 18, 1997, six weeks after purchasing a Thomas H. Benton painting for \$156,500, Sam Wyly sent a letter to Christie’s asking for the invoice to be re-billed to Audubon, formerly known as Fugue: “I am faxing a copy of invoice #J276149 that I need to have rebilled to Fugue Ltd. ... I would like to apologize [sic] for any inconvenience this causes you.” (PSI\_Christ00258-59). These and other requests for invoice changes suggest that there was little, if any, difference between a personal purchase by a Wyly family member and a purchase made in the name of one of the offshore corporations.<sup>1162</sup> It also shows that the Wyls could rely on the trustees to fund the purchases they made.

**Lending \$1.4 Million.** On occasion, some purchases of artwork seemed to have been less about buying specific pieces of art, than about bringing offshore dollars into the United States. For example, during the first half of 2001, the Wrangler Trust, a U.S. trust settled by Sam Wyly, had purchased a number of works of art and other collectibles at a total cost of about \$1.4 million.<sup>1163</sup> On October 2, 2001, the Wrangler Trust abruptly sold all of these items to Audubon for \$1.4 million in offshore dollars.<sup>1164</sup> Later the same day, the Wrangler Trust loaned

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<sup>1161</sup> Mr. French also told the Subcommittee that, from 1992 until 2000, he played no role in recommending the purchase of jewelry by the offshore entities, and any such recommendations must have come from Ms. Robertson alone. Subcommittee interview of Mr. French (4/21/06).

<sup>1162</sup> See also PSI\_ED00015799 (11/3/04 email from Ms. Hennington to Ms. Boucher states: “Rena got an e-mail for \$320k of art today and was going to have it re-invoiced to Audubon provided they have \$\$ – if not we will pay from Sam.”); PSI\_ED00011332-33 (Wyly family office states in an email that Charles Wyly “brought by a note that he had bought a bauble at [a jewelers] and Soulieana should pay,” after which Soulieana paid the \$319,000 invoice, PSI-JEWEL00169-70); and HG0228-30, 375 (paintings nominally owned by Audubon are treated and discussed as if personally owned by Sam Wyly).

<sup>1163</sup> See, e.g., PSI\_ED00022604 (listing five purchases); PSI\_ED00005187 (discussing five Pablo Picasso paintings purchased by Wrangler); PSI00025525-26, 33 (discussing a \$35,000 art purchase); PSI00025571 (9/30/01 financial statement for the Wrangler Trust listing as an asset “Furniture, Art and Jewelry” valued at \$1,460,100).

<sup>1164</sup> See, e.g., PSI00025531, 33, 39 (showing on 10/2/01, Audubon paid \$1,424,850 to the Wrangler Trust for “artwork”).

\$1.4 million to Sam Wyly for a business investment.<sup>1165</sup> As far as the Subcommittee can tell, these transfers of money and ownership had no impact on the underlying works of art or furnishings. The items did not move from one location to another or change possession. The October sale and loan did, however, serve to transfer \$1.4 million from Audubon's offshore account into the pocket of Sam Wyly so that he could invest in a U.S. business venture. None of the "sale" documents show any involvement of the Bessie Trustee in evaluating the items being acquired or consenting beforehand to their purchase.

**Controlling the Details.** Many documents show that Wyly family members exercised direction over even minor aspects of specific purchases by Audubon or Soulieana, such as determining where a particular purchase should be delivered or under what circumstances it should be sold. In 2002, for example, an invoice issued by Christie's for the purchase of two historical documents associated with the presidencies of Harry Truman and Herbert Hoover was addressed to Sam Wyly at Audubon, even though Mr. Wyly held no executive position at the corporation.<sup>1166</sup> An internal Christie's email discussing the sale, on October 30, 2002, stated that Mr. Wyly had asked for the documents to be shipped to Dallas, which meant he needed to pay an added \$2,760 in sales tax. (PSI\_CHRIST00321). That email was followed by another on November 5, 2002, which stated: "The client just told us that she wants it shipped to Colorado NOT Texas so no sales tax due." The documents were delivered to Sam Wyly at his daughter's art gallery in Aspen, Colorado. (PSI-CHRIST00317). None of the documents reviewed by the Subcommittee showed any role played by the Bessie Trustee in evaluating the documents as investments or determining where the documents should be located, despite Audubon's footing the \$33,000 bill.

In another instance, a set of rare books from 1838, The Indian Tribes of North America, was sold to Audubon in 1998, for \$145,000, delivered to Sam Wyly's personal residence, and apparently displayed in his library. (HST\_PSI000006; TPC-S0025, 28-29). In 2005, Sam apparently consigned the books to Sotheby's for sale by auction, and Sotheby's records listed him as the books' owner. (PSI00078328). In a fax dated June 10, 2005, Sam wrote: "[Y]our records are inaccurate regarding 'The Indian Tribes of North America.' These three books are owned by Audubon Asset Limited." (SENATE00213). In response, Sotheby's wrote that it had moved "the consigned property from Mr. Wyly's personal account to the Audubon Assets account," but also stated that "Mr. Wyly should initial the suggested reserve if he agrees to it," continuing to confer on him decisionmaking authority over property nominally held by Audubon. (SENATE00204). The books sold later that month. (PSI00078328).

**Paying for Wyly Family Portraits.** A final example of the offshore art expenditures in this case history involves Wyly family portraits. Over a seven-year period from 1997 until 2004,

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<sup>1165</sup> See, e.g., PSI00025531 (showing Wrangler \$1.4 million loan to Sam Wyly for an investment in "Precept").

<sup>1166</sup> See, e.g., PSI-CHRIST00327 (10/9/02)(purchase of "Truman, H. DS, 8 May 1945, Proclamation – end of European War" and "Hoover, H. Illuminated DS Requesting American Support, 1931"). See also bill of lading (Christie's000019, 23, both with handwritten notations); PSI-CHRIST00272.

Audubon and Soulieana paid at least \$870,000 in offshore dollars to artists who produced 20 portraits of individual Wyly family members, including Sam, Charles, their wives, their children, and their grandchildren.<sup>1167</sup> These portraits cost between \$30,000 and \$50,000 each. In 2004, all of these portraits were apparently hanging in the homes of Wyly family members.<sup>1168</sup> The documents associated with these portraits contain no indication that the Bessie or Tyler Trustees played any decisionmaking role in the selection of the artists or in valuing the paintings. The fact that these portraits were financed with trust funds is additional evidence of the level of influence exercised by the Wyllys over how the trust funds were spent.

**Analysis of the Issues.** Since 1992, at least \$30 million in Wyly-related offshore dollars were spent on Wyly family portraits, other works of art, expensive home furnishings, rare documents and books, and costly jewels worn by Wyly family members. The documents suggest that the Bessie and Tyler Trusts played little or no role in the selection, location, or use of the hundreds of items purchased by Audubon and Soulieana. Instead, the evidence suggests that the Wyllys used offshore funds, funneled through Audubon and Soulieana, to buy the items they wanted. The trusts supplied the funds when asked.

#### **(8) Hiding Beneficial Ownership**

From 1992 to 2004, the 58 offshore trusts and corporations in the Wyly offshore structure opened numerous accounts at prominent securities firms in the United States, Credit Suisse First Boston (CSFB), Lehman Brothers, and Bank of America. They used these accounts to buy and sell securities, make investments, and send multi-million-dollar wire transfers. All three financial institutions knew that the offshore entities were associated with the Wyly family, but none of the institutions ever required the offshore entities to identify their beneficial owners or document their connection to the Wyllys.

These offshore corporations and trusts presented a classic case of hiding beneficial ownership. For more than a decade, U.S. banks have been required to “know their customers” to prevent criminals from misusing bank services; part of that obligation has been, when opening accounts for offshore corporations and trusts from secrecy jurisdictions, to identify the beneficial owners behind the offshore entities. Securities firms did not operate under the same legal requirements until enactment of the 2001 Patriot Act which extended anti-money laundering requirements to securities accounts as well. By July 2002, the Patriot Act required securities firms that opened “private banking accounts” with at least \$1 million for foreign account holders, to identify both the nominal and beneficial owners of those accounts. By May 2003, SEC regulations required securities firms to identify the beneficial owner of each account they administered.

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<sup>1167</sup> See HG0043-44 (invoice for \$330,000 for eight portraits); HG0053-54 (invoice for \$180,000 for six portraits); HG0056 (invoice for \$200,000 for four portraits); HG0057 (invoice for \$80,000 for two portraits).

<sup>1168</sup> See, e.g., possession agreements with Sam and Cheryl Wyly (PSI00078387-88), with Laurie and David Matthews (PSI00078432), with Kelly and Jason Elliott (PSI00078421), and with John Graham and Lisa Wyly (PSI00078442).

By the summer of 2003, the Wyly-related offshore entities had moved to Bank of America and opened dozens of securities accounts. Some of their transactions began tripping alarms in the anti-money laundering surveillance system used by the clearing broker, National Financial Services (NFS), that administered the Bank of America accounts. NFS insisted that, if Bank of America wanted it to continue to handle the accounts, it needed the information required by law – the names of the beneficial owners behind the offshore corporations and trusts using the accounts. For more than a year, the offshore entities resisted providing the information, and Bank of America tried to convince NFS not to press for it. Finally, in late 2004, after Bank of America received subpoenas issued by the Manhattan District Attorney seeking information about the accounts, Bank of America closed them.

Bank of America knew that the offshore entities were associated with the Wyls. The key broker who handled the accounts, Louis Schaufele, knew that Sam and Charles Wyly were directing the offshore entities' investment activities. He nevertheless insisted that the offshore entities be treated as independent of the Wyls and fought efforts to identify the Wyls as their beneficial owners. In addition, when, for tax purposes, the offshore entities submitted W-8BEN forms representing that they were independent foreign entities, beneficially owned the accounts assets, and were not subject to IRS requirements for reporting investment income paid to U.S. persons, Bank of America accepted the forms and never filed a 1099 reporting the account income to the IRS.

Had the offshore entities acknowledged that the Wyls were the beneficial owners of the offshore trusts and corporations for anti-money laundering purposes, and allowed their connection to these entities to be documented at Bank of America, it would have been harder for the Wyls to deny their connection to these entities for tax and securities purposes.

#### **(a) Background on Beneficial Ownership**

For decades, U.S. banks have had an obligation to “know their customers,” to understand the natural persons behind offshore corporations and trusts, to ensure that bank services would not be misused for illegal purposes. U.S. banks have also operated for years under legal obligations to report suspicious transactions to law enforcement to prevent money laundering.

In contrast, until recently, U.S. securities firms did not operate under the same know-your-customer obligations. For many years, brokers were required to evaluate their customers to ensure that they were selling them suitable investments – for example, selling high risk securities to persons with a high tolerance for risk and not to an elderly person on a fixed income – but this obligation was not equivalent to performing a due diligence review to guard against opening an account for a questionable person. Some securities firms set up voluntary anti-money laundering

(AML) programs,<sup>1169</sup> but it was not until passage of the Patriot Act in 2001 that all U.S. securities firms became legally obligated to establish AML programs and to identify and verify the identity of their customers.<sup>1170</sup>

**Beneficial Ownership under Anti-Money Laundering Laws.** Three key laws set out the obligations of U.S. financial institutions to know their customers and guard against misuse of their accounts, the Bank Secrecy Act of 1970, the Money Laundering Control Act of 1986, and the 2001 Patriot Act, which amended both prior laws.<sup>1171</sup> These and other AML laws have, over time, tightened requirements for banks and other financial institutions to evaluate clients, monitor transactions, and report suspicious activity.

The 1970 Bank Secrecy Act was the first to require U.S. financial institutions operating in the United States to undertake AML efforts, authorizing the Treasury Secretary to issue regulations requiring financial institutions to establish AML programs meeting certain criteria.<sup>1172</sup> In 1986, the Money Laundering Control Act was the first in the world to make money laundering itself a crime, prohibiting persons from knowingly engaging in financial transactions involving criminal proceeds.<sup>1173</sup> In 1996, the Treasury Secretary began requiring banks to file Suspicious Activity Reports on client transactions raising red flags of possible misconduct.<sup>1174</sup> In 1997, the Federal Reserve issued special guidance warning banks catering to wealthy individuals through “private banking accounts” of the need to install controls to detect and report possible money laundering.<sup>1175</sup> In 1998 and 2000, federal bank regulators issued

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<sup>1169</sup> See, e.g., “Anti-Money Laundering Efforts in the Securities Industry,” GAO-02-111 (October 2001)(In this report, GAO surveyed 3,015 broker-dealers and 310 mutual fund groups in the United States to determine whether they had voluntary anti-money laundering measures in place, such as procedures to obtain information on customers’ identities and source of funds, review decisions to open new accounts, monitor account transactions for possible money laundering, and report suspicious activity to law enforcement. The GAO survey estimated that only 17% of broker-dealers reported having such voluntary anti-money laundering measures in place; an estimated 83% of the broker-dealers did not).

<sup>1170</sup> Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Public Law 107-56, 115 Stat. 272 (10/26/01)(“Patriot Act”).

<sup>1171</sup> For a more detailed discussion of U.S. anti-money laundering laws, see “Anti-Money Laundering: Issues Concerning Depository Institution Regulator Oversight,” GAO-04-833T (6/3/04), testimony provided by GAO before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, at 4-6.

<sup>1172</sup> 31 U.S.C. § 5318(h). For many years, Treasury required only banks, and not other types of financial institutions, to establish AML programs. After enactment of the 2001 Patriot Act, Treasury expanded the requirement for AML programs to other types of financial institutions, including securities firms.

<sup>1173</sup> 18 U.S.C. §§ 1956-57.

<sup>1174</sup> See, e.g., 31 U.S.C. §§ 5313 and 5318(g); 31 C.F.R. §§ 103.11 and 103.21 et seq.

<sup>1175</sup> “Sound Risk Management Practices Governing Private Banking Activities,” prepared by the Federal Reserve Bank of New York (1997)(providing private banks “with guidance regarding the basic controls necessary to minimize reputational and legal risk and to deter illicit activities, such as money laundering”).

guidance on spotting suspicious transactions and strengthening regulatory reviews of banks' AML programs.<sup>1176</sup>

In 2001, after the terrorist attack of September 11th, President Bush announced an intensified effort to uncover and stop terrorist financing, and Congress enacted the Patriot Act which, in part, greatly strengthened federal AML laws.<sup>1177</sup> Among other provisions, the Patriot Act required all U.S. financial institutions, including securities firms, to establish AML programs,<sup>1178</sup> verify the identity of their account holders,<sup>1179</sup> and exercise due diligence when opening and administering private banking accounts for foreign persons.<sup>1180</sup> It also required securities firms to begin filing Suspicious Activity Reports.<sup>1181</sup>

The Patriot Act imposed a special set of requirements to prevent misuse of "private banking accounts" by foreign account holders. "Private banking accounts" are accounts opened by banks, securities firms, or certain other financial institutions that require a minimum of \$1 million in funds or assets, are opened for individuals with a "direct or beneficial ownership interest" in the account, and use an employee, such as a private banker or account officer, to act as a personal liaison between the financial institution and the "direct or beneficial owner." 31 U.S.C. § 5318(i)(4)(B). The law required all financial institutions that opened such private banking accounts for foreign account holders to "ascertain the identity of the nominal and beneficial owners" of the account. 31 U.S.C. § 5318(i)(3)(A). This provision included, for example, the requirement that financial institutions ascertain the beneficial owners of accounts

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<sup>1176</sup> See, e.g., 1998 Bank Secrecy Act examination manual, and 2000 Bank Secrecy Act/Anti-Money Laundering Handbook, prepared by the Office of the Comptroller of the Currency.

<sup>1177</sup> See, e.g., Title III of the Patriot Act.

<sup>1178</sup> 31 U.S.C. § 5318(h).

<sup>1179</sup> 31 U.S.C. § 5318(l).

<sup>1180</sup> 31 U.S.C. § 5318(i). ("Each financial institution that establishes, maintains, administers, or manages a private banking account ... in the United States for a non-United States person, ... shall establish appropriate, specific, and when necessary, enhanced, due diligence policies, procedures, and controls that are reasonably designed to detect and report instances of money laundering through those accounts.").

<sup>1181</sup> Section 356 of the Patriot Act required the Treasury Secretary to issue regulations requiring brokers and dealers to file Suspicious Activity Reports (SARs) under 31 U.S.C. § 5318(g); those regulations were promulgated on 7/1/02, and required securities firms to begin filing SARs on transactions that took place after 12/30/02. 67 Fed. Reg. 44048.

opened in the name of foreign corporations or trusts.<sup>1182</sup> This provision became legally binding in July 2002.

The Patriot Act also directed the Treasury Secretary to promulgate regulations further delineating the due diligence obligations of financial institutions, and further defining which account holders have “beneficial ownership of an account.” Section 312(b) of the Patriot Act; 31 U.S.C. § 5318A(e)(3). In response, Treasury issued proposed regulations in May 2002, an “interim final rule” in July 2002, and a final rule in January 2006.<sup>1183</sup> Each of these rules repeated the legal obligation of financial institutions to ascertain the nominal and beneficial owners of private banking accounts.<sup>1184</sup>

The U.S. accounts opened by the Wyly-related offshore entities must be viewed through this history of evolving AML laws. In the United States, the offshore entities opened only securities accounts which, prior to the Patriot Act, operated under fewer legal requirements and less scrutiny than bank accounts. When they opened accounts at CSFB in 1992, for example, know-your-customer practices at securities firms were voluntary, and the SEC exercised no routine oversight. When the accounts moved to Lehman Brothers in 1995, the regulatory environment was little changed. By the time the accounts moved to the securities divisions of Bank of America in 2002, however, the Patriot Act had been enacted, AML concerns had heightened, due diligence regulations were being drafted, and U.S. securities firms should have been on full alert about their obligation to know their customers.

**Beneficial Ownership under U.S. Tax Law.** In addition to guarding against clients attempting to launder illegal proceeds, U.S. financial institutions have for many years been required to help guard against tax evasion by reporting client account income to the IRS. These reporting obligations have, for years, applied equally to both banks and securities firms.

Under U.S. tax law, any person who makes payments on a financial account, such as a bank or securities firm that makes interest, dividend, or capital gains payments on a client

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<sup>1182</sup> See, e.g., final regulation implementing Section 312 of the Patriot Act, 71 Fed. Reg. 496, at 509 (“Because of the unique vulnerabilities for money laundering that exist in the private banking context, it is critical that covered financial institutions conduct their own due diligence with respect to the beneficial owners of private banking accounts. Senator Levin specifically discussed accounts opened in the name of investment advisers, shell corporations, or trusts on behalf of other persons, noting that “[they] are exactly the types of accounts that terrorists and criminals use to hide their identities and infiltrate U.S. financial institutions. And thus they are exactly the accounts for which U.S. financial institutions need to verify and evaluate the real beneficial owners.”).

<sup>1183</sup> See definition of “beneficial ownership interest” in proposed rule to implement Section 312 of the Patriot Act, 67 Fed. Reg. 37736 (5/30/02); interim final rule implementing Section 312, 67 Fed. Reg. 48348 (7/3/02); and definition of “beneficial owner” in the final rule implementing Section 312, 71 Fed. Reg. 496 (1/4/06).

<sup>1184</sup> The requirement that financial institutions ascertain the identity of all nominal and beneficial owners of a private banking account is codified at 31 U.S.C. § 1518(i)(3)(A) and 31 C.F.R. § 103.178(b)(1). The final rule issued in 2006 defines a “beneficial owner” of an account as a natural person “who has a level of control over, or entitlement to, the funds or assets in the account that, as a practical matter, enables the individual, directly or indirectly, to control, manage or direct the account.” 31 C.F.R. § 103.175(b).

account, is subject to IRS reporting and withholding obligations with respect to the account holder. The tax code refers to the person who has these reporting and withholding obligations as the “withholding agent,” because under certain circumstances they may be required to withhold income from a financial account and forward that income to the IRS.

To carry out the reporting and withholding obligations assigned to them under the tax code, withholding agents are required to obtain certain information from their account holders.<sup>1185</sup> One key item of information is whether the account holder is a U.S. citizen or resident, or is instead a foreign person. If the account holder is a U.S. citizen or resident, the withholding agent must obtain the person’s Taxpayer Information Number (TIN), and file a 1099 information return with the IRS reporting the person’s name, TIN, and any income paid on the account during the year.<sup>1186</sup> For example, the withholding agent must include on the 1099 form all payments of interest, dividend, or capital gains made to the account. The IRS then uses these 1099 filings to determine whether the account holder, a U.S. taxpayer, has reported all appropriate account income on their tax return.

If the withholding agent files a 1099 report, it has no obligation to withhold any funds from the account, unless the account holder fails to provide a TIN. In the absence of a TIN, the withholding agent is required to withhold 28 percent of all income paid on the account and send the withheld funds to the IRS, where the account holder may file a claim for reimbursement.<sup>1187</sup> The purpose of this withholding requirement is to ensure that the U.S. account holder pays the tax due on U.S. investment income and doesn’t circumvent IRS oversight by failing to submit a TIN.

On the other hand, if an account holder is foreign, rather than a U.S. citizen or resident, the withholding agent is required to file a 1042 or 1042S form with the IRS reporting certain payments of interest and dividend income on the account, to withhold 30 percent of that interest and dividend income as a tax, and to send withheld funds to the IRS where, again, the account holder can file for reimbursement.<sup>1188</sup> Despite this withholding obligation, it is possible that,

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<sup>1185</sup> The IRS regulations actually require the withholding agent to obtain the information from the “beneficial owner” of the account, instead of the account holder. A beneficial owner for tax withholding purposes is “the person who is the owner of the account for tax purposes and who beneficially owns that income . . . under general U.S. tax principles, including principles governing the determination of whether a transaction is a conduit transaction.” 26 C.F.R. § 1.1441-1(c)(6). The regulation states, for example, that a person who receives account income as a nominee, agent, or custodian for another person is not the beneficial owner of that account income.

<sup>1186</sup> 26 C.F.R. §§ 1.6042-2 (dividends); 1.6044-1 (brokerage transactions); 1.6049-4 (interest). Certain exemptions not relevant to this case history apply to the 1099 filing requirement. A Taxpayer Information Number is either an individual’s social security number or a number assigned to the entity by the IRS. The withholding agent is not required to withhold any portion of income reported to the IRS on a 1099 form.

<sup>1187</sup> 26 U.S.C. § 3406(a) and (b)(3).

<sup>1188</sup> 26 U.S.C. § 1441(a). In some cases where a tax treaty has been signed, a rate lower than 30 percent is used. Although these withholding regulations have been in place for almost ten years, many banks, securities firms, and other withholding agents have inadequate systems in place to ensure compliance. In response, the IRS began a

with respect to a particular account, a foreign account holder will be subject to little or no tax and no 1042 form will have to be filed. The primary reason is that, while U.S. law requires foreign account holders to pay tax on certain interest and dividend income, it imposes no tax at all on capital gains paid on accounts held by foreign account holders.<sup>1189</sup> Foreign account holders who construct investment portfolios that produce little or no interest or dividend income, thus, may be free of all or most taxation on the account.

Another key issue for withholding agents is how to handle accounts that are opened in the name of one person to benefit another. The regulations provide that withholding agents are supposed to report account income only for the true beneficial owner of the account's assets, and not for any nominee or intermediary that is managing the account on behalf of the beneficial owner.<sup>1190</sup> Section 1.1441-1(c)(6) of the withholding regulations, for example, defines the "beneficial owner" of an account as "the person who is the owner of the [account] income for tax purposes . . . under . . . generally applicable tax principles." Similarly, the regulations state that, for accounts of entities such as partnerships and trusts, it is the partners, grantors, and beneficiaries – not the partnerships or the trustees – that are the beneficial owners of the accounts and for whom account income must be reported.<sup>1191</sup>

As a practical matter, to determine whether the beneficial owner of an account is a U.S. person subject to 1099 reporting or a foreign person subject to 1042 reporting, the withholding agent typically asks the account holder to fill out a withholding certificate in which the account holder is required to identify the beneficial owner of any account income. U.S. account holders fill out W-9 Forms and are required to supply their identifying information, including a TIN. Foreign account holders fill out W-8 Forms, of which there are two types, the W-8BEN and the W-8IMY. The W-8BEN form is supposed to be filled out by account holders who are the direct beneficial owners of the account assets. These account holder are supposed to supply a TIN if they have one, and name the foreign country of which they are a resident. W-8IMY forms are supposed to be filled out by account holders who are holding account assets as an intermediary for another person. Intermediaries include, for example, trusts. An account holder who is an intermediary is required to file both a W-8IMY form for itself as well as a W-8BEN form for each beneficial owner of the account assets.<sup>1192</sup>

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major push to improve compliance. In 2004, the IRS announced a Voluntary Compliance Program that gave withholding agents until March 31, 2006, to voluntarily disclose and resolve deficiencies in their withholding systems before IRS commenced more aggressive enforcement action. See Rev. Proc. 2004-59, 2004-2 CB 678; Rev. Proc. 2005-71, 2005-47 IRB 985.

<sup>1189</sup> 26 U.S.C. § 861(a).

<sup>1190</sup> 26 C.F.R. § 1.1441-1(b)(v).

<sup>1191</sup> 26 C.F.R. §§ 1.1441-5(c)(1) and (e)(3).

<sup>1192</sup> See IRS Publication 515, "Withholding of Tax on Non-Resident Aliens and Foreign Entities," (Rev. January 2006).

IRS regulations state that a withholding agent may rely on the withholding certificate to treat an account holder as foreign, unless it has “actual knowledge” or “reason to know” that the certificate is false. Treas. Reg. § 1.1441-7(b)(1). The term “actual knowledge” is not defined. Subsections 1.1441-7(b)(2) through (10) contain detailed rules for determining when a withholding agent has “reason to know” that a withholding certificate or supporting documentation is false or unreliable. Subsection (b)(2) provides a general rule, defining “reason to know” as information that would cause a reasonably prudent person to question the claims made. Other subsections provide more narrow tests, which in some cases appear to allow financial institutions to rely on documentation supplied by an account holder even if other information suggests the documentation may present an incomplete or misleading picture.<sup>1193</sup> For example, if an allegedly foreign account holder provides a financial institution with a U.S. address, thereby suggesting it may be a U.S. resident, the account holder can also provide documentation showing that it is organized under the laws of a foreign jurisdiction, and the financial institution apparently may then rely on that documentation to treat the account holder as foreign and not subject to 1099 reporting.<sup>1194</sup>

The regulations do not explicitly address the filing obligations of a withholding agent that, for example, has actual knowledge that an account holder is an offshore shell corporation or trust that is controlled by a U.S. taxpayer.<sup>1195</sup> In such a situation, the U.S. taxpayer may qualify as the beneficial owner of the account assets on several grounds, including legal theories treating the nominal account holder as an agent of the taxpayer, as a sham corporation or trust, or as a “controlled foreign corporation” or “grantor trust” whose income must be attributed to the U.S. taxpayer who controls it.

In the case of the Wyly-related offshore entities, all of the offshore corporations and trusts filed W-8BEN forms representing that they were foreign persons and beneficially owned the account assets, even though their investment activities were being directed by and benefitting U.S. taxpayers. CSFB, Lehman Brothers, and Bank of America apparently never filed 1099 forms for any of these accounts, even though the key broker, Louis Schaufele, knew that the foreign entities were closely associated with the Wyllys who were directing their investment activities.

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<sup>1193</sup> See, e.g., Treas. Reg. § 1.1441-7(b)(4).

<sup>1194</sup> Compare, e.g., subsection 1.1441-7(b)(8)(ii) (providing that documentary evidence is considered unreliable to establish foreign status of an account holder where the withholding agent has a U.S. mailing or residence address for the account) with subsection 1.1441-7(b)(8)(ii)(B) (providing that the withholding agent may treat an account holder that is an entity as a foreign person even if it has a U.S. mailing address for the account, if the withholding agent has a document showing that the entity is “actually organized or created under the laws of a foreign country”).

<sup>1195</sup> A financial institution may acquire this knowledge, for example, after conducting a due diligence review as part of its anti-money laundering (AML) program.

**(b) CSFB, Lehman Brothers, and Bank of America Accounts**

From 1992 until 1995, CSFB opened about 20 securities accounts for Wyly-related offshore trusts and corporations, as well as for Maverick's offshore funds.<sup>1196</sup> Over a seven-year period from 1995 until 2002, Lehman Brothers opened about 125 securities accounts for the Wyly-related offshore entities.<sup>1197</sup> Over a three-year period from 2002 until 2005, Bank of America opened about 65 securities accounts.<sup>1198</sup> At each institution, the key broker handling the accounts was Louis Schaufele.

Despite the involvement of dozens of offshore entities, frequent multi-million-dollar wire transfers across international lines, and the continual tightening of U.S. AML laws, none of these financial institutions ever required the account holders to disclose the names of the persons behind them. Even after passage of the 2001 Patriot Act, the imposition of stiffer AML requirements on foreign account holders with private banking accounts in 2002, and issuance of SEC regulations requiring identification of beneficial owners in 2003, Bank of America allowed the accounts to continue operating while accommodating the refusal of the offshore entities to identify their beneficial owners. In addition, all three financial institutions allowed the offshore entities to file W-8 forms and represent that they were foreign owners of the account assets, even though they were shell offshore entities whose investment activities were being directed by the Wyls and their representatives, and whose account income was benefitting Wyly interests.

**Accounts Move to Bank of America.** At the time the Wyly-related offshore entities opened securities accounts at CSFB in 1992, very little know-your-customer information about securities account holders was required under U.S. law. The same was true in 1995, when the accounts moved to Lehman Brothers. Mr. Schaufele knew and informed both institutions that the offshore accounts were associated with the Wyly family, but insisted that each account be treated as an independent legal entity. In 2002, Mr. Schaufele left the firm and moved to Bank of America, taking the offshore accounts with him.<sup>1199</sup>

Mr. Schaufele had begun employment negotiations in the fall of 2001, and told Bank of America in September that he was willing to make the move.<sup>1200</sup> He received a formal job offer in January 2002, from the Private Client Services division of Banc of America Securities

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<sup>1196</sup> See CSFB list of accounts (CSFB0015938-41)(showing accounts from 1992 to 1995).

<sup>1197</sup> See Lehman Brothers list of accounts prepared by the Subcommittee Minority Staff (showing accounts from 1995 to 2002).

<sup>1198</sup> See Bank of America list of accounts provided to the Subcommittee on 10/24/05 (produced without bates numbers)(showing accounts from 2002 to 2005).

<sup>1199</sup> For more information, see the discussion of Lehman's concerns and how this issue was handled in the Report section on Converting U.S. Securities into Offshore Cash, above.

<sup>1200</sup> See 9/9/01 email from Mr. Schaufele to Jeff Spears at Bank of America (BA054831-32)(discussing plans to move to the new job).

(BAS).<sup>1201</sup> BAS was one of at least two securities divisions within Bank of America. The Private Client Services division catered to wealthy individuals and was the securities equivalent of Bank of America's Private Bank that already administered a number of domestic bank accounts for the Wyly family.

On February 14, 2002, Mr. Schaufele sent Sam and Charles Wyly an email explaining that, unlike Lehman Brothers, where the offshore account holders were sometimes treated as related accounts, each of the offshore accounts would come into BAS as "a totally separate entity without any linkage," which he would work to maintain. (BA007662) On February 19, 2002, Ms. Boucher emailed Ms. Robertson that "Lou's move to B of A was final last week. Sam & Charles have consented to moving all their stuff with him," including the offshore accounts. (PSI\_ED00009278-79).

Mr. Schaufele's employment with BAS officially started on February 19, 2002.<sup>1202</sup> That same day he alerted Ms. Boucher to his willingness to travel to the Isle of Man and send his assistant, Michele Crittenden, to the Cayman Islands to expedite the BAS account opening process for the Wyly-related offshore entities.<sup>1203</sup> He also sent an email to the trustees of the Wyly-related offshore trusts, explaining his move to Bank of America. He wrote that, "assuming that you want to move the relationship," he would send account opening documentation and travel to the Isle of Man the following week to pick up the signed documents. The next day, the trustees responded that they were "considering with the Trust Protectors" the future of the existing Lehman accounts, and would be in contact shortly. Mr. Schaufele responded that he had taken the liberty of sending the account opening documentation via overnight delivery, and would be in the Isle of Man the following week. The Isle of Man personnel apparently executed the documents on February 26 and 27, 2002, while the Cayman personnel executed their documents on March 12, 2002. In all, 32 offshore corporations and one offshore trust submitted documentation to open BAS accounts during Mr. Schaufele's first month at BAS.

Even after the 33 forms were submitted, however, BAS did not immediately open the accounts. BAS compliance personnel expressed concerns and asked a number of questions about the offshore entities. At the time, compliance personnel at all U.S. securities firms were facing deadlines under the 2001 Patriot Act to establish formal AML programs, verify the identity of their customers, and to develop systems to identify and report suspicious activity to law enforcement. Among other provisions was a requirement, due to become effective in July 2002, that securities firms "ascertain the identity of the nominal and beneficial owners" of all

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<sup>1201</sup> 1/16/02 letter from Banc of America Securities to Mr. Schaufele (BA055294).

<sup>1202</sup> 2/19/02 email from Cindy Kellen at BAS to Virgil Harris and Mr. Schaufele (BA 056293)("Lou is the only member of your team that is effective with BAS as of Monday, Feb. 19<sup>th</sup>."). Mr. Schaufele brought two Lehman employees with him to BAS, Michele Crittenden and Virgil Harris.

<sup>1203</sup> 2/19/02 email from Mr. Schaufele to Ms. Boucher (BA083458).

private banking accounts opened or maintained for foreign account holders, which was exactly the type of BAS Private Client accounts being opened for the 33 offshore entities.<sup>1204</sup>

BAS compliance personnel apparently began working on the request to open the new accounts even before they received the signed account opening documentation. On Friday, March 8, Mr. Schaufele's supervisor in the BAS sales department, Cindy Kellen, sent him the following message:

“[I] just got off the phone with our Compliance folks and next step is we have to run all the principals thru CDC [Compliance Data Center]. . . . Tom and I will be responsible for reviewing and approving all the activity in these accounts and as part of the ‘Know Your Customer’ requirement, will need to get comfortable with these entities.”<sup>1205</sup>

Ms. Kellen also sent Mr. Schaufele a list of eight account transactions from the latest Lehman account statements for the offshore entities that had raised compliance concerns, including wire transfers that had moved \$15 million through the Sarnia and Greenbriar accounts on the same day.<sup>1206</sup> Mr. Schaufele responded with assurances that he had known the customers for many years and would obtain explanations for the specific transactions, adding: “I don’t know how familiar you are with offshore corp. Usually they are set up for a reason that being asset protection or tax deferral.”<sup>1207</sup> A few days later, another sales employee wrote to the supervisor that, “I just spoke with Jerry Timmons to get a better feel for our experience with offshore entities such as these. He confirmed that entities such as these are not unusual.”<sup>1208</sup>

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<sup>1204</sup> See 31 U.S.C. § 5318(i)(3)(A). In addition, the SEC promulgated a regulation in 2001, which, among other provisions, required brokers to obtain the name and address of each account’s “beneficial owner.” 17 C.F.R. § 240.17a-3(a)(9). For corporate accounts, the rule required beneficial ownership information only for the persons actually transacting business on the account. This regulation became effective in May 2003.

<sup>1205</sup> 3/8/02 email from Sales Supervisor Cindy Kellen to Michele Crittenden and Mr. Schaufele (BA056104). Apparently the Compliance Data Center was used by BAS to run background checks on proposed account holders, as part of BAS’ anti-money laundering efforts.

<sup>1206</sup> 3/8/02 email from Ms. Kellen to Mr. Schaufele and Ms. Crittenden (BA056097).

<sup>1207</sup> 3/8/02 email from Mr. Schaufele to Ms. Kellen (BA056096).

<sup>1208</sup> 3/11/02 email from Thomas Sailors to Ms. Kellen (BA056077). Other documentation confirms that Bank of America routinely administered accounts for offshore entities associated with wealthy clients and had developed procedures and paperwork requirements to handle these accounts. For example, when Compliance personnel questioned a \$1.2 million journal of cash from an Elegance account to a Soulieana account, (BA077033), it identified the problem as missing documentation. (BA069730) BAS personnel explained: “[W]e recently processed a journal for [Elegance], ironically one of these offshore accounts. BAI does have paperwork policy on offshore trust accounts ... normally these accounts are opened through Bank of America in the Cayman Islands but occasional third party PIC [Private Investment Corporation] accounts are allowed by the Risk Committee, I am assuming these accounts were approved during conversion. The issue we are having with this account is that it does not have the required paperwork on file to process money movement requests. The paperwork requirements for PIC accounts are as follows:

On Monday, March 11, Mr. Schaufele's assistant, Ms. Crittenden, provided additional information about the specific account transactions that had been questioned. She wrote in part: "These entities use the Lehman Brothers accounts as a vehicle to hold publicly traded investments and to pool excess funds that are not currently invested in other investments, as such some of the activity is related to proceeds of sales or redemptions from other investments that cleared directly through the entities' Bank of Bermuda accounts."<sup>1209</sup> She also briefly described the circumstances behind several wire transfers. For example, she explained that a \$1 million wire transfer from Soulieana covered "an unexpected capital call on a real estate development that a related company [had] invested in." She described the \$15 million wire transfers between Sarnia and Greenbriar as transfers between "wholly owned subsidiaries of the same parent."<sup>1210</sup> While this description was not technically accurate – Sarnia was owned by the Lake Providence International Trust, and Greenbriar by the Delhi International Trust – both trusts had been settled by Sam Wyly, a fact not mentioned in the email. In any event, the information appeared to satisfy BAS Compliance, as no further questions were asked about the transactions.

Another standard part of BAS's know-your-customer effort was to check the names of account signatories and beneficial owners against a database that, for example, listed known terrorists, drug traffickers, and other persons barred from transacting business at U.S. financial institutions. On Friday, March 8, a list of 19 employees from the Isle of Man offshore service providers that serviced the Wyly-related offshore entities, each of whom planned to act as an account signatory, were submitted for a CDC background check.<sup>1211</sup> On March 11, BAS compliance told Ms. Kellen that nothing negative had shown up and, "[b]ased on the results and the questions and answers you have received I think you have done adequate due diligence."<sup>1212</sup>

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- BAI Corporate Account Agreement & Enabling Resolutions signed by the Trust Officers managing the account. ...
  - Depending on the underlying customer we require different paperwork. When the underlying customer is a corporation we require Articles of Incorporation, if it's a trust we require their Trust Document ... if it's an LLC they can provide us our LLC form.
  - BAI has our own KYC forms for PIC accounts, we need these signed by the Bank

We processed a recent \$1.2 million journal for the above account without this appropriate paperwork as an exception, we need to get all this paperwork on this account (and any other offshore trusts you may have – if you plan on moving money out of them) to satisfy this exception." 3/26/04 email from Cheryl Thompson, BAS Regional Operations Manager, to Lori Bensing, Private Bank Sales Manager (BA007690).

<sup>1209</sup> 3/11/02 email from Ms. Crittenden to Ms. Kellen (BA007597).

<sup>1210</sup> *Id.* The recipient of the wire was Stargate Farms, Ltd. [Tyler Trust], which passed the money on to Stargate Horse Properties, Inc., a Nevada corporation, ultimately for construction costs with respect to Emily Wyly Lopez's horse farm titled in the name Stargate Sport Horses LP. See 3/12/02 fax from Trident Trust to Michele Boucher (BA044166-67).

<sup>1211</sup> 3/8/02 email from Ms. Kellen to James Wu (BA056097).

<sup>1212</sup> 3/11/04 email from Carol Bonina to Ms. Kellen (BA056009).

The next day, Ms. Kellen told BAS Compliance that another person in the BAS sales department, Tom Sailor, had indicated that, while he was comfortable with the offshore accounts based on his conversation with Mr. Schaufele, he would not tell her the family name behind the entities because Mr. Schaufele said the family was “extremely worried about being linked to these accounts.”<sup>1213</sup> In response, a BAS compliance manager asked Ms. Kellen to “ring me when you have a chance.” Later that day, Ms. Kellen requested a CDC background check on Sam Wyly, presumably because BAS compliance had disclosed to her the family behind the offshore accounts.<sup>1214</sup>

By the end of the following day, March 13, BAS compliance had provided verbal approval to open the accounts, but a more senior compliance officer declined to provide written approval until BAS had “one more thing,”<sup>1215</sup> documentation on the identities of the account holders. BAS did not have this information for any of the 33 new accounts. Both the 2001 Patriot Act and 2001 SEC regulation contained provisions that would require financial institutions to ascertain the beneficial owners of their accounts, but neither of these provisions had yet taken legal effect. Mr. Schaufele apparently resisted pressing the offshore entities for this information, and a round of discussion followed.

The next day, March 14, a compromise was apparently reached in which BAS compliance agreed to allow the account opening process to go forward, while waiting for additional documents to arrive. Moreover, BAS compliance had agreed to obtain the documents, not from the “local family from Texas,” but from the “primary individuals responsible for communicating with BAS,” in other words the offshore personnel authorized to administer the accounts and act as account signatories:

“Please do not forward this email!

As discussed today ( in great detail). Please send your approval to Adrian Woods in new accounts to open the series of foreign accounts for the Dallas office today. As we talked about these offshore entities are holding investment companies vehicles ultimately owned by a trust. The trust is established by a local family from Texas. The source of the wealth is from a software company and a consumer retail chain. While the trust does not have an account here the broker has had the relationship for 10 years. We know full well the family however confidentiality is critical to this relationship and the assets are technically completely separate from the family as the stock of the corporations is owned by ‘the trust’. The family has also a relationship with the private bank. While we have all the BAS documents executed we have also asked for verification of the primary individuals responsible for communicating with BAS (drivers licensee, passport etc) and the official articles of incorporation or like

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<sup>1213</sup> 3/12/02 email from Ms. Kellen to Carol Bonina in Compliance (BA055983).

<sup>1214</sup> 3/12/02 email from Ms. Kellen to James Wu and Allen Ching (BA055940).

<sup>1215</sup> 3/14/02 email from Jeff Spears to Tom Sailor (BA055903).

document. We are requesting that the accounts be opened so we can start the ACAT [Automated Customer Account Transfer] from Lehman. The broker understands that if we do not get the documentation that we need in 30 days the accounts will be restricted.”<sup>1216</sup>

Later the same day, Ms. Crittenden emailed the Isle of Man offshore trustees requesting additional documents from them due to the “increased scrutiny for offshore entities in the US now.”<sup>1217</sup> She wrote: “We are just trying to show that we have done our due diligence. I think if we could get some additional documentation from you ‘for the file’ it would be very helpful.” She requested copies of articles of incorporation for the offshore corporations and, “[a]s crazy as this may sound, . . . proof of identification for all corporate officers i.e. drivers license or passport.” IFG responded: “Don’t worry, we are used to being asked for this kind of information.”

Over the next week, the Isle of Man offshore service providers sent the requested documents, including incorporation certificates and photocopies of drivers licences and passports for the persons acting as nominee officers and directors of the offshore corporations, all of whom were employees of the offshore service providers.<sup>1218</sup> By March 26, 2002, the only outstanding documents were W-8 forms needed for two accounts, Devotion and Relish.<sup>1219</sup>

At one point, Ms. Kellen compared the incorporation papers with the current account signatories, and noticed that the names of the listed persons were different. She asked Ms. Crittenden: “Are these folks employees of Trident Trust? Are they still involved in these entities? Does the ownership of these entities change hands often?” Ms. Crittenden responded: “I’m sure that in 1992 those people were employees of Trident as Francis and the others are now. I assume employment changes for these people as it does for all of us occasionally. If they are no longer employed by Trident, they would no longer be involved with said entities. . . . I don’t believe the ‘ownership’ of the entities has ever changed.”<sup>1220</sup> This email shows that BAS was fully aware that it was getting know-your-customer information for nominee officers and directors, rather than for the true beneficial owners of the offshore entities.

The 33 accounts for the Wyly-related offshore entities were opened by BAS in March 2002, about a month after Mr. Schaufele began employment there. Apart from the CDC

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<sup>1216</sup> 3/14/02 email from Laura Smith to Gerard Timmons (BA055891).

<sup>1217</sup> 3/15/04 email from Ms. Crittenden to Anna Benbatoul at IFG, Andy Wallis at InterContinental, and Francis Webb at Trident (BA055866).

<sup>1218</sup> For example, documents supplied for the Relish account included certified copies of the Relish incorporation certificate and articles of association, and photocopies of the Isle of Man passports of four IFG employees serving as Relish’s officers and directors. (BA043895).

<sup>1219</sup> 3/26/02 emails from Susan Stephenson at Bank of America to officials at BAS (BA075667-68).

<sup>1220</sup> 3/27/02 emails between Ms. Kellen and Ms. Crittenden (BA055795).

background check on Sam Wyly, all of the know-your-customer documentation obtained by BAS related to Isle of Man and Cayman residents who had no beneficial interest in the account assets. None of the account opening documentation identified the Wyly family as the U.S. persons behind the offshore entities; none stated that the 33 accounts had been opened together and the entities were related to each other; and none named the beneficial owners of the accounts despite Patriot Act requirements due to go into effect a few months later.

**Beneficial Information for Tax Purposes.** Also in March 2002, in connection with the opening of the accounts for the Wyly-related offshore entities, Banc of America Securities secured a W-8BEN form from each account holder. All but one of the nominal account holders were Isle of Man or Cayman corporations; the remaining account holder was an Isle of Man trust. The W-8BENs were generally signed by one or more Isle of Man or Cayman nominee directors of the relevant offshore corporation certifying that the corporation was foreign and beneficially owned the account assets.<sup>1221</sup>

Evidence cited elsewhere in this Report indicates that Mr. Schaufele knew that the offshore corporations were paper operations with no employees or offices of their own, and that the Wyllys and their representatives were directing their investment activities.<sup>1222</sup> Soon after beginning work at BAS, Mr. Schaufele commented to his superior when discussing the offshore entities: “I don’t know how familiar you are with offshore corp. usually they are set up for a reason that being asset protection or tax deferral.”<sup>1223</sup> Besides Mr. Schaufele, the evidence shows that other BAS personnel knew that the account holders were offshore entities, that the accounts were being processed as a group, and that they were associated with the Wyllys, but there is little evidence that Mr. Schaufele’s BAS colleagues pressed him to explain or detail the relationship between the Wyllys and the offshore entities.

For tax purposes, BAS accepted the W-8BEN forms provided by the Wyly-related offshore entities and apparently did not file any 1099 forms with the IRS reporting their account income.

### **(c) NFS Requests Beneficial Ownership Information**

The Wyly-related offshore entities opened 33 accounts at Bank of America in March 2002. More followed in the following months. All were securities accounts in the Banc of America Securities division. All were opened and administered by Mr. Schaufele and his team, Michele Crittenden and Virgil Harris, each of whom was employed by the BAS Private Client division and reported to the BAS sales department.

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<sup>1221</sup> See, e.g., W-8BEN for Relish Enterprises, Ltd. (BA044220).

<sup>1222</sup> See Report section on Converting U.S. Securities into Offshore Cash, above.

<sup>1223</sup> 3/8/02 email from Mr. Schaufele to Ms. Kellen (BA056096).

In August 2003, Bank of America decided to reorganize its brokerage operations. As part of that reorganization, it moved all non-institutional brokerage accounts, including the Wyly-related offshore accounts, from Banc of America Securities (BAS) to Bank of America Investment Services (BAI), its retail brokerage subsidiary. After the reorganization, Mr. Schaufele and his team members continued to manage the Wyly-related offshore accounts, but did so using BAI's systems. In addition, all three were moved to the Bank of America Private Bank. Mr. Schaufele reported to Lori Bensing, the Private Bank Sales Manager; her superior, Phil White, the Private Bank Market Executive, and his superior, Timothy Maloney, the Private Bank President for the Central Region.

One key difference between BAS and BAI was how they cleared their clients' securities transactions. While BAS had processed all of the securities transactions engaged in by its clients, BAI used an outside securities firm as its clearing broker.<sup>1224</sup> BAI's clearing broker was National Financial Services (NFS), which is a subsidiary of Fidelity Investments, a major securities firm. For this reason, after the reorganization, BAI converted the Wyly-related offshore accounts to clear through NFS.<sup>1225</sup>

In response to the 2001 Patriot Act, NFS, with the support of its parent Fidelity Investments, initiated a major overhaul of its AML controls to strengthen its ability to monitor account activity and identify potentially suspicious transactions posing money laundering risks. Its new AML controls included an electronic surveillance component that could identify securities transactions that met certain parameters. For example, the surveillance system could identify wire transfers that exceeded a specified threshold amount, or account transactions that transferred cash or securities by journal entry to an apparently unrelated account. Transactions that met these and other specified parameters were automatically listed on an AML "exception report" that NFS compliance personnel then examined and attempted to resolve. Typically, NFS personnel asked the broker handling the customer relationship for additional information about the transaction in question. If NFS was unable to obtain information resolving its concerns, NFS could refuse to clear the account, either by limiting or freezing permitted transactions or by closing the account altogether. This system was already in place when Bank of America moved the Wyly-related offshore accounts to BAI in August 2003. Soon after the accounts were switched, they began setting off AML alarms within the NFS surveillance system due to wire transfers and journal entries involving millions of dollars.

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<sup>1224</sup> Clearing brokers are often large securities firms that perform back-office and other services for other securities firms, including maintaining client records, executing client trades on the exchanges, and performing the withholding agent duties. They perform these services for "introducing" brokers who find and manage the client relationships, and contract with the clearing broker for the clearing services. Banc of America Securities cleared its own securities transactions, but Bank of America Investment Services contracted with an outside party to clear its transactions.

<sup>1225</sup> 8/20/03 email from Tara Hall at Bank of America to Ms. Crittenden with a list of NFS clients (BA073178-85).

In September 2003, for example, NFS asked BAI about \$432,000 in wire transactions between Ms. Boucher and three offshore entities named Two Oceans, Brown Dog, and Altonco.<sup>1226</sup> This inquiry produced a flurry of emails and a due diligence investigation by NFS between September 12 and November 20, 2003, over the beneficial ownership of those accounts and their relationship to Trident Trust.<sup>1227</sup> The issue was apparently resolved after Ms. Boucher disclosed that the corporations were under her direction.

In January 2004, the NFS surveillance system flagged transactions involving Devotion. An NFS risk analyst asked BAI about the account, pointing out that Devotion was an offshore corporation in the Isle of Man, held mostly cash in its securities account, engaged in minimal investment activity, and engaged in numerous wire transactions with apparently unrelated parties, including the LaFourche Trust, Red River Ventures I, and Queensgate Bank and Trust.<sup>1228</sup> NFS asked a series of questions, including why the account was acting like a money conduit, what the relationship was between the account and the third parties, and the identity of the beneficial owner. NFS asked BAI not to alert the customer to the NFS inquiry and requested a response in ten days. (BA008159).

BAI discussed the account internally, but did not respond to NFS until NFS sent a followup request two weeks later. In response, BAI produced account records, a copy of the W-8BEN for the account, and a copy of Devotion's articles of incorporation. It also offered the following explanation:

“Devotion Ltd. is an offshore corporation (Incorporated in the Isle of Man), which serves as an investment entity. The beneficial owner of the entity is an offshore grantor trust . . . the beneficiaries of which are U.S. individuals. The securities in the account are owned by the entity. The relationships to the third party groups referenced in the e-mail we believe are strictly for investment purposes (both incoming and outgoing wires). We believe the entity would have no problem in providing additional details, in a macro-sense (ex. Real estate purchase, etc.) for what the wire transfers are for.”<sup>1229</sup>

**Resisting Disclosure of Beneficial Owners.** In February 2004, NFS and BAI began a discussion that was to consume most of a year regarding the beneficial ownership of not only the Devotion account, but a widening number of accounts held by the Wyly-related offshore entities. Essentially, through increasingly senior officials at both companies, NFS pressed for the names

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<sup>1226</sup> 9/12/03 email from NFS to BAI (BA007670).

<sup>1227</sup> See 9/22/03 email from Scott Chandler to Denise Wollard (BA057379-80)(“Michele Boucher is the Directorate of the corporations listed below.”). See also 11/5/04 letter from Ms. Boucher to BAI (BA148314-15)(disclosing she beneficially owned the three corporations).

<sup>1228</sup> 1/15/04 email from NFS risk analyst Zach Pinard to BAI ( BA008159).

<sup>1229</sup> 1/29/04 fax from Margo Hursh of BAI Compliance, to Zach Pillard (BA007849).

of the beneficial owners of the accounts, but BAI resisted demanding the information from its clients. Compliance personnel, lawyers, brokers, and private bankers got involved. BAI's key broker, Mr. Schaufele, told the trust protector, Ms. Boucher, and the trustees, orally and in email communications, that the bank needed the beneficial ownership information, but the offshore entities steadily resisted providing it. BAI finally sent a written request for the information in October 2004. The offshore entities responded with a letter asking why the information was needed, what it would be used for, and what steps Bank of America would take to protect its confidentiality. By then, the Manhattan District Attorney had served subpoenas on the Bank seeking information about the accounts held by the Wyly-related offshore entities. By the end of 2004, Bank of America closed the accounts.

The beneficial ownership debate began in early February 2004, when BAI's own compliance personnel inquired about six accounts for offshore entities called Balch, Bubba, Elegance, Katy, Quayle, and Soulieana. All six had appeared on BAI's Large Margin Debit Report, because they all had large positions in Michaels stock. BAI compliance asked BAI's business unit about any relationship between the accounts and the reason for the concentrated position in Michaels stock.<sup>1230</sup> At about the same time, NFS asked BAI compliance for information about the same accounts. BAI responded that it was already examining the accounts internally.<sup>1231</sup> On February 18, BAI told its compliance personnel the following:

“Each account is a separate corporation. There is no relationship between the corporations other than the original grant of options of Michael's Stores from the grantor to set up the corporations. These are offshore corporations which serve as investment entities. The beneficial owners of the entities are offshore grantor trusts . . . the beneficiaries are U.S. individuals.”<sup>1232</sup>

Handwritten notes on the February 18, 2004, BAI compliance department email suggest that Mr. Schaufele or his team had disclosed that the trust beneficiaries were Wyly heirs, but stated there was no Wyly control of the stock.

BAI compliance forwarded the email describing the accounts to NFS Compliance which immediately asked additional questions about the accounts:

“I do have more questions. If all the accounts were funded by the same ‘grantor’, then they are all related in that aspect. I guess I would want to know the following:

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<sup>1230</sup> 2/6/04 email from Steven Hudgins, BAI Compliance officer, to Denise Wollard, BAI Market Administrative Manager (BA012815).

<sup>1231</sup> 2/18/04 email from Margo Hursh of BAI Compliance, to Denise Wollard, BAI Market Administrative Manager (BA008301).

<sup>1232</sup> 2/18/04 email from Denise Wollard, BAI Market Administrative Manager, to Steven Hudgins, BAI Compliance (BA007969-71).

- 1) Where did the original stock options come from?
- 2) Who/What acted as the 'grantor' of the stock options? If an entity deposited the shares, who was the owner of the entity?
- 3) Who are the beneficial owners of all of the grantor trusts?
- 4) Copies of the account applications, W8-IMY information for the grantor trusts, and if information is being held on the grantor trusts themselves, I want to see that information to determine which US individuals are the owners of these accounts.

My concern is that I do not believe that this company is reporting the ownership of the shares adequately. The fact that they are all being treated as separate companies does not impact the matter because they clearly have a link due to the original deposit. In addition, some of the accounts also maintain a control relationship even as independent accounts. Therefore, an account like P86017043 (Quayle Ltd), which made a sale of 100,000 shares of Michael's on 09/02/03 should have filed a form 144 with the SEC because of their control relationship before the sale. Do we have a copy of that form on file? This is an important issue that I do not believe can be explained in a paragraph and without documentation. I know that this issue will take a lot of time to resolve, but I do not believe that we understand their business, and I want to make sure they are in compliance with SEC regulations. Thank you for the preliminary information."<sup>1233</sup>

BAI compliance sent the NFS questions to BAI who promised answers as soon as possible.

Discussions about the accounts appear to have taken place over the next few days. On March 8, 2004, Mr. Schaufele received the following message from his supervisor, Lori Bensing:

"Of the 11 accounts that hold concentrated Michaels positions, I need to understand the relationship between them better. I thought that they had all been set up separately but today we got instruction to sell in Elegance and send the proceeds to Souliana to 1) pay off margin debt 2) add to the operating account at Citibank. Can you explain it to me again?" (BA006231).

Mr. Schaufele apparently responded that all the Wyly offshores bought Michaels options at the same time, in 1992 and 1995, and then purchased the stock outright in 1997 and 1998, because Ms. Bensing provided that information to BAI compliance on March 11.<sup>1234</sup> Handwritten notes on one copy of this email state: "What/who really owns the 'accts' and "3/17/04 Margo –

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<sup>1233</sup> 2/18/04 email to Margo Hursh of BAI Compliance from Zach Pinard at NFS Compliance (BA007969).

<sup>1234</sup> 3/11/04 email from Ms. Bensing to Steven Hudgins of BAI Compliance (BA007968).

Chairman of Board – Michael’s – Charles Wyly. they think he is the common thread in all these accts.”<sup>1235</sup>

Two weeks later, both NFS and BAI elevated the issue within their organizations to more senior personnel. NFS Compliance sent an email to the NFS Director of Client Services, alerting him to the beneficial ownership issue and the 11 accounts then in question: Balch, Bubba, Devotion, Dortmund, Elegance, Flo Flo, Katy, Pops, Orange, Quayle, and Soulieana.<sup>1236</sup> He, in turn, sent the account list to the BAI Group Operations Manager, Tom Wiegand, asking him to address the issue.<sup>1237</sup> Mr. Wiegand forwarded the list to the BAI Deputy Director of Compliance, Geoff Rusnak<sup>1238</sup> who, in turn, sent it to BAI’s General Counsel Barry Harris. Mr. Harris apparently requested an explanation from the Private Bank and received the following explanation from Lori Bensing:

“At conversion, Barry you may remember that we got approval to hold several Isle of Man accounts. We have been experiencing a lot of difficulty with NFS on these accounts since conversion and in particular 10 accounts that hold MIK stock (Michael’s Stores). These accounts were created a number of years ago by trusts and according to the directorate the accounts share several of the same beneficiaries (various Wyly Family members and various charities). In short, NFS thinks that there might be Patriot Act issues and that the stock might be affiliated in some way. MUCH of their misunderstanding stems from a general lack of knowledge of the purpose and benefits of offshore accounts. The stock transferred in as clean stock but if need be we can go to corporate counsel for Michaels and get an opinion (1.7mm shares total) or statement that the shares are not affiliated. We can also go to the Isle of Man attorney for these accounts and get some letter that states that the beneficiaries are not terrorists. What we probably cannot do is get a list of the names, addresses and social security numbers of the beneficiaries. I am afraid that if we can’t provide this that they may tell us to move the accounts. We may need someone from legal to help us with this (I should mention that BAI compliance is satisfied). Your thoughts?”<sup>1239</sup>

BAI’s General Counsel responded that, on the securities issue, NFS would probably be satisfied with a written legal opinion that the stock was neither control stock held by an affiliate nor restricted, but that the Patriot Act issue was more problematic. “I believe that our policies

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<sup>1235</sup> See 3/11/04 email copy belonging to Denise Wollard (BA008300)(emphasis in original).

<sup>1236</sup> 3/25/04 email from NFS risk analyst Zach Pinard to NFS Director of Client Services Steven Worthy (BA029445-46).

<sup>1237</sup> Id.

<sup>1238</sup> 3/25/04 email from Mr. Wiegand to Mr. Rusnak (BA029445).

<sup>1239</sup> 3/25/04 email from Lori Bensing to Barry Harris, BAI General Counsel, and Mike Hearn, BAI Counsel, with copies to Mr. Schaufele and others (BA006209).

require that we know the I'd [identity] of all beneficiaries as required by law. If the trustees or beneficiaries are unwilling to disclose, I believe that leaves us and NFS with little option."<sup>1240</sup> Mr. Schaufele asked in response whether it would be sufficient to say that the trust beneficiaries were members of the Wyly family subject to the discretion of the trustees. Mr. Harris replied that BAI needed specific names in order to do the necessary background checks.<sup>1241</sup> Mr. Schaufele held a conference call with the trust protectors and legal counsel, and passed on the trust protectors' question as to what would be done with the beneficial ownership information.<sup>1242</sup> When told the names would be run through databases "to check for drug dealers and terrorists and the like," Mr. Schaufele replied: "then I don't think it is that big of a problem, they just want to talk about it, confidentiality is HUGE."<sup>1243</sup>

On March 31, 2004, Ms. Bensing asked Mr. Schaufele to find out if BAI could get the specific names of the beneficial owners of each of the 11 accounts.<sup>1244</sup> Mr. Schaufele immediately responded: "as it stands right now, No on beneficial owners but supposedly the certification draft letter is forthcoming as is the Michaels Stores opinion of counsel." (BA029708) He sent a second message a few minutes later: "What I would like to do is to arrange a conference call with the trustees to talk about the certification letter and seeing how we could come to some resolution. Someone needs to ask the question what about the other Isle of Man accounts we have? NFS does have other accounts in IOM and I bet in other tax jurisdictions." (BA079633) On April 1, 2004, 20 "certification letters" arrived on behalf of 20 IOM entities managed by IFG, including the 11 with Michaels stock. The letters certified that IFG had done its own "usual accepted Anti-Money Laundering checks" on the beneficial owners of the offshore entities, and stated that all results were satisfactory, but did not disclose any specific names. (BA008241-60)

Throughout April, NFS continued to press for the beneficial ownership information. As of April 16, NFS had told BAI that it was "in serious jeopardy of [NFS'] totally shutting down the accounts – not just commissions but ALL ACTIVITY." (BA029766)(Emphasis in original). On the same day, a lawyer from Bank of America (Corporate)(BAC), Philip Wertz, spoke to Ms. Boucher about the need to supply the names.<sup>1245</sup> Ms. Boucher indicated that providing the

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<sup>1240</sup> 3/25/04 email from Mr. Harris to Ms. Bensing and Mr. Hearn, with copies to Mr. Schaufele and others (BA029540).

<sup>1241</sup> 3/26/04 email from Mr. Harris to Mr. Schaufele, Ms. Bensing, and Mr. Hearn (BA006208).

<sup>1242</sup> 3/31/04 email from Mr. Schaufele to Ms. Bensing (BA079633).

<sup>1243</sup> 3/26/04 email from Mr. Schaufele to Mr. Hearn (BA079635-37)(emphasis in original).

<sup>1244</sup> Ms. Bensing was passing on a request from Steve Hudgins of BAI Compliance: "I just received word from NFS regarding the Michaels Stores accounts. They need the following information: . . . The specific names of the beneficial owners for each of the accounts. (I believe there are 11 total accounts.) Please respond as soon as possible." (BA029708).

<sup>1245</sup> 4/19/04 email from Ms. Crittenden to Mr. Schaufele (BA080020).

names of the beneficial owners would not be a problem, but that it would take between four days and two weeks to get the information together. On April 19, NFS asked BAI to supply the information no later than April 30.<sup>1246</sup> Mr. Schaufele's assistant commented that "4 days would be great. 2 weeks from today is May 3. I can't control NFS but I will tell you that my sense is that we are down to our last chance. All we can do is relay the sense of urgency to her, I guess."<sup>1247</sup> Mr. Schaufele replied: "We are making a sale today for Dortmund of [Michaels stock] (6800shs). They have a capital call for another investment. Can you make sure NFS is not going to hang up the funds as we will be getting the beneficial owners (my understanding)."<sup>1248</sup>

On April 23, 2004, Mr. Schaufele began exploring the possibility of moving the Wyly offshore accounts back to BAS, which cleared its own transactions, did not use NFS, and might ask fewer questions. His initial communication with a BAS acquaintance elicited the response that BAS' due diligence requirements "may not be dissimilar to NFS or others on the street." (BA007700). Mr. Schaufele continued to press for a return to BAS over the next few weeks, contending that the accounts wanted to engage in the type of derivative transactions handled by BAS, and would generate sufficient fees to justify the work it would require for that division to take on accounts.<sup>1249</sup>

Ms. Boucher was supposed to be gathering the beneficial ownership information, but at the same time was suggesting alternatives to full disclosure. One suggestion she offered was to give the beneficial ownership information to a third party, which would do the due diligence checks and certify to BAI that there was no problem. The third party she suggested was Scottish Re,<sup>1250</sup> the Cayman insurance conglomerate once owned by the Wyllys and still run by Michael French, who was once a trust protector for the Wyly-related offshore trusts. Mr. Schaufele explained to Philip Wertz of BAC's legal department why Ms. Boucher was comfortable with Scottish Re, but did not disclose the company's relationship to the Wyllys:

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<sup>1246</sup> 4/19/04 email from Jaidip Chanda to Mike Hearn (BA087712).

<sup>1247</sup> 4/19/04 email from Ms. Bensing to Ms. Crittenden and Mr. Schaufele (BA080020).

<sup>1248</sup> 4/19/04 email from Mr. Schaufele to Ms. Bensing (BA080020).

<sup>1249</sup> See, e.g., 4/29/04 email from Mr. Schaufele to Ms. Boucher (BA079968)("Let me say this, if we were to enter into some type of forward sale with any of the entities that stock would be moved out of BAI (this is where you are now) and into BAS. I do not think we would have the beneficiary issues. I know this is nuts but BAS deals more with offshore than BAI (yes, we are the same company??? go figure)"); 5/10/04 emails from Mr. Schaufele to BAS personnel (BA005632; BA079577)("I talked to Sam Hocking (prime) about opening accts on his platform. He can but says Innes really wants accts to generate revs, can you speak to Chris and explain situation to see if he is OK with that? . . . The only thing [requiring effort] is just holding the MIK. I have told offshore if we do this we need to do a fwd to help pay for having accts at prime.").

<sup>1250</sup> 4/27/04 email from Ms. Boucher to Ms. Crittenden (BA069251).

“She has a history with Scottish and would be comfortable in their acting in some sort of capacity. Her problem with us is that she knows us, but is unable to ascertain if we can keep the information confidential (she understands that we would give up on legal inquiry). . . . I hope that the Scottish Re is a viable option. I understand that when you all spoke it was mentioned that we could allow a US regulated financial institution to act in some capacity so perhaps that can work. Scottish has a US sub in Charlotte.”<sup>1251</sup>

BAI’s legal department declined to use Scottish Re, noting that insurance companies were not subject to the same Patriot Act rules as banks and brokers, and expressing doubt that NFS would be willing to rely on a third party. Mr. Schaufele forwarded the legal department’s reaction to Ms. Boucher, adding: “I don’t think Scottish Re is going to work.”<sup>1252</sup>

Ms. Boucher’s second suggestion was to provide the names of the beneficial owners to BAI, but not to NFS. She proposed that, in lieu of receiving the names, NFS receive a certification from BAI that BAI had obtained the names and were comfortable with them. BAI forwarded this suggestion to NFS which promised to respond by April 29.<sup>1253</sup> On that date, NFS sent the following message to BAI:

“Sorry to be the bearer of bad news, but regarding the [Michaels] accounts, I confirmed with our Anti-Money Laundering Officer at NFS that we are not comfortable with not receiving the names of the beneficial owners. By not knowing the names of the beneficial owners does not allow us to fulfill our Patriot Act obligations. I am also being told by my AMLO [Anti-Money Laundering Officer] that this is the last time that they will be asking for these names. Please supply this information to myself by end of day tomorrow.”<sup>1254</sup>

The message was forwarded to Mr. Schaufele, adding: “NFS’s position is they insist on the names themselves.”<sup>1255</sup>

Mr. Schaufele’s reaction was immediate:

“That is not what we wanted to hear. I guess the next question is whom can we appeal this to. It is amazing to me that a third party can be used in some cases

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<sup>1251</sup> 4/29/04 email from Mr. Schaufele to Philip Wertz, BAC legal department (BA079964-65).

<sup>1252</sup> 4/29/04 email from Mr. Schaufele to Ms. Boucher (BA079964).

<sup>1253</sup> 4/28/04 email from Jaidip Chanda of NFS to Ms. Bensing of the Private Bank (BA087455).

<sup>1254</sup> 4/29/04 email from NFS to Mr. Weigand, BAI Group Operations Manager, Ms. Bensing of the Private Bank, Michael Hearn and Philip Wertz of the BAC legal department (BA029435-38).

<sup>1255</sup> 4/29/04 email from Mr. Wertz to Mr. Schaufele and Ms. Crittenden (BA029435-38).

and that NFS won't let BAI act as that third party. In talking with the client they are very concerned over NFS having this information. I think they are +90% in giving us the information they just don't want NFS to have it. Their reasons are their own but I suspect that they are concerned over NFS and have no operating history with them. I would like to appeal this decision on the basis that if my client gives us the required information (beneficiaries) and we are comfortable on the securities side (letter from company that this is not affiliate stock) that we tell NFS that we are satisfied with the AML and securities issues. I get the sense that NFS has other issues here than AML, those being security issues with the MIK. Why wouldn't a letter from company counsel or lawyer saying this is not affiliate stock and independently owned be sufficient. Why this would not be enough is amazing. We are NFS' largest client. This is a very large relationship to BAI and the bank. I really don't want +100mm of assets to leave. Please let me know." (BA066900).

BAI personnel worried that, if the beneficial ownership information were not supplied by the next day, the accounts would be restricted from all activity but closing transactions and withdrawals.<sup>1256</sup> That evening, however, the BAC legal department announced that NFS had agreed to forgo taking immediate action to close the accounts, while reserving the right to do what they deemed appropriate if additional questionable transactions surfaced:

"Here is where we are with the Michaels accounts. I understand that Michele Boucher has agreed to give Bank of America the beneficial ownership information, and has requested that we sign a confidentiality agreement. I have sent a brief draft to the sales folks and hopefully that can be worked out by tomorrow afternoon. I spoke with Jai Chanda and Carl Brown at NFS and they understand that we will not be sharing the beneficial ownership information with them. They said that the accounts will not be closed and no restrictions would be placed on the accounts. We are not giving them at this time a formal reliance agreement of any sort. Given that they will not have all the information we have in their files, if they flag transactions or issues that raise questions or concerns, Bank of America staff may from time to time have to have discussions to try to make them comfortable that transactions are appropriate and not suspicious. If NFS cannot get comfortable on any given issue, they may do what they feel they need to do to comply with their regulatory requirements and procedures. I was assured that such actions would not include putting restrictions on accounts or closing accounts without dialogue with Bank of America and an opportunity to work through the issue. Long story short, we should still get the beneficial

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<sup>1256</sup> 4/29/04 email from Steven Hudgins to Ms. Bensing (BA029435-38).

ownership information as soon as possible, but we are not facing an ultimatum from NFS about account closure anymore.”<sup>1257</sup>

To carry out Bank of America’s end of the deal, on May 6, 2004, Mr. Schaufele sent the following request to David Harris at IFG:

“[W]e request that you deliver to us the names and city, state and country of residence of all entities or individuals who directly or indirectly are beneficial owners of the accounts. We are requesting this information in order to fulfill our obligations under Bank of America’s know-your-customer policies and procedures. These policies and procedures are part of Bank of America’s anti-money laundering and anti-terrorism financing program that has been implemented in order to comply with applicable United States law, including the Bank Secrecy Act (as amended by the USA PATRIOT Act). I am sorry for the inconvenience but this appears out of my control.” (BA080144).

On the same day he made this demand for specific information on behalf of BAI, Mr. Schaufele was engaged in email and telephone discussions with Mr. Harris and Michelle Boucher in which he suggested that they might try to satisfy BAI with a response that was more vague and did not tie specific names to specific accounts.<sup>1258</sup> He also told Ms. Boucher that he was still pursuing moving the accounts back to BAS and cautioned her to make sure she had a back up plan in case BAI restricted the accounts.<sup>1259</sup> Mr. Schaufele also suggested that IFG might be able to justify withholding the names of the beneficial owners by contending such a disclosure would violate Isle of Man law. He wrote that he had just spoken with Philip Wertz in the BAC legal department about this possibility:

“Can you get me a couple of things: We are going to go to our int’l attorney and ask about a IOM law that might prohibit them from releasing the names. You used a term for some law you had in Cayman’s but anything you can get me will be great (if possible today on this). Also can you get Meadows Owens to give me a brief legal note as to why they feel you cannot give the names up voluntarily. I think if he saw this argument this would help immensely. Also if you have opened accounts elsewhere recently and they have not required owners if appropriate what firms did this as maybe we could ask their legal as to why or how they see it that it is not needed (you may feel not appropriate and I understand).”<sup>1260</sup>

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<sup>1257</sup> 4/29/04 email from Mr. Wertz (BA087648). Ms. Bensing replied: “is this the part where I respond ‘you’re my hero’”? (BA087648).

<sup>1258</sup> 5/6/04 email from Mr. Schaufele to Ms. Boucher (BA080141).

<sup>1259</sup> 5/6/04 email from Mr. Schaufele to Ms. Boucher (BA080144).

<sup>1260</sup> 5/6/04 email from Mr. Schaufele to Ms. Boucher (BA080139).

Mr. Schaufele later wrote to Mr. Wertz: “Michelle is getting us something from Meadows Owen and also on the IOM. The term that she spoke of in the Caymans was a law regarding the preservation of the confidentiality relationship. She said they have something like it in IOM but in banking law and she is getting. As an aside they have opened accounts in the last 6 months they have opened accounts with Morgan Stanley and US Bancorp.”<sup>1261</sup> Mr. Wertz replied: “According to our IPB attorney, Caymans (and likely IOM) do have confidentiality laws that state unauthorized disclosure of client information is prohibited. In order to give the names, the trustee/director may need to get consent of their beneficiaries to do it. Our Cayman’s trust office goes through this as well. We’ll see what they say, but I still think it is more based on not wanting to give the information rather than not able to.”<sup>1262</sup> In response to this last comment, Mr. Schaufele told Ms. Bensing that the legal confidentiality issue had been raised by the Isle of Man administrators: “Phil is correct, these folks do not want to give the names. As a last resort they were and then found that there are adverse legal effects if they did. Boucher is getting supporting docs on this. One thing you might mention to Phil /which I alluded to) is that the probable beneficiaries are extremely large PB [Private Bank] clients (my guess is +lmm revs. Obviously we don’t know the exact beneficiaries but good idea . . .”<sup>1263</sup>

On May 11, 2004, Mr. Schaufele received a letter from IFG, then the offshore trustee, declining to provide the requested beneficial ownership information. The letter cited a legal opinion that Isle of Man confidentiality laws prohibited them from providing the requested information.<sup>1264</sup> Upon receipt of the IFG letter, Mr. Schaufele asked Ms. Bensing at the Private

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<sup>1261</sup> 5/6/04 email from Mr. Schaufele to Mr. Wertz (BA080138).

<sup>1262</sup> 5/6/04 email from Mr. Wertz to Mr. Schaufele (BA080138).

<sup>1263</sup> 5/6/04 email from Mr. Schaufele to Ms. Bensing (BA080138).

<sup>1264</sup> The 5/11/04 letter from IFG stated in full:

“We refer to your email of May 6. We have sought advice from our Advocates in relation to your request and a copy of their letter of today is attached for your information. In view of this advice we regret that we are unable to comply with your request.

“We would add that we have already confirmed to you that we hold all appropriate due diligence information on these clients as confirmed to you in our letters of 31 March 2004. As stated in our letters of 31 March 2004 the Isle of Man is a FATF approved jurisdiction which is substantially in compliance with all FATF/IMF AML requirements, indeed probably to a greater extent than those currently operating in the USA.” (BA007781).

The opinion of counsel stated:

“We understand that you have been asked by a foreign banking institution for details of the underlying persons beneficially interested in certain companies administered by yourselves which companies are owned by trusts of which you are trustees.

“We can confirm that, as trustees, you have, under Isle of Man law, a fiduciary duty of confidentiality which may prevent you from complying with such requests.

Bank about involving upper management at BAI in a business decision to override the BAI compliance and legal offices and retain the accounts: “It seems to me that we are at somewhat of a standoff. I think at some point management (as opposed to legal) is going to have to weigh in on this. I don’t know at what level . . . Phil White [Market Executive] or Tim [Maloney – Private Bank Regional President]. Could you talk to Phil White and just bring more in the loop.”<sup>1265</sup>

On May 12, Mr. Schaufele sent his own email to Mr. White, laying out the case that the Wyly-related offshore accounts should be made an exception to the rule:

“[H]ere are what I believe are the salient points:

- 1) If Phil W. is pressed he thinks we are OK on this one (more worried on future situations)
- 2) I have done business with these accounts since the early 90’s
- 3) While I do not know for a fact the beneficiaries my guess is that they are members of the Wyly family. The Wyly family **pays fees to the Private Bank of over 1.2mm per year**. This does not include what they do in PCS. Nor does any of those numbers include what the offshore accounts produce. Bottom line is that the trustees generally do not involve the beneficiaries in the operation of the offshores but should they inform them of this development we could potentially lose the onshore family relationship (I doubt this, but it could happen).
- 4) We know that entities like this have opened accounts recently with Morgan Stanley and US Bancorp without this problem. We are also told by Prime (who has 2 accounts that are very similar to the ones in questions) that they could open these accounts. On that issue Phil Wertz disagrees but we have talked with Prime specifically on this.
- 5) The offshores have retained legal counsel on this (both US and IOM) and there are legal issues as to why they cannot divulge this aside from the fact that they believe there is no need. At one point we told them we were willing to let them divulge to US financial institution the names and then have that institution represent to us that there is no AML problems. They came back to us with Scottish Re (NYSE-SCT) but for whatever reason we took that off the table as an option.
- 6) We have a 300-400k collar pending with one of these entities.<sup>1266</sup>

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“In addition, a dissemination of confidential client information may involve a breach of the Isle of Man Data Protection laws which carries criminal sanction.

“We would be happy to advise more fully upon receipt of further details.” (BA008234).

<sup>1265</sup> 5/11/04 email from Mr. Schaufele to Ms. Bensing (BA007707).

<sup>1266</sup> A collar is a stock option transaction that can produce significant fees for the broker that arranges it.

“I think someone is going to have to make a management decision on this and move on. I do not want to see 50-75mm of assets move. The account wants to maintain our +10yr relationship but does have choice to move. Lori has worked very hard on this and I believe understands the issues, I just wanted to give you my overview.”<sup>1267</sup>

On May 18, 2004, Phil White, the Private Bank Market Executive; Geoff Rusnak, BAI Deputy Director of Compliance; Mr. Wertz from the BAC legal department; Ms. Bensing from the Private Bank; and Mr. Schaufele held a conference call to discuss the beneficial ownership issue. In an email prior to the call, Ms. Bensing told Mr. Rusak: “We are basically at a point where what NFS wants (disclosure of the beneficial owners) is not going to happen because the client has been advised by their US and IOM counsel not to do it .... We have been told that Compliance will require someone from the business side (my [Market Executive]) to say that we are comfortable with the risk.”<sup>1268</sup> Mr. Rusnak, who had been out of the office for several weeks, wanted to know whether NFS had offered a solution as to how BAI could maintain the accounts without disclosing the beneficial owners. He said: “if we know the identity of the beneficial owners (which I recall you do), I am going to require (if we have not already done so) that we obtain any and all information regarding these beneficial owners and have Bank of America Corporate Security conduct complete due diligence reviews of these individuals.”<sup>1269</sup> Ms. Bensing replied:

“[NFS] will want assurance from our legal and compliance people that we are comfortable not documenting the beneficial owners. We were told who the beneficial owners were on a call by someone who apparently was not supposed to disclose them. Their counsel (both sides) will not allow it. Wertz has spoken directly with them and can explain the law surrounding this .... Our business decision (whether it comes from Phil or Tim [Regional President Maloney]) will be based on knowing this information and being comfortable with it on a business risk and client relationship.”<sup>1270</sup>

At the conference call, the group agreed to elevate the issue to BAI’s risk committee.<sup>1271</sup> Later, Mr. Rusnak from compliance and Mr. Wertz from the BAC legal department agreed to advise the committee that it was essential to secure the beneficial ownership information for the

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<sup>1267</sup> 5/12/04 email from Mr. Schaufele to Phil White (BA007708)(emphasis in original).

<sup>1268</sup> 5/18/04 email from Ms. Bensing to Mr. Rusnak (BA007709-10).

<sup>1269</sup> 5/18/04 email from Mr. Rusnak to Ms. Bensing (BA007709).

<sup>1270</sup> 5/18/04 email from Ms. Bensing to Mr. Rusnak (BA007709).

<sup>1271</sup> 5/19/04 email from Mr. Rusnak to Ms. Bensing (BA087370). A risk committee is a committee of executives that evaluates issues or transactions that could have a material impact on the company.

file because, in the event of a regulatory demand for the information, BAI could not rely on the client to produce it in the five days the law allowed to respond to the demand.<sup>1272</sup>

Prior to going to the risk committee, Mr. Schaufele contacted BAS legal counsel, seeking a different view of the due diligence rules, and was referred to Bank of America's Assistant General Counsel, Daniel Robey. In an email, Mr. Schaufele made the same points he had made in his May 12 email to Phil White. Mr. Robey responded that he would not second-guess BAI's counsel on the legal requirements applicable to BAI.<sup>1273</sup>

Mr. Schaufele then wrote to Mr. Wertz, in BAC's legal department, asking him if he would classify the need for beneficial ownership as a "gray" area, given that the final version of the Patriot Act regulations had not yet been issued.<sup>1274</sup> Mr. Wertz responded with a long email analyzing the Patriot Act and concluding that its requirements were not as gray as had been argued by counsel for the Isle of Man entities. The email shows that BAI viewed the accounts as private banking accounts opened for a non-U.S. person under Section 312 of the Patriot Act, which required BAI to "ascertain the identity of the nominal and beneficial owners ... of the account." The email stated that the legal counsel representing the offshore entities had argued that, for purposes of Section 312 in the Patriot Act, the account holders were "not necessarily a non-US customer if you drill down to the beneficial owners," presumably arguing that the beneficial owners were, in fact, U.S. citizens.<sup>1275</sup> Mr. Wertz disagreed with this analysis, and concluded that the only way to keep the accounts open without the beneficial ownership information was to make an exception for these accounts.<sup>1276</sup> Mr. Schaufele forwarded this

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<sup>1272</sup> 5/20/04 emails between Mr. Rusnak and Mr. Wertz (BA087790).

<sup>1273</sup> 5/25/04 email from Mr. Robey to Mr. Schaufele (BA066886).

<sup>1274</sup> 5/25/04 email from Mr. Schaufele to Mr. Wertz (BA087785).

<sup>1275</sup> 5/25/04 email from Mr. Wertz to Mr. Schaufele (BA029518-20).

<sup>1276</sup> The email in its entirety is as follows:

"Set forth below is the relevant text of section 312 of Patriot Act. As the proposed regulations are not yet final, the interim rules state that we must apply with the statutory language itself. Section 3(A) is pretty clear about the need to identify beneficial owners. The proposed rules (which will eventually be finalized) would clarify some of the scope of the rules. For example, it provided that you need to identify the holders of beneficial ownership interests if they have a right to at least \$1MM or 5% of the value of the account (therefore setting a de minimus threshold).

"All of these rules are subject to interpretation and therefore it is difficult to say it is black and white, however, I don't think this is as gray as the [Michaels] counsel argues it is. They argued that it is not technically a "private banking account." They argued that it is not necessarily a non-US customer if you drill down to the beneficial owners. They argued that the family may not technically have "beneficial ownership interests" depending on how that term is defined. As pointed out to their counsel, the issue we face is that the Banking Regulators and Congress are interpreting the Patriot Act rules with a mindset that expects banks to not split hairs on technicalities and to go beyond the letter of the rules. When the final rules are published, I think

analysis to Charles Pulman, a Meadows Owens lawyer who sometimes represented the Wyly family and the offshore entities on tax matters. (BA080202).

To prepare for the upcoming risk committee meeting, Mr. Schaufele wrote an extensive email describing the history of his and the Private Bank's relationship with the Wyly family.<sup>1277</sup> This history, which was apparently jointly written by Mr. Schaufele and Marta Engram, the Wyly's private banker, stated that the Wyly family was well known to both of them, posed no money laundering risks, and was a major source of revenue for both the Private Bank and BAI.<sup>1278</sup> They also argued that the family lacked control over the offshore corporations, analogizing the trust protectors to a board of directors who could hire and fire the management of the offshore corporations. At another point, however, they stated that, "The Wyly family viewed the [offshore corporations] as one of their main investment vehicles." They concluded by asking BAI to make an exception to its AML due diligence policies in the case of the Wyly-related offshore entities and dispense with obtaining the beneficial ownership information.

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they will be relatively consistent with the proposed rules. This was also the basis of our Corporate Policy. I would not feel comfortable advising the bank that our policy should eliminate the need for this information in all cases, so I believe you must argue that you have done enough to warrant an exception to the general rule.

"If the decision is made to keep the account open, we will take the position that we have sufficient information in the file and know enough overall to satisfy this legal obligation. Without the names themselves, I think there is a risk that we will be deemed to have not met that obligation under Section 312. Without the names themselves, there is also a risk that we are criticized because we are unable to screen these people against OFAC and other terrorist lists that are issued from time to time. None of those are guarantees of a legal violation or a regulatory sanction and therefore must be weighed by the business unit.

"I must admit that I have not heard any persuasive arguments from the client about why they should withhold the names, other than that they just want to maintain secrecy. I agree with the IOM counsel that the director couldn't give the names without consent of their clients, but I have confirmed that we get such consent all the time for offshore trusts that we manage when faced with such circumstances. Given how much we know about the family overall and your relationship with them, I don't understand why they would object if the director asked for their consent. [quotation of Section 312 omitted]" (BA029518-20).

<sup>1277</sup> 5/25/04 email from Ms. Crittenden to Mr. Schaufele (BA080216-18).

<sup>1278</sup> Mr. Schaufele wrote: "From a business perspective these accounts and the Wyly family are very profitable to the firm. We have an 800k share collar on with one of the OC [offshore corporation] entities and are working on another collar/forward that will probably be 500k shares. Aside from that the OC accounts produced +100k in business last year. Collectively they have around 50-75mm in assets here along with the potential of bringing other assets in. . . . We did a VERY profitably derivative trade in [SCT] warrants for another client and I think that when the OC decides to monetize we would get that business. The Wyly family itself is extremely profitable and long standing relationship with the bank (see Marta Engram's memo). Because of our relationship with the me [sic] the family has referred several pieces of business to me over the years, both onshore and offshore. The sale of the 450k SCT warrants were a result of this." *Id.*

On May 27, 2004, Phil White, the Private Bank Market Executive, submitted the following agenda item for the next day's risk committee meeting:

“WHAT: The directorates of the offshore trusts do not want to disclose the beneficial owners for two reasons: they are not being asked to do it anywhere else and they need confidentiality. We feel like we know enough about the clients and could defend that they are not persons of ill repute if the information was requested.

“IMPACT: We would definitely lose the offshore business to someone else which would open the door for another institution to take the loan and deposit business as well. These people are true PB [Private Bank] clients and very well known in the community.”<sup>1279</sup>

The matter went to the risk committee on May 28, 2004. After hearing from representatives of BAI sales, compliance, and legal departments, the risk committee decided to reject the request to make an exception to the know-your-customer rules for the Wyly-related offshore entities, but also to raise the issue to more senior management and discuss it again the following week.<sup>1280</sup> The committee noted the following points as influencing their decision:

- BAI had a corporate policy of getting the names of all beneficial owners.
- The company was required to produce the information to a regulator within 120 hours of a request.
- Morgan Stanley did not grant exceptions to its similar policy.
- While no one suggested the Wyllys were terrorists or drug dealers, AML is a focus of SEC, NASD, and the banking regulators. Sooner or later, NFS would file a suspicious activity report (SAR) on one of the accounts, that would lead a regulator to BAI, and the regulator would find that they had not followed their own policy.
- BAI had never made an exception to the policy before.<sup>1281</sup>

Upon learning of the risk committee's decision, Mr. Schaufele asked Mr. Wertz, in the BAC legal department, if it would help to get a letter from the offshore trustees agreeing to disclose the beneficiaries if BAI received a request from a regulator or if the law became “more

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<sup>1279</sup> 5/27/04 email from Phil White to Greg Strieby (BA086388).

<sup>1280</sup> 5/28/04 email from Craig Krapf to Nancy Yarbrough (BA113167).

<sup>1281</sup> Handwritten account of Risk Committee meeting dated 5/31/04 (BA007792).

definitive.”<sup>1282</sup> Mr. Wertz responded that such a letter would not help because, once a request was received and the regulators found they did not have the information, the damage would be done. Mr. Wertz also stated that the trustees could not be relied on to produce the information, particularly with a quick turnaround: “What has been clear in my earlier discussions with their lawyers is that they philosophically take a different approach to interpreting what the law and regs say. They are not subject to the laws and have no regulatory compliance obligation, therefore, they are willing to take a very strict and narrow reading of the rules. ... I don’t think the law will ever be clear enough such that the client and their lawyers concede that they have no choice but to comply.”

In June 2004, BAI presented a proposal to NFS to have the offshore entities disclose their beneficial ownership to a law firm mutually agreed to by BAI and NFS.<sup>1283</sup> The law firm would conduct a due diligence review and report the results, but not the names, to BAI and NFS. The law firm would retain the names, subject to the attorney client privilege, and release them to BAI only in the event of a regulatory inquiry or the adoption of regulations clearly requiring BAI to collect the names. These activities would be performed at the Wyllys’ expense. This proposal was presented to the risk committee, at which time BAI’s General Counsel Barry Harris was assigned to discuss the proposal with NFS.<sup>1284</sup>

Mr. Harris met with NFS representatives on June 15, and reported that NFS’ concerns were broader than customer identity. He said that their concerns included:

“1. Customer id: they don’t know the basic info. required for money-laundering/OFAC/Patriot policies.

“2. They are concerned that the stock in the accounts is 144 or control [stock], given Mr. Wyley’s position. They question whether the US filings required of Michaels/Mr. Wyley require disclosure of these shares and, if so, were they in fact disclosed. They also question whether the stock is restricted by US laws.

“3. The accounts have been buying Michaels stock. They question the propriety of and filing requirements on such purchases.

“4. Money has moved from, into and between the accounts. The lack of information makes this very troublesome to NFS; even if they had the info., the movements and the fact that the accounts are Isle of Mann entities would hit

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<sup>1282</sup> 6/1/04 emails between Mr. Schaufele and Mr. Wertz (BA082073).

<sup>1283</sup> Series of emails, dated 6/3/04 to 6/7/04, involving Barry Harris, BAI General Counsel, Timothy Maloney, Private Bank President for the Central Region, and others (BA087178-81).

<sup>1284</sup> BAI Risk Committee Minutes dated 6/11/04 (BA042062-63).

tripwires in the NFS systems. Isle of Mann is a known haven for hiding ownership and assets, apparently.”<sup>1285</sup>

Since the proposal for using an outside counsel to process the beneficial owner information would not address these other concerns, NFS agreed to think about whether the proposal could be expanded to include certifications on the specified issues and provide their views in a week. Mr. Harris reported that NFS said, in their view, BAI as introducing broker should be more nervous about the accounts than NFS. They also indicated that, if any other activity in the accounts hit their compliance tripwires, NFS would be filing a Suspicious Activity Report with law enforcement.<sup>1286</sup>

On July 20, 2004, Mr. Harris met again with NFS which informed him that the outside attorney proposal would not satisfy their needs. He reported to the BAI risk committee that NFS had countered with the following proposal: “NFS will prepare written questions which they need answered to continue to support the accounts; BAI will add any questions which it believes need to be answered. I would forward the questions to the attorney representing the Wyley's and the trusts, informing them that we and NFS need answers within 30 days, or it will be necessary to ask them to move the accounts to another BD [broker dealer] which can support them based upon the information which they are willing to share. I need your input on the proposal.” He also reported:

“I believe we have hit the wall. NFS is extremely nervous about these accounts, if not for actual violations of Patriot/AML, for negative regulatory action based on the lack of info. and activity. . . . If we proceed as suggested, we need to alert the PB [Private Bank] on the decision, and possibly seek their assistance in getting the necessary information from the Wyley's.

“I share NFS' concern that we are exposed here. While we frequently have the benefit of facts/knowledge of the PB in our AML due dilly efforts, we too don't know the identities of the beneficiaries. I additionally am concerned that the PB doesn't know of/is not involved in the sales and cash transfers, and therefore we have no comfort from that side.” (BA086801-03).

The NFS questions were supposed to be supplied by August 8, 2004. Because of scheduling conflicts, the list of questions was actually provided on September 22. In brief, the NFS questions sought identifying information for each direct account holder, each entity behind the direct account holders, and each natural person with an ultimate beneficial ownership interest in the account, as well as an explanation as to why so many entities were used by the same indirect owners and an explanation of the inter-account transactions. Additional questions

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<sup>1285</sup> 6/15/04 email from Barry Harris, BAI General Counsel, to Timothy Maloney, Private Bank President for the Central Region, and Michael Santos (BA148741-42).

<sup>1286</sup> Id.

sought information about whether the indirect beneficial owners were Michaels insiders and, if so, the reasons why Michaels stock was handled in the entity accounts in the manner that it was.<sup>1287</sup>

In addition, in late September or early October 2004, the Manhattan District Attorney served subpoenas on Bank of America seeking information about the accounts held in the name of the Wyly-related offshore entities.<sup>1288</sup>

BAI did not forward the detailed NFS questions to the account holders. Instead, on October 22, 2004, BAI sent identical letters to the four offshore trustees, IFG, Close Bank, Intercontinental Management, and Trident, and to Ms. Boucher, asking for the following information “for each entity, natural person or trust that directly or indirectly owns, controls or holds a beneficial ownership interest in whole or in part” in each of the offshore account holders:

- (i) Name,
- (ii) physical address (primary residence for individuals or primary business address for legal entities),
- (iii) date of birth (for individuals only), and
- (iv) identification number (a U.S. taxpayer identification number or social security number for a U.S. person; a U.S. taxpayer identification number, social security number or foreign government issued identification number (such as a passport number) for non-U.S. persons).

The letters requested the information by October 29, 2004.<sup>1289</sup>

In response, BAI received five substantially identical letters dated either October 28 or 29, 2004, asking BAI to clarify the following points:

- “Why the information is being requested.”
- “Under what legal authority is the request for this information being made, and provide us with a copy of such authority.”
- “How Bank of America intends to use this information, including to whom such information may ultimately be disseminated.”

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<sup>1287</sup> 9/22/04 letter from Mr. Harris to Steve Ganis, Anti-Money Laundering Officer for NFS (BA086888-92).

<sup>1288</sup> Subcommittee interview of Bank of America (6/23/05).

<sup>1289</sup> 10/22/04 letters from BAI to the four offshore trustees and Ms. Boucher (BA149362-71).

- “The controls Bank of America undertakes to ensure the confidentiality and integrity of this information is maintained and provide us with a written description and confirmation that such controls are in place.”<sup>1290</sup>

On November 8, 2004, BAI advised the Wyly-related offshore entities of its decision to close all of their accounts.<sup>1291</sup> The accounts were closed in about 30 days, with most securities and cash balances transferred to the Bank of Bermuda branch in the Isle of Man.

Bank of America reduced the bonuses of Private Bank President Alan Rappaport, Private Bank Regional President Tim Maloney, and BAI President Mike Santo. A subsequent review of records and inquiries made by the Subcommittee staff indicate that BAI General Counsel Barry Harris was not fired, as reported in an earlier version of the Subcommittee’s report, but left the bank due to a bank merger.<sup>1292</sup>

#### **(d) Analysis of Issues**

The offshore entities that Louis Schaufele brought to Bank of America posed a classic anti-money laundering problem, clients who wanted to use the services of a U.S. financial institution to safeguard, invest, and transfer their funds, without telling the financial institution who they were. For U.S. banks, it has been settled law for years that offshore corporations and trusts must disclose the natural persons behind them to ensure that bank services are not being misused by criminals, terrorists, tax evaders, or other persons of concern. U.S. securities firms, until recently, operated with voluntary, rather than mandatory, requirements to identify the beneficial owners behind their accounts. By the time Bank of America opened accounts for the Wyly-related offshore entities in 2002, however, the Patriot Act had made it clear that U.S. securities firms were under the same legal requirements as U.S. banks to know their customers and safeguard the U.S. financial system from abuse.

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<sup>1290</sup> Letters dated October 28, 2004 from Irish Trust (BA149061,63) and Michelle Boucher (BA149062), and October 29, 2004, from Trident Trust (BA149060) and IFG International (BA149064-65). No responses appear to have been received from Close Bank or Intercontinental Management.

<sup>1291</sup> 11/8/04 letters from BAI to IFG, Close Private Bank, Trident Trust, and Intercontinental Management (BA149110-11, 14-15, 18-19, 22-23). In addition, on November 9, BAI advised Ms. Boucher of its intention to close accounts for three offshore entities associated with her, Altonco, Brown Dog, and Two Oceans. (BA149128-29) BAI made this decision even though, on October 29, 2004, it had asked her for information about these corporations (BA151499), and on November 5, 2004, she had responded with a strongly worded letter complaining of the unreasonableness of the BAI demand for beneficial ownership information, but nevertheless providing it. (BA148314-15) On November 12, 2004, Charles Pulman of Meadows, Owens wrote BAI on Ms. Boucher’s behalf to demand the return of her November 5 letter and instructing the BAI not to “disclose that information to any person.” (BA149164)

<sup>1292</sup> Subcommittee interview of Bank of America (6/23/05) and subsequent followup discussions.

In this case history, Bank of America was repeatedly told in an informal way that the offshore entities were associated with the Wyls, but when it sought to get this information formally, by documenting the beneficial owners of the accounts, the offshore entities refused to cooperate. Despite being pressed for nearly a year by its clearing broker, NFS, Bank of America never obtained the beneficial ownership information required by the Patriot Act. Bank of America also accepted, for tax purposes, the W-8BEN forms provided by the offshore entities representing that they were the beneficial owners of the account income, when the bank knew that U.S. taxpayers, the Wyls, were directing the offshore entities' investments.

Had the offshore entities acknowledged, for anti-money laundering purposes, that the Wyls were the beneficial owners of the accounts opened by the offshore trusts and corporations, it would have been harder for the Wyls to disavow ownership and control of these same entities for tax and securities purposes. Perhaps that is why the offshore entities worked so hard to hide their beneficial ownership from Bank of America, despite the legal requirements of the Patriot Act.

**APPENDIX 1**  
**Wyly-Related Offshore Entities**

**Bulldog Non-Grantor Trust (PSI00007371-405)**

Established: 1992  
Grantor: Sam Wyly  
Beneficiaries: British Red Cross  
Community Chest of Hong Kong  
Sam Wyly issue  
Merged: 2000 (with Bulldog II Trust)  
Reconstituted: 2004  
Corporations: East Baton Rouge Ltd.  
East Carroll Ltd.  
Locke Ltd.  
Moberly Ltd.  
Morehouse Ltd.  
Richland Ltd.  
Tensas Ltd.  
West Carroll Ltd.

**Pitkin Non-Grantor Trust (PSI00009196-230)**

Established: 1992  
Grantor: Charles Wyly  
Beneficiaries: British Red Cross  
Community Chest of Hong Kong  
Charles Wyly issue  
Merged: 2000 (with Pitkin Trust II)  
Reconstituted: 2004  
Corporations: Little Woody Ltd.  
Maroon Ltd. (later named Rugosa Ltd.)  
Roaring Creek Ltd.  
Roaring Fork Ltd.

**Tallulah International Trust (PSI00009752-84)**

Established: 1992  
Grantor: Sam Wyly  
Beneficiaries: Sam Wyly issue  
Terminated: 1996

**Woody International Trust (PSI00009819-53)**

Established: 1992  
Grantor: Charles Wyly  
Beneficiaries: Charles Wyly issue  
Terminated: 1996

**Castle Creek International Trust (PSI00009011-46)**

Established: 1992  
Grantor: Charles Wyly  
Beneficiaries: British Red Cross  
Community Chest of Hong Kong  
Charles Wyly issue  
Merged: 2000 (with Pitkin II Trust)  
Reconstituted: 2004  
Corporations: Quayle Ltd.

**Delhi International Trust (PSI00009087-122)**

Established: 1992  
Grantor: Sam Wyly  
Beneficiaries: British Red Cross  
Community Chest of Hong Kong  
Sam Wyly issue  
Merged: 2000 (with Bulldog II Trust)  
Reconstituted: 2004  
Corporations: Greenbriar Ltd.

**Lake Providence International Trust (PSI00008151-85)**

Established: 1992  
Grantor: Sam Wyly  
Beneficiaries: British Red Cross  
Community Chest of Hong Kong  
Sam Wyly issue  
Merged: 2000 (with Bulldog II Trust)  
Reconstituted: 2004  
Corporations: Sarnia Investments Ltd.

**Bessie Trust (PSI00008897-953)**

Established: 1994

Grantor: Keith King, benefitting family of Sam Wyly

Beneficiaries: Keith King

Sam Wyly, his wife and issue

University of Michigan (added 12/7/97)

Any First Church of Christ Scientist Church (added 12/7/97)

Communities Foundation of Texas (added 12/7/97)

Corporations: Audubon Assets Ltd. (formerly Fugue Ltd.)

Cottonwood I Ltd.

Cottonwood II Ltd.

Mi Casa Ltd.

Newgale Ltd.

Rosemary's Circle R Ranch Ltd. (formerly Two Mile Ranch Ltd. and  
Woody Creek Ranch Ltd.)

Spitting Lion Ltd.

Yurta Faf Ltd.

Balch LLC

Bubba LLC

FloFlo LLC

Katy LLC

Orange LLC

Pops LLC

**Tyler Trust (PSI00006985-7042)**

Established: 1994

Grantor: Keith King, benefitting family of Charles Wyly

Beneficiaries: Keith King

Charles Wyly, his wife and issue

Any First Church of Christ Scientist Church (added 3/6/97)

Lady Thatcher's Archive at the Cambridge Foundation (added 9/14/99)

Corporations: Elysium Ltd.

Gorsemoor Ltd.

Jordan Way Ltd.

Little Woody Creek Road Ltd.

Ramona Ltd.

Soulieana Ltd.

Stargate Farms Ltd.

**Plaquemines Trust (PSI0006467-99)**

Established: 1995  
Grantor: Bulldog Trust  
Beneficiaries: British Red Cross  
Community Chest of Hong Kong  
Voided: 1999  
Corporations: East Baton Rouge Ltd. (transferred from Bulldog in 1995)  
East Carroll Ltd. (transferred from Bulldog in 1995)

**La Fourche Trust (PSI00009130-58)**

Established: 1995  
Grantor: Shaun Cairns, benefitting family of Sam Wyly  
Beneficiaries: Sam Wyly and issue  
Corporations: Devotion Ltd.  
Relish Ltd.

**Red Mountain Trust (PSI00009235-63)**

Established: 1995  
Grantor: Shaun Cairns, benefitting family of Charles Wyly  
Beneficiaries: Charles Wyly, his wife and issue  
Any First Church of Christ Scientist Church (added 3/11/97)  
Shaun Cairns (added 9/16/00)  
Corporations: Elegance Ltd.

**Arlington Trust (PSI00092920-51)**

Established: 1995  
Grantor: Sam Wyly  
Beneficiaries: Sam Wyly, his wife and issue  
Terminated: 1996

**Crazy Horse Trust (PSI00009048-83)**

Established: 1995  
Grantor: Sam Wyly  
Beneficiaries: Sam Wyly, his wife and issue  
Terminated: 1996

**Maroon Creek Trust (PSI00009886-917)**

Established: 1995  
Grantor: Charles Wyly  
Beneficiaries: Charles Wyly, his wife and issue  
Terminated: 1996

**Lincoln Creek Trust (HST PSI004498-531)**

Established: 1996  
Grantor: Charles Wyly  
Beneficiaries: Charles Wyly, his wife and issue  
Terminated: 1996

**Sitting Bull Trust (PSI00092969-3000)**

Established: 1996  
Grantor: Sam Wyly  
Beneficiaries: Sam Wyly, his wife and issue  
Terminated: 1996

**Bulldog II Trust**

Established: 2000  
Grantor: Sam Wyly  
Beneficiaries: British Red Cross  
Community Chest of Hong Kong  
Sam Wyly issue  
Merged: 2000 (with Bulldog Trust)  
2001 (with Lake Providence and Delhi International Trusts)  
Voided: 2004  
Corporations: East Baton Rouge Ltd.  
East Carroll Ltd.  
Greenbriar Ltd.  
Locke Ltd.  
Moberly Ltd.  
Morehouse Ltd.  
Richland Ltd.  
Sarnia Investments Ltd.  
Tensas Ltd.  
West Carroll Ltd.

**Pitkin Trust II**

Established: 2000  
Grantor: Charles Wyly  
Beneficiaries: British Red Cross  
Community Chest of Hong Kong  
Charles Wyly issue  
Merged: 2000 (with Pitkin Trust)  
2001 (with Castle Creek International Trust)  
Voided: 2004  
Corporations: Little Woody Ltd.  
Maroon Ltd. (later named Rugosa Ltd.)  
Quayle Ltd.  
Roaring Creek Ltd.  
Roaring Fork Ltd.

**APPENDIX 2**  
**Isle of Man Offshore Service Providers**

**Close Trustees Ltd. (Close)**

Key Personnel: Mark Lewin  
Trustees For: Red Mountain Trust (2002-present)

**IFG International, Inc. (IFG)**

Key Personnel: David Harris  
Anna Maria Benbatoul  
Trustees For: Bessie Trust (1998-present)  
Bulldog Non-Grantor Trust (1996-present)  
Bulldog II Trust (2000-2004)  
Castle Creek International Trust (2000-2004)  
Delhi International Trust (2000-present)  
Lake Providence International Trust (2000-present)  
Pitkin Non-Grantor Trust (1997-2004)  
Pitkin Trust II (2000-2001)  
Plaquemines Trust (August 1995-2004)

**Inter-Continental Management Company Ltd. (Inter-Continental)**

Key Personnel: Colin Platten  
Andy Wallis  
Trustees For: LaFourche Trust (2001-present)

**Lorne House Trust Company Ltd. (Lorne House)**

Key Personnel: Ronald Buchanan  
Keith L. King  
Russell Collister  
Trustees For: Bessie Trust (1994-1998)  
Bulldog Non-Grantor Trust (1992-1996)  
Pitkin Non-Grantor Trust (1992-1997)  
Tallulah International Trust (1992-1996)  
Tyler Trust (1994-1998)  
Woody International Trust (1992-1996)

**MeesPierson/Valmet/Northern Bank**<sup>1293</sup>

Key Personnel: Andy Wallis  
Trustees For: Arlington Trust (1995-1996)  
Castle Creek International Trust (1992-2000)  
Crazy Horse Trust (1995-1996)  
Delhi International Trust (October 1995-2000)  
Lake Providence International Trust (1992-2000)  
Maroon Creek Trust (1995-1996)

**Trident Trust Company Ltd (Trident)**

Key Personnel: David H. Bester  
Richard Scott  
Francis Webb  
Trustees For: Castle Creek International Trust (2004-present)  
LaFourche Trust (1996-2001)  
Lincoln Creek Trust (January-December 1996)  
Pitkin Non-Grantor Trust (2004-present)  
Pitkin Trust II (2001-2004)  
Red Mountain Trust (1996-2002)  
Sitting Bull Trust (January-December 1996)  
Tyler Trust (1998-present)

**Wychwood Trust Ltd. (Wychwood)**

Key Personnel: Shaun Cairns  
Trustees For: Delhi International Trust (March-August 1995)  
LaFourche Trust (1995-1996)  
Plaquemines Trust (February-August 1995)  
Red Mountain Trust (1995-1996)

Janek K. Basnet, an Isle of Man resident who is not associated with any of the above offshore service providers, served briefly as a trustee for the Plaquemines Trust and the Delhi International Trust.

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<sup>1293</sup> Pierson Holding & Pierson (Isle of Man) Ltd. changed its name to MeesPierson (Isle of Man) Ltd. and is hereinafter referred to as MeesPierson. MeesPierson was sold to Valmet (Isle of Man) Ltd. in 1998, which was sold to Northern Bank Trust Company (Isle of Man) Ltd. in 1999. For ease of reference, the company is referred to as “MeesPierson/Valmet/Northern Bank.”

**APPENDIX 3**

**Wyly Offshore Trusts and Their Trustees**

**Arlington Trust**

MeesPierson (1995-1996)

**Bessie Trust**

Lorne House (1994-1998)

IFG (1998-present)

**Bulldog Non-Grantor Trust**

Lorne House (1992-1996)

IFG (1996-present)

**Bulldog II Trust**

IFG (2000-2004)

**Castle Creek International Trust**

MeesPierson/Valmet/Northern Bank (1992-2000)

IFG (2000-2004)

Trident (2004-present)

**Crazy Horse Trust**

MeesPierson (1995-1996)

**Delhi International Trust**

Credit Suisse Trustees (1992-1995)

Wychwood (March-August 1995)

Janek K. Basnet (August-October 1995)

MeesPierson/Valmet/Northern Bank (October 1995-2000)

IFG (2000-present)

**La Fourche Trust**

Wychwood (1995-1996)

Trident (1996-2001)

Inter-Continental (2001-present)

**Lake Providence International Trust**

MeesPierson/Valmet/Northern Bank (1992-2000)

IFG (2000-present)

**Lincoln Creek Trust**

Trident (January-December 1996)

**Maroon Creek Trust**

MeesPierson (1995-1996)

**Pitkin Non-Grantor Trust**

Lorne House (1992-1997)

IFG (1997-2004)

Trident (2004-present)

**Pitkin Trust II**

IFG (2000-2001)

Trident (2001-2004)

**Plaquemines Trust**

Wychwood (February-August 1995)

Janek K. Basnet (August-October 1995)

IFG (November 1995-2004)

**Red Mountain Trust**

Wychwood (1995-1996)

Trident (1996-2002)

Close (2002-present)

**Sitting Bull Trust**

Trident (January-December 1996)

**Tallulah International Trust**

Lorne House (1992-1996)

**Tyler Trust**

Lorne House (1994-1998)

Trident (1998-present)

**Woody International Trust**

Lorne House (1992-1996)

## **APPENDIX 4**

### **Additional Security Capital Loans**

As discussed in the Report section on Bringing Offshore Dollars Back with Pass-Through Loans, Security Capital Ltd. participated in at least ten transactions with Wyly-related parties involving offshore dollars and other financial assets totaling nearly \$140 million. Three of those ten transactions are summarized in the Report text; the remaining seven are summarized here.

**\$10 Million Loan to Green Mountain.** The Subcommittee has been told that the first Security Capital transaction was a \$10 million loan provided on August 26, 1998, by Security Capital to Green Mountain Energy Resources LLC (Green Mountain), a business venture in the United States that the Wyls had acquired the year before.<sup>1294</sup> The funds for the \$10 million loan were supplied to Security Capital by two Wyly-related IOM corporations, Morehouse and Richland.<sup>1295</sup> The purpose of this loan was to provide additional capital for the Green Mountain venture.<sup>1296</sup> The Subcommittee was told that both loans associated with this transaction were repaid in full a few months later, on November 25, 1998.<sup>1297</sup>

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<sup>1294</sup> See Bickel & Brewer letter and attachments, chart entitled, “Security Capital Loans” (hereinafter “Bickel & Brewer Security Capital Chart”). For more information on the Green Mountain business venture, see the Report section on Investing Offshore Dollars in An Energy Company, above. The term “Green Mountain” is used here to refer to various corporations involved in that venture. The Subcommittee has not been provided with a promissory note related to this loan or any documentation referring to such a note. The Subcommittee did locate a draft \$10 million promissory note to be provided by Queensgate Bank, but the Subcommittee was told that this loan was not finalized and was replaced by the Security Capital loan. See draft promissory note (PSI-WYBR00476-78). The Subcommittee has also been unable to locate documentation substantiating a \$10 million payment by Security Capital to Green Mountain, although other evidence suggests this transfer did take place.

<sup>1295</sup> Bickel & Brewer Security Capital Chart. Bank documentation shows that, on 9/1/98, Richland ordered a wire transfer of \$5.5 million to Security Capital (CC022992); and on 10/22/98, Morehouse ordered a wire transfer of \$4.5 million to Security Capital (CC023454). These wire transfers took place in September and October 1998, after Security Capital had already supposedly provided the \$10 million to Green Mountain in August. The Subcommittee has not been provided with any promissory notes related to these loans, or any documentation referring to such notes.

<sup>1296</sup> Bickel & Brewer Security Capital Chart.

<sup>1297</sup> Id. The Subcommittee has been unable to locate documentation establishing that the loans were repaid with cash. Some documentation suggests that Green Mountain instead repaid the loan by issuing \$10 million in Green Mountain stock to Morehouse and Richland, presumably via Security Capital. See, e.g., 11/19/98 email from Ms. Robertson and Mr. French to Aundyr Trust Co. (IOM)(PSI\_ED00070493)(“The cash call [for Green Mountain] in total is \$10,000,000. (The protectors are recommending leaving the \$10,000,000 loan to Security Capital outstanding at this time, more on that later.)”); 11/30/98 chart showing transactions involving 12 Wyly-related offshore entities (PSI\_ED00073857-58)(chart indicates Morehouse and Richland were to each get a “Repay from Security Capital” that could be used to buy interests in GMP Holdings, a company involved with Green Mountain); 2/2/99 email on “GMP/Security Capital” (PSI\_ED00046780)(“Security Capital loan should be cancelled. The two entities now own \$10,000,000 more Green Funding 2, Ltd.”); 4/19/99 document entitled, “Summary of investment in Green Funding II L.L.C.” (HST\_PSI031913)(listing as one investment “conversion of Security Capital loan [of] 10,000,000”). Green Funding 2, Ltd. and Green Funding II LLC were additional companies involved with Green Mountain.

**\$1.5 Million Loan to Green Mountain.** The Subcommittee has been told that the second Security Capital transaction took place in October 1998, when Security Capital issued a \$1.5 million loan to Green Mountain, financed by \$1.5 million supplied by a Wyly-related IOM corporation, East Carroll.<sup>1298</sup> The purpose of this loan was apparently to provide additional capital for the Green Mountain venture.<sup>1299</sup> The Subcommittee was told that both loans associated with this transactions were repaid in full on October 22, 1999.<sup>1300</sup>

**\$3 Million Loan to Green Mountain Executive.** The Subcommittee has been told that the next transaction took place in January 1999, when East Carroll issued a \$3 million loan to Security Capital,<sup>1301</sup> and Security Capital issued a \$3 million loan to the chief executive officer of Green Mountain, then David White.<sup>1302</sup> The purpose of this loan may have been to finance

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<sup>1298</sup> Bickel & Brewer Security Capital Chart. The Subcommittee has been unable to locate any promissory notes related to these loans. The Subcommittee has also been unable to locate documentation substantiating a \$1.5 million payment by East Carroll to Security Capital, or a \$1.5 million payment by Security Capital to Green Mountain. Documents were located showing that, on 10/23/98, East Carroll wired \$2.2 million to GMP Holdings, a company related to Green Mountain (CC020008; PSI\_ED00073857-58; PSI-ED00073913-16), but because the date, amount, and payee in these documents do not match the information supplied about the transactions in question, these documents do not directly support the Security Capital loan transactions described in the Bickel & Brewer materials.

<sup>1299</sup> Bickel & Brewer Security Capital Chart.

<sup>1300</sup> Id. The Subcommittee has been unable to locate any documentation substantiating repayment of either loan involved in this transaction.

<sup>1301</sup> Id. The Subcommittee has been unable to locate any promissory note for an East Carroll loan to Security Capital. The Subcommittee has also been unable to locate evidence substantiating a \$3 million transfer by East Carroll to Security Capital in January 1999. Documentation has been located showing that, on 1/8/99, East Carroll wired \$1.3 million to Security Capital (CC019923-25; Mizuho000465-67); and on 1/20/99, East Carroll wired \$300,000 to Security Capital (CC019922, 33; Mizuho000486-88).

<sup>1302</sup> A series of documents, from January and February 1999, indicate that Security Capital did, in fact, issue a \$3 million loan to David White. See, e.g., 1/7/99 email on "David White loans from Security Capital" (PSI\_ED00043243)(listing \$3 million worth of loans requested by Mr. White); 1/7/99 "Account Control Agreement" (CC037451-56)(establishing a M. David & Jennifer J. White "Pledge Account" at Lehman Brothers to secure any past or future loans from Highland Stargate or Security Capital, signed in part by Highland Stargate on behalf of itself and the holder of the "notes"); 1/8/99 email from Lehman Brothers (PSI00039165)(providing wiring instructions for the pledge account); 1/31/99 Pledge Account statement (CC035951-53)(listing account transactions for January 1999, including a 1/13/99 deposit of \$2.7 million, and a 1/25/99 deposit of \$300,000); undated document entitled "David White Lehman's" (PSI00039164)(listing a series of transactions including a 1/13/99 entry of \$2.7 million for "Loan-Security Capital," and a 1/25/99 entry of \$300,000 for "Loan-Security Capital"). Together, these documents indicate that Security Capital did lend \$3 million to Mr. White in January 1999, that one or more promissory notes were prepared and executed, and that Mr. White provided security to repay these amounts by establishing the pledge account at Lehman Brothers.

Mr. White's purchase of Green Mountain stock.<sup>1303</sup> Both loans related to this transaction were allegedly repaid in full on October 29, 1999.<sup>1304</sup>

**\$8 Million Loan to Malibu Trust.** The next transaction took place in April 1999, when on April 14, 1999, Security Capital loaned \$8 million to the Sam Wyly Malibu Trust, a U.S. trust created by Mr. Wyly in 1978, to hold certain real estate he had purchased in Malibu, California.<sup>1305</sup> This loan was partly secured by a second mortgage on that real estate.<sup>1306</sup> The funds used to make this loan had been supplied to Security Capital two days earlier, on April 12, 1999, by two Wyly-related IOM corporations, Locke which provided \$3 million, and Moberly which provided \$5 million.<sup>1307</sup> The purpose of the \$8 million transfer was to provide Sam Wyly with a personal loan.<sup>1308</sup>

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<sup>1303</sup> Bickel & Brewer Security Capital Chart.

<sup>1304</sup> *Id.* The Subcommittee has been unable to locate documentation substantiating that Security Capital repaid the \$3 million loan to East Carroll. However, a series of October 1999 documents suggest that David White, who had by then left Green Mountain, did repay his outstanding loan to Security Capital by tendering 750,000 shares of Green Mountain stock. It is possible that Security Capital, in turn, tendered these shares to East Carroll. See, e.g., 10/13/99 email from Ms. Robertson to Ms. Boucher (MAV008588) ("David White is no longer with Green Mtn. Evan has been negotiating a settlement of David's employment contract with Highland. The settlement ... is the following: All Security Capital debt forgiven in exchange for 750,000 shares of Green Mountain Energy that has debt of \$1,500,000 attached to it. ... I need to know who funded Security Capital."); 10/14/99 email from Ms. Boucher to Ms. Robertson on "SECURITY CAPITAL" (MAV007724) ("THE LOAN WAS MADE FROM EAST CARROLL LIMITED.") (capitalization in original); 10/18/99 email from Mike Bursell, treasurer of Green Mountain, to Ms. Robertson on "Loan Receipt" (PSI\_ED00043760) ("Received your voice mail this morning. I will give you paydown information as soon as I can get hold of David White loan information."); 10/19/99 email from Mr. Bursell to Ms. Boucher and Ms. Robertson, with copies to others (PSI\_ED00080040) ("The \$4 million dollar cash request should be made up of two payments based on my correspondence with Shari. The first payment of \$1,569,677 represents the paydown of the \$1,500,000 promissory note executed by M. David White and Jennifer J. White with six percent interest charges, (total interest payment of \$69,677), from the effective date of January 11, 1999 to the payment date of October 20, 1999."); bank records (CC020002-03) (showing that, on 10/19/99, East Carroll wired \$1,569,677 to Green Mountain).

<sup>1305</sup> See 4/14/99 Promissory Note between Security Capital and the Sam Wyly Malibu Trust (HST\_PSI089322-26) (providing for an \$8 million, thirty-year loan, with a 6.75 percent interest rate, monthly payments of \$51,887 starting 5/14/99, payable in full by 4/14/29, secured by a deed of trust on the Malibu property; promissory note was signed by Sam Wyly but not Security Capital). See also mortgage amortization schedule (HST\_PSI089333-34); Bickel & Brewer Security Capital Chart; bank documents showing that, on 4/14/99, Security Capital wired \$8 million to the Sam Wyly Malibu Trust (Mizuho007530-33; BA147331). For more information on this transaction, see discussion in Appendix 5.

<sup>1306</sup> See 4/14/99 "Deed of Trust and Assignment of Rents" (PSI00087590-96) (placing second mortgage on Malibu property as security for the \$8 million loan).

<sup>1307</sup> Bickel & Brewer Security Capital Chart; bank documents show that, on 4/12/99, Locke wired \$3 million to Security Capital, (CC022578) and Moberly wired \$5 million to Security Capital. (CC023636). The Subcommittee has not, however, located a copy of any promissory notes between Security Capital and Locke or Moberly.

<sup>1308</sup> Bickel & Brewer Security Capital Chart; information provided by Bickel & Brewer.

Over the next two days, the Sam Wyly Malibu Trust transferred \$5 million of the loan proceeds to one of Sam Wyly's personal bank accounts,<sup>1309</sup> and \$3 million to a securities account opened by the Trust itself.<sup>1310</sup> Unlike the other Security Capital transactions, the promissory note in this case required monthly rather than annual repayments. Over the next two years, monthly payments were made on both the Security Capital-Malibu Trust loan,<sup>1311</sup> and the Security Capital-Locke and Moberly loans.<sup>1312</sup> In February 2002, Mr. Wyly sold the property to a third party.<sup>1313</sup> The Subcommittee was told that, in connection with the sale, on February 13, 2002, both of the loans associated with this transaction were repaid.<sup>1314</sup>

**\$15 Million Loan to Sam Wyly.** Another Security Capital transaction involves a \$15 million loan from Security Capital to Sam Wyly on January 30, 2002.<sup>1315</sup> The funds were supplied to Security Capital by Greenbriar, an Isle of Man corporation associated with Sam

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<sup>1309</sup> On 4/15/99, the day after the loan was issued, the Sam Wyly Malibu Trust wired \$5 million to one of Sam Wyly's personal checking accounts. (BA147334; BA093058-60) Over the course of the month, Mr. Wyly used the funds to make various transfers. (BA093058-60).

<sup>1310</sup> On 4/16/99, the Sam Wyly Malibu Trust wired \$3 million to a securities investment account that it had just opened. (BA147443; PSI00037184). Over the next two years, the Trust used the funds in this account to pay utilities, household expenses, construction costs, and real estate taxes, as well as make monthly payments to Security Capital.

<sup>1311</sup> See, e.g., bank records (Mizuho000250-52; 313-15; 377-79; 921-23; 942-44; 975-77; 1005-07; 1011-13; 1122-24; 1127-29; 633-35; 663-68; 681-83; 1270-72; 717-19; 735-37; 741-43; 15105-09; 15166-70; 1080-82; 15183-92; 15199-203; 15225-29; 15247-51; 15294-98; 15310-15; 15332-36; 15343-47; 15110-14)(showing, from 5/14/99 to 1/14/02, the Sam Wyly Malibu Trust made regular monthly payments to Security Capital of about \$51,887). Altogether, the Sam Wyly Malibu Trust sent Security Capital over \$1 million.

<sup>1312</sup> See, e.g., Irish Trust emails on 11/21/00 (PSI00037246), 5/11/01 (PSI00038919), and 5/22/01 (PSI00038916)(referencing Security Capital Malibu loan involving Locke and Moberly, and monthly loan payments by Security Capital to Locke of about \$18,500 and to Moberly of about \$30,700); bank documents (Mizuho012938-45; 13139-46)(showing Security Capital payments to those corporations on 12/5/01 and 12/14/01).

<sup>1313</sup> Although the Subcommittee was unable to locate the property sale documents, other evidence indicates that the sale took place on 2/13/02, and Sam Wyly sold the Malibu property to a third party for about \$8.1 million. See discussion of this sale in Appendix 5.

<sup>1314</sup> Bickel & Brewer Security Capital Chart. The Subcommittee has not located documentation substantiating the repayment of these loans; however other documentation suggests that repayment was, in fact, made. See, e.g., 2/21/02 financial statement for "Global SW Family" (PSI00110067)(internal Wyly financial report listing outstanding Security Capital loans and indicating the Malibu loan had been repaid).

<sup>1315</sup> See 1/30/02 Promissory Note between Security Capital and Sam Wyly (PSI00027412-15)(providing for a \$15 million, ten-year loan, with a 5.50 percent interest rate, interest payments in 10 annual installments of \$825,000 starting 1/30/03, no payment of principal required until 2/15/12, when the loan was due in full, unsecured; promissory note signed by Sam Wyly and J.D. Hunter as director of Security Capital). See also 1/2/02 fax from David Harris of IFG to Ms. Boucher (PSI00039588)(discussing possible Security Capital loan to Sam Wyly; handwritten notations state: "92 - 94," "94 loan to Sec Cap," "Sec Cap to SW"); Bickel & Brewer Security Capital Chart. The Subcommittee has not located bank documentation substantiating a \$15 million transfer from Security Capital to Sam Wyly, although other evidence indicates that this transfer did take place.

Wyly.<sup>1316</sup> The purpose of the loan was to enable Sam Wyly to make an additional investment in Ranger Capital, a hedge fund that he founded.<sup>1317</sup> The loan was unsecured, despite the substantial funds involved. In 2003, for an unknown reason, another Wyly-related offshore corporation, Newgale Ltd., was apparently inserted into the lending chain between Greenbriar and Security Capital.<sup>1318</sup> Both loans related to this transaction apparently remain outstanding.<sup>1319</sup>

**\$5 Million Loan to Wrangler Trust.** The next Security Capital transaction was a \$5 million loan in June 2002, from Security Capital to the Wrangler Trust, a U.S. trust established by Sam Wyly.<sup>1320</sup> The funds had been supplied to Security Capital on the day before by Locke, an Isle of Man corporation associated with Sam Wyly.<sup>1321</sup> The purpose of the loan was to enable

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<sup>1316</sup> See “draft” promissory note between Greenbriar and Security Capital (CC021671-74)(providing for a \$15 million, ten-year loan with the same terms as above, except the interest rate is 5.25 percent and the annual payments are \$787,500). But see Bickel & Brewer Security Capital Chart which states that the interest rate for this loan was 5.4625 percent. See also emails discussing wire transfer of \$15 million to Security Capital, including 1/29/02 email from Ms. Boucher to Lehman Brothers (CC012691)(providing wire transfer instructions to move funds as follows: “\$15M from Devotion to Sarnia[;] \$15M from Sarnia to Greenbriar[;] \$15M from Greenbriar to Security Capital”); second email from Ms. Boucher to Lehman Brothers later the same day (CC012690)(explaining proposed wire transfers as follows: “– Devotion bought \$15Million of Ranger Fund LLC shares from Sarnia, so the transfer to Sarnia is to pay for those shares. – Sarnia is lending the funds to Greenbriar as an intercompany advance, Greenbriar are related companies – wholly owned by the same Trust. – Greenbriar is making a \$15Million loan to Security Capital”); bank documents showing money transfers on 1/29/02 (BA PSI-W013595; CC027316)(Sarnia transfer of \$15 million to Greenbriar); (CC021725; BA PSI-W013589; CC027039)(Greenbriar transfer of \$15 million to Security Capital); (CC000312; BA PSI-W003526, 011369-70, 72; CC021669) (Greenbriar securities account statement showing 1/29/02 deposit of \$15 million from Sarnia and wire transfer of \$15 million to Security Capital); (Mizuho015692-96)(Security Capital receipt of funds). See also 3/11/02 email (BA007597-98)(providing same explanation of chain of wire transfers).

<sup>1317</sup> Bickel & Brewer Security Capital Chart; 2/21/02 financial statement for “Global SW Family” (PSI00110067)(listing as a loan receivable “Loan - Security Capital (SW-Ranger) \$15,000,000”).

<sup>1318</sup> Bickel & Brewer Security Capital Chart (Newgale “[r]eplaces Greenbriar loan”).

<sup>1319</sup> Id. See also documents showing that Sam Wyly made specified annual payments of \$825,000 to Security Capital in 2003, 2004, and 2005, (HST\_PSI005707, 8730)(indicating 2003 transfer of \$825,000); (PSI\_ED00011301-02)(indicating 2004 transfer); (IW002070)(indicating 2005 transfer). The Subcommittee has not located bank documentation showing corresponding payments by Security Capital to Newgale.

<sup>1320</sup> See unsigned 6/4/02 Promissory Note between Security Capital and Wrangler Trust (PSI\_ED00013667-70)(providing for a \$5 million, five-year loan, with a 4.75 percent interest rate, interest payments due in 5 annual installments of \$237,500 starting 6/4/03, no payment of principal required until 6/3/07, when repayment of the loan was due in full). See also Bickel & Brewer Security Capital Chart; bank documents (Mizuho001658-61)(showing Security Capital wire transfer of \$5 million to Wrangler Trust); and (PSI00025917, 19; HST\_PSI041867)(Wrangler receipt of wire transfer on 6/4/02).

<sup>1321</sup> The Subcommittee has been unable to locate a copy of a promissory note between Security Capital and Locke, but did locate documentation showing that Locke transferred \$5 million to Security Capital on 6/3/02. See, e.g., bank documentation (BA003936)(showing Locke ordered \$5 million wire transfer to Security Capital on 6/3/02 “to enable the company to acquire a work of art.”); and (Mizuho015866-70)(showing Locke wired \$5 million to Security Capital on 6/3/02).

the Trust to buy a famous Norman Rockwell painting called, “Rosie the Riviter.”<sup>1322</sup> The painting was pledged as collateral to secure repayment of the loan.<sup>1323</sup> In 2003, for reasons that are unclear, the promissory note was revised about nine months later, without the alterations being disclosed on the document.<sup>1324</sup> Both loans associated with this transaction were apparently repaid on or around April 30, 2004.<sup>1325</sup>

**\$6 Million Loan to Charles Wyly.** The final Security Capital transaction described here is a \$6 million loan in October 2002, provided by Security Capital to Charles Wyly.<sup>1326</sup> The funds had been supplied to Security Capital on the same day by Gorsemoor, an Isle of Man corporation owned by the Tyler Trust, which was associated with Charles Wyly and his family.<sup>1327</sup> The apparent purpose of the transaction was to enable Charles to make an additional

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<sup>1322</sup> See, e.g., unsigned promissory note between Security Capital and Wrangler Trust (PSI\_ED00013667-70); bank document showing that, on 6/3/02, Wrangler transferred \$4.9 million to the Elliott-Yeary Gallery to pay for the painting (PSI00025918-19, 68-70); Bickel & Brewer Security Capital Chart.

<sup>1323</sup> See Promissory Note between Security Capital and Wrangler Trust (PSI\_ED00013667) (stating painting is collateral for note and referring to a “Pledge Agreement” effective on the same date, 6/4/02); Bickel & Brewer Security Capital Chart. The Subcommittee was unable to locate a copy of the Pledge Agreement.

<sup>1324</sup> See 3/4/03 email from Ms. Boucher to Ms. Hennington (PSI-WYBR00673)(Ms. Boucher wrote: “Can you fax me what you have executed for CW/SW/Wrangler regarding the \$6M, \$15M, \$5M loans. We don[’t] have execution copies. I know there will be a change to some of them (1 or 2).” Ms. Hennington responded: “[T]wo of the ones I have are not signed by Security Capital (one of these is the one we are changing).”); 3/7/03 email from Alan Stroud of Meadows Owens law firm to Ms. Hennington (PSI\_ED00013666)(“Attached is the revised Wrangler note. The effective date is still 6/4/02. The qualified obligation language has been removed. I also corrected the amount stated as interest (it formerly said \$250,000, but I changed it to \$237,500).” Ms. Hennington forwarded the Stroud email to Ms. Boucher and Ms. MacInnis on the same date, stating: “I am sending federal express to you today signed originals for the restated Wrang[le]r note ... for execution by Security Capital.”).

<sup>1325</sup> See, e.g., Bickel & Brewer Security Capital Chart; bank documentation (PSI00038626-27, 43, 48)(showing, on 5/3/04, Wrangler wired \$5.2 million to Security Capital). See also 1/29/04 email from Ms. Hennington to Ms. Alexander (PSI00038501)(discussing plans to repay loan); April emails calculating interest due on note (PSI\_ED00009470-72; PSI00038649-50)(Ms. Alexander Ms. Hennington, and Ms. MacInnis together appear to determine interest owed on note is \$217,977); internal Wyly financial records for the Wrangler Trust in April and May 2004 showing loan has been repaid (PSI00038624, 31, 46-47, 53, 56). The Subcommittee has not located any documentation substantiating Security Capital’s corresponding repayment of the \$5 million obtained from Locke.

<sup>1326</sup> See 10/1/02 Promissory Note between Security Capital and Charles Wyly (PSI00027423-26)(providing for a \$6 million, ten-year loan, with a 4.90 percent interest rate, interest payments due in 10 annual installments of \$294,000 starting 10/1/03, no payment of principal until 9/30/12, when repayment of the loan is due in full; promissory note signed by Charles Wyly and J.D. Hunter as director of Security Capital). See also Bickel & Brewer Security Capital Chart; emails discussing transaction (PSI\_ED00013466; PSI\_ED00013492; PSI00027422)(describing notes and anticipated wire transfer on 10/15/02). The Subcommittee did not locate bank documentation showing the actual transfer of \$6 million from Security Capital to Charles Wyly.

<sup>1327</sup> See unsigned Promissory Note between Security Capital and Gorsemoor (PSI\_ED00013467-70)(providing for a \$6 million, ten-year loan with the same terms as the Security Capital-Charles Wyly loan, except the interest rate is 4.525 percent and the annual payments are \$271,500). But see Bickel & Brewer Security Capital Chart (stating interest rate for the Security Capital-Gorsemoor loan is 4.8625 percent). See also emails and correspondence discussing transaction (PSI\_ED00013466, 92; PSI00027422; PSI\_ED00011718); 10/31/02 financial statement for Tyler Trust (PSI00078301)(showing Gorsemoor with a \$6 million Security Capital note as a

investment in Ranger Capital, the Wyly-related hedge fund.<sup>1328</sup> The loan was unsecured, despite the substantial funds involved. Both loans associated with this transaction apparently remain outstanding.<sup>1329</sup>

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receivable); 12/31/02 document entitled, "Cash Flow Summary-Domestic" for Charles Wyly (PSI\_ED00063802)(listing cash inflow from Security Capital of \$6 million). The Subcommittee did not locate bank documentation showing the actual transfer of \$6 million from Gorsemoor to Security Capital.

<sup>1328</sup> Bickel & Brewer Security Capital Chart.

<sup>1329</sup> Id. See also documents showing that Charles Wyly made the specified annual payment of \$294,000 to Security Capital in 2003 and 2004 (HST\_PSI009336, PSI00038252)(indicating 2003 transfer of \$294,000) and (HST\_PSI011025, 40-41, PSI\_ED00015095-101, and PSI\_ED00008911-12) (showing 2004 transfer).

## **APPENDIX 5**

### **Additional Real Estate Transactions**

As discussed in the Report section on Funneling Offshore Dollars Through Real Estate, during the thirteen years examined in this Report, tens of millions of untaxed, offshore dollars were used to acquire, improve, and operate U.S. real estate properties used by the Wyllys for personal residences or business ventures. Five real estate transactions, financed with about \$85 million in offshore dollars, were examined to illustrate the issues involved. Two examples, involving Rosemary's Circle R Ranch and the LL Ranch, appear in the above Report section. The remaining three examples, involving Cottonwood Ventures, Stargate Horse Farm, and oceanside property in Malibu, California, are examined here.

#### **(1) Cottonwood Ventures**

In contrast to Rosemary's Circle R Ranch and the LL Ranch involving residential property, Cottonwood Ventures was a business venture that utilized commercial property in the United States. This property was purchased for about \$8.5 million in 2000, using primarily offshore dollars, and, over the next five years, used another \$5 million in offshore funding to cover 99 percent of its operating and construction costs. These offshore dollars were funneled through both a U.S. management trust and a Nevada corporation. On one occasion in 2003, the property was also used as a vehicle to transmit over \$700,000 in offshore funds to Sam Wyly for his personal use. By early 2005, the offshore funds spent on Cottonwood Ventures exceeded \$13 million.<sup>1330</sup>

Cottonwood Ventures operates out of a set of condominium units on two floors of a commercial office building in downtown Aspen, Colorado. About 1,500 square feet of space was purchased on the first floor to enable Sam Wyly's daughter, Kelly Wyly Elliott, and her business partner, Kristin Yeary, to operate two art galleries. On the second floor, nearly 5,000 square feet of space was purchased to provide offices and an apartment for use by Sam Wyly family members.<sup>1331</sup> The first floor purchase was referred to within Wyly records as Cottonwood Ventures I, while the second floor purchase was referred to as Cottonwood Ventures II. Internal Wyly documents show that, at all times, offshore funds were intended to and actually provided 90 percent or more of the funding for Cottonwood Ventures.<sup>1332</sup>

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<sup>1330</sup> See chart entitled, "Cottonwood Ventures Offshore Funding," prepared by the Subcommittee Minority Staff (listing 24 wire transfers from IOM entities that, from 8/10/00 to 12/21/04, transferred over \$13 million into the United States to be spent on this real estate).

<sup>1331</sup> See Pitkin County Assessor/Treasurer online real estate records; 7/13/00 email from Ms. Hennington to Evan Wyly describing property (PSI\_ED00004735).

<sup>1332</sup> See, e.g., 7/13/00 email from Ms. Hennington to Evan Wyly describing property (PSI\_ED00004735) ("We are using a structure very similar to the Two Mile Ranch structure. New grantor trusts will be formed owned by a new foreign corporation and the individuals who will be using the property (1%) each. Of the total cost, 98% will be funded from offshore."); 12/31/04 financial statement for "Cottonwood Ventures – First Floor" (HST\_PSI007034); 12/31/04 financial statement for Cottonwood II Ltd. (PSI00026597).

The condominiums used by Cottonwood Ventures are located in a two-story building, known as the Paragon Building, in a prominent business area of Aspen. Ms. Elliott appears to have identified the property as a possible location for the Cottonwood business ventures and played a lead role in negotiating for their purchase.<sup>1333</sup> The IOM trust that would be involved with the real estate appears to have been informed of the purchase after the terms had already been determined and appears to have played no role in the negotiations.<sup>1334</sup> In August 2000, the condominium units were bought by two Colorado LLCs, Cottonwood Ventures I, LLC which became the owner of record for the first floor units, and Cottonwood Ventures II, LLC which became the owner of record for the second floor units.

These two Cottonwood Ventures LLCs were owned by different combinations of U.S. and offshore entities, all of which were ultimately traceable to members of the Sam Wyly family.<sup>1335</sup> Cottonwood Ventures I, LLC, the nominal owner of the first floor units, was jointly owned by two U.S. companies, Wyly Works, Inc., a U.S. corporation wholly owned by Ms. Elliott,<sup>1336</sup> and Cottonwood Gallery, Inc., a Nevada corporation wholly owned by an IOM corporation called Cottonwood I Ltd.<sup>1337</sup> Cottonwood I Ltd. was, in turn, owned by the 1994 Bessie Trust associated with Sam Wyly.<sup>1338</sup> Using offshore funds, Cottonwood Gallery, Inc., the

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<sup>1333</sup> See, e.g., 7/13/00 email from Ms. Hennington to Evan Wyly (PSI\_ED00004735) (describing property and indicating Ms. Elliott was playing a leading role in negotiating its purchase); 4/18/00 email from Ms. Boucher to Ms. Hennington (PSI-WYBR00577); 4/26/00 email from Ms. Boucher to Ms. Hennington and others (PSI-WYBR00578) (indicating Ms. Yeary and Ms. Elliott had agreed to final terms); 5/5/00 email exchange between Ms. Hennington and Ms. Boucher (PSI\_ED00048162)(discussing specific details of the purchase).

<sup>1334</sup> See, e.g., 6/14/00 email from Ms. Boucher to IFG, then trustee of Bessie Trust, on “cottonwood capital” (PSI\_ED00000376-77)(apparently informing IFG of plans for “a future structure necessary for the acquisition of additional colorado real estate”).

<sup>1335</sup> See chart entitled, “Cottonwood Ventures Funding Structure,” prepared by the Subcommittee Minority Staff. Both structures were apparently designed by legal counsel. See, e.g., 4/18/00 email from Ms. Boucher to Ms. Hennington (PSI-WYBR00577)(“I called Rodney, and, with respect to the structure – they are still working on it.”); 4/26/00 email from Ms. Boucher to Ms. Hennington and others (PSI-WYBR00578) (“Rodney advised me this evening that he and Charles Pulman have put together a structure they are comfortable with – we should receive their memo very shortly.”).

<sup>1336</sup> See Colorado Secretary of State online articles of organization for Cottonwood Ventures I, LLC and II LLC (showing Ms. Elliott as the manager of both LLCs); 12/31/03 internal Wyly financial report on Cottonwood Ventures I, LLC (PSI\_ED00056008-09)(“Kelly is the sole shareholder of Wyly Works”).

<sup>1337</sup> See Nevada Secretary of State online documentation for Cottonwood Gallery, Inc., showing corporation formed on 7/31/00; HST\_PSI007036 (indicating Cottonwood Gallery Inc. is wholly owned by IOM corporation); financial statements showing Cottonwood Gallery Inc. is wholly owned by IOM corporation (PSI\_ED00024967, 74; PSI00044670); emails discussing ownership (PSI\_ED00007683, 4935). Ms. Elliott is president, and Ms. Yeary is secretary-treasurer of the Nevada corporation. Ms. Hennington told the Subcommittee that the IOM corporation used a Nevada corporation here instead of a U.S. management trust, because it was easier for a corporation to run a business like art galleries.

<sup>1338</sup> See, e.g., PSI00040010 (email reporting the corporation incorporated on 7/14/00); PSI\_ED00024963 (undated document showing corporation owned by Bessie Trust). In 2001, Bubba LLC, the Cayman LLC associated with Ms. Elliott, acquired two shares of Cottonwood I Ltd. (IOM), thereby becoming a part owner of the corporation along with the Bessie Trust. See, e.g., 6/30/01, 12/31/01, and 12/31/04 financial statements for Bubba LLC (PSI00039532, PSI00078962, HST\_PSI006916).

Nevada corporation, provided most of the funding for the Cottonwood Venture on the first floor, which consisted of the art galleries.<sup>1339</sup>

Cottonwood Ventures II, LLC, the nominal owner of the second floor units, was wholly owned by a U.S. management trust named the Cottonwood Ventures II Management Trust (Cottonwood Management Trust).<sup>1340</sup> The Cottonwood Management Trust had three grantors, Sam Wyly, Kelly Wyly Elliott, and an IOM corporation named Cottonwood II Ltd.<sup>1341</sup> Sam Wyly and Ms. Elliott each assumed a “trust share” of 1 percent, while the IOM corporation assumed a “trust share” of 98 percent. When the Cottonwood Management Trust was first established in 2000, Mr. Wyly and Ms. Elliott each contributed \$60,000, while Cottonwood II Ltd. (IOM) contributed \$5,880,000.<sup>1342</sup> This pattern of 1 percent, 1 percent, and 98 percent contributions continued through the following five years. By the end of 2004, for example, internal Wyly documents show that the offshore corporation, Cottonwood II Ltd., had contributed about \$10.4 million, or 98 percent of Cottonwood Management Trust assets.<sup>1343</sup>

This pattern, in which offshore dollars paid for the vast majority of real estate acquisition, construction, and operating costs, matches the pattern in the examples involving Rosemary’s Circle R Ranch and the LL Ranch.

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<sup>1339</sup> From 2000 to 2002, Cottonwood Gallery, Inc. contributed 92 percent of the assets of the first floor Cottonwood Venture; after 2003, it contributed 88 percent. See, e.g., 1/31/01 financial statement for Cottonwood Gallery Inc. (PSI00043785); 11/30/01 financial statement for “Cottonwood Ventures – First Floor” (PSI00045205) (showing Cottonwood Gallery Inc. had contributed 92 percent of its capital or \$2.79 million, while Wyly Works had contributed 8 percent or \$244,000); 9/30/02 financial statement for “Cottonwood Ventures – First Floor” (PSI00051123); 12/31/03 “Cottonwood Ventures I, LLC Partners Allocations” (PSI\_ED00056008-09); 12/31/04 financial statement for “Cottonwood Ventures – First Floor” (HST\_PSI007034)(showing Cottonwood Gallery Inc. had contributed 88 percent of the capital or \$2.67 million, while Wyly Works had contributed 12 percent or \$374,429).

<sup>1340</sup> See 8/1/00 U.S. trust agreement (BA163416-44). The trustee was Highland Trust Company, a Wyly-related U.S. corporation whose chief financial officer was Ms. Hennington. See also 2002 financial statement for Cottonwood II Ltd. (PSI\_ED00024968)(showing Cottonwood Ventures II, LLC was wholly owned by the U.S. management trust). Apparently a U.S. management trust was used for Cottonwood Ventures II, instead of a Nevada corporation, because Cottonwood Ventures II functioned primarily as a real estate holding company for the second floor offices and apartment, and did not operate an active business.

<sup>1341</sup> See 8/1/00 trust agreement (BA163416-44). Cottonwood II Ltd. was apparently established in July 2000, and initially wholly owned by the Bessie Trust. (PSI00040010; PSI\_ED00024963) In 2001, the six Cayman LLCs associated with Sam Wyly’s six children acquired one share each of Cottonwood II Ltd., apparently becoming part owners of the corporation along with the Bessie Trust. See 2001 financial statements for the Cayman LLCs (PSI00039529-34; PSI00078959-64).

<sup>1342</sup> See 8/1/00 U.S. trust agreement (BA163416-44).

<sup>1343</sup> See 12/31/04 financial statement for Cottonwood II Ltd. (PSI00026597). Presumably, by the end of 2004, Mr. Wyly and Ms. Elliott had together contributed about 2 percent of the Trust’s assets or \$200,000. See also 1/31/01 financial statement for Cottonwood Management Trust (PSI00043784)(showing Mr. Wyly and Ms. Elliott had each contributed \$59,912 to the Trust, while Cottonwood II Ltd. had contributed \$5,871,363, reflecting their proportional trust shares of 1%, 1%, and 98%); 7/31/01 financial statement for Cottonwood Management Trust (PSI00044669)(showing Mr. Wyly and Ms. Elliott had each contributed \$69,884 to the Trust, while Cottonwood II Ltd. had contributed \$6,868,638).

Although both Cottonwood corporations in the Isle of Man were owned by the Bessie Trust, the Bessie Trust did not provide the initial funds used to buy the Cottonwood real estate. Instead, the initial funds were supplied by Greenbriar, an IOM corporation owned by the Delhi International Trust, another trust associated with Sam Wyly. Bank documents show that, on August 10, 2000, Greenbriar wired \$2 million to Cottonwood Gallery Inc. and \$5,880,000 to Cottonwood Management Trust.<sup>1344</sup> These U.S. entities, in turn, wired \$2 million to Cottonwood Ventures I, LLC and \$5.8 million to Cottonwood Ventures II, LLC, to buy the first and second floor condominiums.<sup>1345</sup> In addition, Sam Wyly apparently provided \$600,000 in a separate earnest money payment to complete the purchase of this property for about \$8.5 million.<sup>1346</sup>

After purchasing the property, Ms. Elliott and Ms. Yearly oversaw a major renovation of the commercial space. Working with architects and builders, they oversaw construction to provide art galleries on the first floor, and offices and an apartment on the second floor, spending millions of dollars.<sup>1347</sup> Once the renovations were complete, the U.S. business entities appear to have used the commercial space on a rent-free basis.

From 2000 until 2005, offshore funds were regularly provided to pay for 90 percent or more of the costs associated with Cottonwood Ventures.<sup>1348</sup> Wyly-related offshore entities typically wired sums ranging from \$10,000 to \$1.5 million to the U.S. entities associated with the Cottonwood Ventures. For example, in November 2000, Audubon Assets, a subsidiary of the Bessie Trust, wired \$400,000 to Cottonwood Gallery Inc., which then wired the funds to Cottonwood Ventures I LLC.<sup>1349</sup> In April 2001, Greenbriar, a subsidiary of the Delhi International Trust, wired \$1 million to the IOM corporation, Cottonwood II Ltd., which then

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<sup>1344</sup> See CC021662, 65-67, BA135176, 259 (showing, on 8/10/00, Greenbriar wired \$2 million to Cottonwood Gallery Inc. and \$5,880,000 to Cottonwood Management Trust).

<sup>1345</sup> See BA135176, 150178 (showing, on 8/11/00, Cottonwood Gallery Inc. wired \$1.99 million to Cottonwood Ventures I LLC); BA150178 (showing, on 8/14/00, Cottonwood Ventures I LLC wired \$1.82 million to "Pitkin County Title," presumably for the closing); BA135260, 150108 (showing, on 8/11/00, Cottonwood Management Trust wired \$5.99 million to Cottonwood Ventures II LLC); BA150108 (showing on 8/14/00, Cottonwood Ventures II LLC wired \$5.46 million to "Pitkin County Title," presumably for the closing). See also related emails explaining transactions. (PSI000134658, PSI\_ED00004874, 4898, 4902).

<sup>1346</sup> See, e.g., documents discussing earnest money payment (PSI-WYBR00578, PSI\_ED00004908, PSI00040007, 38739).

<sup>1347</sup> See, e.g., initial cost projections provided by Ms. Yearly (PSI\_ED00043807-08)(projecting total construction costs of about \$2.4 million); 9/7/00 and 9/8/00 emails between Evan Wyly, Ms. Yearly, Sam Wyly, and others on the remodeling (PSI\_ED00043805, 15).

<sup>1348</sup> See, e.g., 8/14/00 email from Ms. Boucher to Ms. Yearly, with copy to Ms. Hennington and others (PSI00040007)("[W]e will need cash projections put together to know when funds will be needed and in what amounts. ... I think we will probably make arrangements to advance funds at the beginning of each month, based on your cash flows."); 9/3/01 email requesting \$1.5 million (PSI\_ED00014220).

<sup>1349</sup> See BA135181 (showing, on 11/20/00, Audubon Assets wired \$400,000 to Cottonwood Gallery Inc., referencing Cottonwood I Ltd. in the wire transfer); BA135181, 150183 (showing, on 11/21/00, Cottonwood Gallery Inc. wired \$400,000 to Cottonwood Ventures I LLC).

wired the funds directly to Cottonwood Ventures II, LLC.<sup>1350</sup> In September 2001, Sarnia Investments, a subsidiary of the Lake Providence International Trust, wired \$1.5 million to the IOM corporation, Cottonwood II Ltd., which then wired the funds directly to Cottonwood Ventures II, LLC.<sup>1351</sup> Internal Wyly records identify another \$2.5 million in “loans” made by Yurta Faf, a Bessie Trust subsidiary, to the IOM corporation, Cottonwood II Ltd.<sup>1352</sup> Cottonwood II Ltd. apparently transferred these offshore funds over time via wire transfers to Cottonwood Management Trust in the United States. Altogether, by the end of 2004, about \$5 million in offshore funds had been sent to the United States to pay for 90 percent or more of the first and second floor renovations, as well as legal, operational, and other costs associated with the Cottonwood Ventures.<sup>1353</sup>

On one occasion in 2003, Cottonwood Ventures was used as a vehicle to transfer \$732,000 in offshore funds to Sam Wyly, apparently to repay the \$600,000 in earnest money used to help buy the property in 2000, plus interest. A 2003 document contains a footnote stating that this \$600,000 “should have been a debit to real estate and credit to notes payable” in 2000, but the “entry was never recorded.”<sup>1354</sup> Nevertheless, in November 2003, several Wyly-related employees engaged in an email exchange which stated, in part, that Sam Wyly was “in need of \$” and identified repayment of the \$600,000 as a possible source of funds for him.<sup>1355</sup> On November 20, 2003, bank records show that Cottonwood I Ltd. (IOM) wired \$183,000 in offshore funds to Cottonwood Gallery Inc., and Cottonwood II Ltd. (IOM) wired \$549,000 to the Cottonwood Management Trust.<sup>1356</sup> Cottonwood Gallery Inc. and the Cottonwood Management

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<sup>1350</sup> See CC021722, 27046, 273 (showing, on 4/18/01, Greenbriar wired \$1 million to Cottonwood II Ltd.); BA150118 (showing, on 4/19/01, Cottonwood II Ltd. wired \$1 million to Cottonwood Ventures II LLC).

<sup>1351</sup> See CC027321, 4191 (showing, on 9/10/01, Sarnia wired \$1.5 million to Cottonwood II Ltd.); BA150125 (showing, on 9/11/01, Cottonwood II Ltd. wired \$1.5 million to Cottonwood Ventures II LLC).

<sup>1352</sup> See, e.g., 12/31/01 financial statement for Cottonwood II Ltd. (PSI00078967)(listing \$1.2 million Yurta Faf loan);12/31/04 financial statement for Cottonwood II Ltd. (PSI00026597)(listing \$2.5 million Yurta Faf loan).

<sup>1353</sup> See chart entitled, “Cottonwood Ventures Offshore Funding,” prepared by the Subcommittee Minority Staff (listing wire transfers).

<sup>1354</sup> 12/31/03 “Working Trial Balance” for Cottonwood Ventures I LLC (PSI\_ED00055991-99, 56005-13)(“to record earnest money paid by Sam in 2000 for purchase of gallery; should have been a debit to real estate and credit to notes payable; entry was never recorded, but note was paid off in 2003 – WP J.”). The Subcommittee has been unable to locate any loan documentation associated with the \$600,000.

<sup>1355</sup> 11/10/03 email from Ms. Hennington to Ms. Boucher and Ms. MacInnis (PSI\_ED00003443-44)(“Sam is in need of \$ .... We still show a 600,000 receivable from Cottonwood on the start up – maybe we could pay that?”); 11/18/03 email from Keeley to Margot on “cash” (PSI\_ED00003461-62)(“Do you know when the \$600k is going to hit for Sam?”).

<sup>1356</sup> See internal Wyly financial document (PSI00011979)(showing the following wire transfers on 11/20/03:

\$10,000 from Cottonwood Mgmt Trust to Cottonwood Ventures II LLC  
\$549,000 from Cottonwood Mgmt Trust to Sam Wyly  
\$183,000 from Cottonwood Gallery Inc. to Sam Wyly).

See also bank documents showing wire transfers of \$549,000 to the Cottonwood Management Trust (BA135309); \$549,000 to Sam Wyly (BA135309; HST\_PSI009506, 10235; PSI00011979); \$183,000 to Cottonwood Gallery Inc.

Trust then wired the same amounts on the same day to Sam Wyly for his personal use. Internal Wyly documents characterize the \$732,000 in offshore funds paid to Sam Wyly on that date as a repayment of his earlier \$600,000 “loan” plus interest.<sup>1357</sup>

Cottonwood Ventures is an example of U.S. commercial real estate that was bought and paid for primarily with untaxed, offshore dollars. It provided Wyly family members with a rent-free business address for art galleries, office space, and an apartment in downtown Aspen. It also served as a vehicle to provide over \$700,000 in offshore dollars to Sam Wyly for his personal use in 2003. Altogether, more than \$13 million in offshore dollars was spent on this commercial property. That the offshore trustees spent millions of dollars on this property, complied with funding requests within days, exercised no apparent management control over the property, and used funds from multiple trusts associated with Sam Wyly to finance the costs, is additional evidence of the ability of the Wyls to direct the use of the offshore assets.

## **(2) Stargate Horse Farm**

Stargate Horse Farm is another example of U.S. commercial real estate that was acquired primarily with offshore dollars and used offshore funding to cover 90 percent or more of its construction and operating costs. The property was purchased in 2001, from a third party, for about \$2.2 million, using primarily offshore dollars. Over the next four years, more than \$10 million in offshore funds were spent on construction and operating costs. Unlike the other Wyly-related real estate transactions, none of the offshore spending on this property was funneled through a U.S. management trust; instead all offshore funds were directed through a Nevada corporation. By the end of 2004, the total amount of offshore funds spent on the Stargate Horse Farm venture exceeded \$12 million.<sup>1358</sup>

Stargate Horse Farm is a 95-acre property located in a rural area of Denton County, Texas, near the Dallas-Fort Worth metropolitan area.<sup>1359</sup> The property was purchased to enable the daughter of Charles Wyly, Emily Wyly Lopez, to build and operate a state-of-the-art equestrian facility and to import, breed, train, and show internationally competitive sport horses. Mr. Wyly apparently identified the property and sought offshore funding for the business venture.<sup>1360</sup> The Tyler Trust provided \$2.2 million in offshore dollars to purchase the property,

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(BA135236); and \$183,000 to Sam Wyly (BA135236; HST\_PSI009505, 10248; PSI00011979).

<sup>1357</sup> See, e.g., “Sam Wyly Cash Flow Summary Year Ended December 31, 2003” (PSI\_ED00061526-27)(“Payment on Cottonwood Note with Interest 732,000”).

<sup>1358</sup> See chart entitled, “Stargate Horse Farm Offshore Funding,” prepared by the Subcommittee Minority Staff (listing 19 wire transfers from IOM entities that, from 1/3/01 to 10/4/04, transferred over \$12 million into the United States to be spent on this real estate).

<sup>1359</sup> See Denton Central Appraisal District online property records. The property was recently put up for sale. Subcommittee interview with Ms. Hennington (4/26/06).

<sup>1360</sup> See, e.g., 10/16/00 memorandum from Ms. Boucher to Ms. Robertson, Mr. French and others (MAV008220-21)(“Charles is looking at establishing a breeding and equestrian training facility with Emily’s involvement. A business plan has been presented, involving the acquisition of approximately 140 acres of land just north of DFW airport. Only 50 acres will be used for the business venture, and it is likely that the remaining land

despite having little detailed information about the transaction.<sup>1361</sup> Over the next four years, Mr. Wyly and Ms. Lopez oversaw the design, funding, and operation of the horse farm, which made use of millions more in offshore dollars.<sup>1362</sup>

The Stargate horse farm business venture was owned by a combination of U.S. and offshore entities, each of which was ultimately traceable to members of the Charles Wyly family.<sup>1363</sup> Stargate Sport Horses, LP, a Texas limited partnership, actually purchased and became the owner of record for the real estate.<sup>1364</sup> It also operated the equestrian facility on a daily basis. Stargate Sport Horses, LP was, in turn, owned by two partners, Stargate Sport Horses Management LLC, the general partner, and Stargate Horse Properties, Inc., the limited partner.<sup>1365</sup> Both are U.S. corporations. Stargate Sport Horses Management LLC is a Texas limited liability corporation that was wholly owned by Emily Wyly Lopez.<sup>1366</sup> Stargate Horse

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will be subsequently sold. Keeley and I are consulting Rodney to see if we can use a structure similar to that which was used for the gallery in Aspen, thus utilizing foreign assets for the cash injection and contributing Emily's horses in the same way Kelly contributed the gallery's inventory stocks. ... The anticipated initial commitment will be a minimum of \$3 million."); 9/1/00 communication between Mr. Wyly and Ms. Hennington referencing initial planning for "horse farm" (HST\_PSI030962); 11/6/00 agenda for meeting with Trident, then trustee of the Tyler Trust (PSI\_ED00046460)(listing "Sport Horses Venture" as one of several "[p]lanned CW real estate transactions").

<sup>1361</sup> See, e.g., 1/26/01 email from Ms. Boucher to Ms. Hennington three weeks after the purchase of the property (PSI\_ED00005215)("I have very little details on the transaction and structure. What did the IOM company buy when it invested in Stargate Horse Properties Inc. for \$2.5M[?] I assume we'll eventually get a transaction binder.").

<sup>1362</sup> See, e.g., 2/28/01 email from Ms. Hennington to Ms. Boucher (PSI\_ED00005370)(stating Mr. Wyly was thinking of using \$3 million in "off-shore cash" on "capital improvements" for the "Sport Horses" property); 5/3/01 email from Ms. Hennington to Ms. Boucher (PSI\_ED00012663)("We met on Stargate Sport Horses yesterday – this thing is getting out of hand and just growing and growing. We went through all of the budgeted numbers with the builder, etc. and are now estimating total cost at close to \$6.5M (but that could still go up)."); 10/16/01 memoranda from Mr. Wyly requesting additional information from the builder and horse farm managers (HST\_PSI084396-97); 5/3/02 emails discussing horse farm status (PSI\_ED00004864); August 2002 emails discussing property expenditures (PSI\_ED00013262); 9/9/03 email from Ms. Hennington to Mr. Wyly, Ms. Lopez and others forwarding report on the horse farm (HST\_PSI036524); 3/17/05 memorandum by Allan Duncan to Ms. Hennington and others providing information on the horse farm (HST\_PSI036490-94). See also "Premier Dressage Facility" on Stargate Sport Horses website, [www.stargatesporthorses.com](http://www.stargatesporthorses.com) (downloaded 8/11/05)("Stargate Sport Horses was designed by Emily Lopez for the serious dressage competitor. ... [M]uch thought was put into the health and safety of the horses. The style of this facility is in keeping with the old world tradition of dressage. ... Climate-controlled tack rooms, kitchen and lounge areas, showers, tack lockers and commercial washers and dryers are a few of the amenities.")

<sup>1363</sup> See chart entitled, "Stargate Horse Farm Funding Structure," prepared by the Subcommittee Minority Staff.

<sup>1364</sup> See, e.g., 12/19/00 Certificate of Limited Partnership (BA121247); partnership agreement (BA121248-86); Denton Central Appraisal District online property records.

<sup>1365</sup> See partnership agreement (BA121248-86).

<sup>1366</sup> See 12/19/00 articles of organization (BA151451-53); LLC regulations (BA151425-50); Texas Comptroller of Public Accounts online corporation records, BA151450, and PSI\_ED00005215-16 (showing it is a single member LLC whose sole member is Ms. Lopez).

Properties, Inc. is a Nevada corporation whose president was Emily Wyly Lopez, but which was wholly owned by an IOM corporation called Stargate Farms Ltd.<sup>1367</sup> Stargate Farms Ltd. was wholly owned by the Tyler Trust, the IOM trust associated with Charles Wyly.<sup>1368</sup>

Throughout its existence, the vast majority of the assets of Stargate Sport Horses, LP appears to have come from offshore. Its general partner, Stargate Sport Horses Management LLC, owned by Emily Wyly Lopez, appears never to have provided more than 10 percent of the partnership assets at any time, while its limited partner, Stargate Horse Properties Inc., consistently provided more than 90 percent of the funding, all from offshore. For example, in January 2001, when the partnership began, Stargate Horse Properties Inc. contributed offshore funds to the partnership totaling \$2.5 million, while Stargate Sport Horses Management LLC contributed horses valued at \$240,000.<sup>1369</sup> By the end of 2004, financial reports showed that Stargate Horse Properties Inc. had contributed offshore funds totaling 98 percent of the partnership assets, while “Stargate Sport Horses Management, LLC (Emily)” had contributed less than 2 percent.<sup>1370</sup>

Bank records show that the offshore funds supplied by Stargate Horse Properties Inc. came from three IOM corporations, Stargate Farms Ltd., Elysium Ltd., and Soulieana Ltd.<sup>1371</sup> All three were subsidiaries of the 1994 Tyler Trust associated with Charles Wyly. Bank documents show, for example, that in January 2001, Elysium wired \$2.5 million to Stargate Horse Properties, Inc. which, in turn, wired \$2.49 million to Stargate Sport Horses, LP for the initial purchase of the 95 acres.<sup>1372</sup> There is no record of any mortgage, and no evidence that the horse farm paid rent for the use of the property.

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<sup>1367</sup> See 12/19/00 Nevada Corporate Charter (BA121293); articles of incorporation (BA121291-92); corporate bylaws (BA121294-305); Nevada Secretary of State online corporate records; PSI\_ED00005215-16 (showing corporation is wholly owned by Stargate Farms Ltd.).

<sup>1368</sup> See, e.g., PSI00040534, 78301; HST\_PSI006922 (listing Tyler Trust subsidiaries); BA003219, 5029 (wire transfer documentation describing Stargate Farms Ltd. as a “sister company” to other Tyler Trust subsidiaries).

<sup>1369</sup> See BA121248-86, at 86 (partnership agreement).

<sup>1370</sup> See 12/31/04 financial statement for Stargate Sport Horses LP (HST\_PSI007052). See also financial reports showing that, in 2001 and 2002, Stargate Horse Properties Inc. had provided between 91 and 98 percent of the partnership assets (2/28/01 financial statement – 91 percent, PSI00043967; 7/31/01 financial statement – 93 percent, PSI00044683; 11/30/01 financial statement – 96 percent, PSI00045219; 2/28/02 financial statement – 96 percent, PSI00050263; 6/30/02 financial statement – 98 percent, PSI00050698; 8/31/02 financial statement – 98 percent, PSI00050990; 9/30/02 financial statement – 98 percent, PSI00051137).

<sup>1371</sup> See chart entitled, “Stargate Horse Farm Offshore Funding,” prepared by the Subcommittee Minority Staff (listing wire transfers).

<sup>1372</sup> See BA063571 (showing, on 1/3/01, Elysium wired \$2.5 million to Stargate Horse Properties, Inc.); BA063571, 119667 (showing, on 1/4/01, Stargate Horse Properties, Inc. wired \$2,490,000 to Stargate Sport Horses LP); and BA119668 (showing, on 1/5/01, Stargate Sport Horses LP wired \$2,229,987 to Allegiance Title Company, presumably as part of the real estate closing). See also related emails (PSI\_ED00005060-61, 5087, 5216).

From 2001 until 2005, every few months, Wyly family office personnel requested additional offshore funding to cover expenses associated with the horse farm.<sup>1373</sup> In response, one of the three IOM corporations typically wired from \$100,000 to \$1 million in offshore funds to Stargate Horse Properties Inc. which, in turn, transferred the funds to Stargate Sport Horses, LP. For example, in April 2001, Elysium wired \$750,000 to Stargate Horse Properties Inc. which then transferred the funds to Stargate Sport Horses, LP.<sup>1374</sup> In October 2001, Stargate Farms Ltd. wired \$1 million to Stargate Horse Properties Inc.<sup>1375</sup> In March 2002, Soulieana wired another \$1 million to Stargate Horse Properties Inc.<sup>1376</sup> Four such offshore transfers took place in 2001, six in 2002, five in 2003, and another four in 2004. Altogether, by the end of 2004, \$12.3 million in Wyly-related offshore funds had been wired to Stargate Horse Properties Inc. to buy and develop the property, build the equestrian facility, purchase horses for breeding and showing, and pay for a wide range of operational costs associated with the Stargate Sport Horses venture.

Documents show that key persons involved with this venture expressed concern about its cost almost from inception.<sup>1377</sup> A 2002 report showed that, as of the end of August, the property had cost \$7.4 million to construct, had monthly operating costs of \$68,000, and income over eight months of just \$113,000.<sup>1378</sup> It also showed that \$4.75 million in offshore dollars had been contributed to the business venture in the first eight months of 2002. A 2004 cash flow analysis showed that, during the year, the horse farm had incurred costs of \$1.4 million and generated income of only \$1.2 million – and most of that “income” had consisted of offshore funds supplied by Stargate Horse Properties, Inc.<sup>1379</sup> A 2005 memorandum reported that the horse farm was generating \$24,000 per month in income for services costing \$37,000 per month,

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<sup>1373</sup> See, e.g., 1/28/02 email requesting \$1 million (PSI\_ED00004559); 3/21/02 email requesting \$1 million (PSI\_ED00004712); 5/3/02 email requesting \$1 million (PSI\_ED00004866); 8/7/02 email requesting \$750,000 (PSI\_ED00013159); 10/31/02 email requesting \$500,000 (PSI\_ED00011166-67); 2/24/03 email requesting \$300,000 (PSI\_ED00013570); 6/20/03 email requesting \$300,000 (PSI\_ED00005830). These requests generally were made by a Wyly family office employee to Ms. Boucher, who communicated the request to Tyler Trust.

<sup>1374</sup> See CC009340, 42, CC020819, BA063559 (showing that, on 4/5/01, Elysium wired \$750,000 to Stargate Horse Properties Inc.); and BA063561, 119675 (showing that, on 5/24/01, Stargate Horse Properties Inc. wired \$750,000 to Stargate Sport Horses LP).

<sup>1375</sup> See BA063567 (showing that, on 10/24/01, Stargate Farms Ltd. wired \$1 million to Stargate Horse Properties Inc.)(wire transfer document referred to funds as a “loan”); and BA063569, 119688 (showing that, on 11/16/01, Stargate Horse Properties Inc. wired \$1 million to Stargate Sport Horses LP).

<sup>1376</sup> See BA005029, 50925, 93545 (showing that, on 3/22/02, Soulieana wired \$1 million to Stargate Horse Properties Inc.); and BA093547, 119591 (showing that, on 4/1/02, Stargate Horse Properties Inc. wired \$1 million to Stargate Sport Horses LP).

<sup>1377</sup> See, e.g., 5/3/01 email from Ms. Hennington to Ms. Boucher (PSI\_ED00012663) (“this thing is getting out of hand and just growing and growing. We ... are now estimating total cost at close to \$6.5M (but that could still go up).”).

<sup>1378</sup> “Stargate Sport Horses 2002 Activity” (PSI\_ED00011168).

<sup>1379</sup> 12/31/04 “Stargate Sport Horses, LP Statement of Cash Flows as of December 31, 2004” (HST\_PSI007053).

“suffer[ing] a loss of \$13,000 per month [\$156K loss per year.]”<sup>1380</sup> In short, according to internal Wyly financial documents, Stargate Farms Ltd. and its parent, the Tyler Trust, were spending millions of offshore dollars on a losing business venture.

Stargate Horse Farms is another example of a Wyly-related U.S. business venture that made use of U.S. real estate bought and operated primarily with offshore dollars. In addition to the \$2.2 million purchase price, about \$10.1 million in offshore dollars were used to construct a state-of-the-art equestrian facility and operate it over a four-year period, from 2001 to 2005. The fact that the offshore trustees complied with all funding requests and kept supplying funds despite the venture’s history of losing money provides more evidence of the ability of the Wylys to direct the use of the offshore assets.

### **(3) Malibu Property**

The final example involves real estate located in Malibu, California, that was owned by Sam Wyly and pledged as security for an \$8 million loan provided by an offshore entity known as Security Capital. The \$8 million was used to provide Sam Wyly with \$5 million in personal funds, while the remaining funds were used, among other purposes, to pay for a \$2 million renovation of the Malibu property. In 2002, Mr. Wyly sold the Malibu property for \$8.1 million, and the sales proceeds were used to repay the offshore loan in full.

The Malibu property is located within a gated community on the California coastline and has a single residence.<sup>1381</sup> It was apparently purchased by Sam Wyly around 30 years ago from a third party for less than \$500,000.<sup>1382</sup> In 1978, he established The Sam Wyly 1978 Malibu Revocable Trust (Sam Wyly Malibu Trust), a U.S. trust, to manage the property.<sup>1383</sup> Mr. Wyly, however, remained the owner of record for this property until he sold it in late 2001 or early

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<sup>1380</sup> 3/17/05 memorandum from Allan Duncan to Ms. Hennington and others on “SSH – Status Report and Recommendations” (HST\_PSI036490-94, at 93).

<sup>1381</sup> The official address for the Malibu house is [REDACTED] Road, Malibu, CA 90265. Wyly documents, however, often refer to it as 36 Malibu [REDACTED].

<sup>1382</sup> See Los Angeles County Recorder’s Office property records. The chain of title shows that Mr. Wyly was the personal owner of the property until it sold. A general warranty deed produced to the Subcommittee indicates that, in 1993, Sam Wyly conveyed the property to his partnership, Tallulah Ltd., but this deed was apparently never recorded. (PSI00092624-25) It is possible that, at some point, Tallulah Ltd. distributed this asset back to Mr. Wyly. In any event, Tallulah is not mentioned in the California chain of title or in other documents relating to this property after 1993. The original purchase price for the property is unclear, but appears to have been in the range of \$340,000 to \$485,000. See, e.g., PSI00039355-57, 47549, 92609 (financial statements and related documentation).

<sup>1383</sup> See, e.g., BA061150-54 (appointment of successor trustee to 1978 trust), PSI00087594-96 (Deed of Trust and Assignment of Rents).

2002.<sup>1384</sup> It is one of two oceanside properties that Sam Wyly purchased within the same Malibu community.<sup>1385</sup>

Sam Wyly family members made personal use of the Malibu house over the years.<sup>1386</sup> It does not appear to have been rented to any third party. Internal Wyly records show that, unlike the other four properties examined in this Report, the Sam Wyly Malibu Trust obtained “rental income” for the property from Sam Wyly in amounts which varied from \$18,100 per month in 1995, to \$12,100 per month in 2000 and 2001.<sup>1387</sup>

On April 14, 1999, Security Capital issued an \$8 million loan to the Sam Wyly Malibu Trust, secured by a second mortgage on the Malibu property.<sup>1388</sup> The Subcommittee has been told that the purpose of this loan was to provide Mr. Wyly with personal funds.<sup>1389</sup> Security Capital is a shell corporation that was formed in the Cayman Islands in 1998, and began to

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<sup>1384</sup> See Los Angeles County Recorder’s Office property records. These records indicate that Mr. Wyly transferred the property to a third party on 12/27/01; however, other documents indicate that this sale actually closed on 2/13/02.

<sup>1385</sup> The official address of the second property is [REDACTED] Road, but it is often referred to in internal Wyly documents as 35 Malibu [REDACTED]. According to Los Angeles County Recorder’s Office records, Sam Wyly apparently transferred this property in 1978 to the Sam Wyly Malibu Trust which, in 1986, transferred it to Sterling Software Inc. Later, the property apparently ended up as a gift to Mr. Wyly’s second wife, Victoria Steele, as part of a divorce settlement. The circumstances under which Sterling Software transferred title to the property and she eventually acquired title to the property are unclear.

<sup>1386</sup> See, e.g., documents indicating that Wyly family members stayed at the house, remodeled and decorated it, and maintained it. (PSI00111934-35, 101302, 102471-72, 79922; PSI\_ED0036419, 62823, 65566, 69996-97; HST\_PSI001433, 36) See also 3/19/01 emails between Ms. Boucher and Ms. Hennington re “Malibu” (PSI\_ED00005464)(Ms. Hennington states that a Wyly family office employee “said Sam had told the kids that the house was theirs, so that may have been why they seemed so surprised” when he indicated, in 2001, that he intended to sell the property).

<sup>1387</sup> See, e.g., 8/31/95 financial statement for Sam Wyly (PSI00105211-15)(showing rental income of \$116,426 for the year to date or \$18,100 per month); 12/31/00 financial statement for Sam Wyly Malibu Trust (PSI00039356-57)(showing rental income of \$145,200 for the year or \$12,100 per month); 2/28/01 financial statement for Sam Wyly Malibu Trust (PSI00039355) (showing rental income of \$24,200 for the year or \$12,100 per month). It is unclear why the rental payments decreased over time. Sam Wyly apparently paid the rental costs. See, e.g., 5/3/99 email from Wyly family office employee (HST\_PSI005494)(“Starting in January 99 Sam had to place money into the Malibu Trust in order to pay the RJW Builders remodeling fees. Monthly Sam places money into the Trust to pay the mortgage +. We have always treated this as rental exp/inc.”); bank records showing monthly payments of \$12,100 from Sam Wyly’s personal account to the Malibu Trust throughout 2000 and 2001 (BA065429, 55 and BA089951-68).

<sup>1388</sup> See 4/14/99 Promissory Note (HST\_PSI089322-26); mortgage amortization schedule (HST\_PSI089333-34); 4/14/99 Deed of Trust and Assignment of Rents (PSI00087590-96)(placing second mortgage on Malibu property as security for \$8 million loan). The “loan” was issued to the Sam Wyly Malibu Trust and secured by the Malibu property, even though the Trust never owned the property; Sam Wyly owned it.

<sup>1389</sup> Discussions with Wyly legal counsel. See also 1/26/06 letter and attachments from Wyly legal counsel, Bickel & Brewer, responding to Subcommittee questions about Security Capital, chart entitled, “Security Capital Loans” describing the “purpose” of each “loan” (stating purpose of Malibu transaction was to provide a “Sam Wyly Loan”)(hereinafter “Bickel & Brewer Security Capital Chart”).

provide a series of pass-through loans to Wyly-related persons and entities in the United States, using funds supplied by Wyly-related offshore entities.<sup>1390</sup> In the case of the Malibu transaction, Security Capital had obtained the \$8 million used in the loan from two IOM corporations, Locke and Moberly, associated with Sam Wyly.<sup>1391</sup> Security Capital had then, in turn, loaned the \$8 million to the Sam Wyly Malibu Trust.<sup>1392</sup>

On April 15, 1999, the day after the Sam Wyly Malibu Trust received the \$8 million, it transferred \$5 million to Sam Wyly's personal checking account.<sup>1393</sup> Mr. Wyly disbursed the funds over the course of the next month. On April 16, 1999, the Sam Wyly Malibu Trust transferred the remaining \$3 million in offshore funds to a securities investment account it had just opened.<sup>1394</sup> Over the course of the next few years, the Sam Wyly Malibu Trust gradually drew down the offshore funds in its investment account to pay for construction projects, real estate taxes, utilities, and other expenses associated with the property until it was sold in 2002.<sup>1395</sup> In addition to paying construction and operating costs, the Sam Wyly Malibu Trust used the offshore funds in its investment account to make routine "loan" payments to Security

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<sup>1390</sup> For more information about Security Capital, see Report section on Bringing Offshore Dollars Back with Pass-Through Loans, above.

<sup>1391</sup> See, e.g., CC022578, 23636 (showing, on 4/12/99, Locke wired \$3 million and Moberly wired \$5 million to Security Capital).

<sup>1392</sup> See, e.g., April 1999 bank statements (Mizuho007530-33; BA147331)(showing, on 4/14/99, Security Capital wired \$8 million to the Sam Wyly Malibu Trust). At the time of the \$8 million loan, the Malibu property had an appraised value of only \$7.2 million and was already encumbered by a \$1.2 million mortgage. For that reason, the Malibu property was worth about \$6 million and could not fully secure the \$8 million loan. This \$2 million deficiency suggests the 1999 transaction was a less than arm's-length transaction.

<sup>1393</sup> See BA147334, 93058-60 (showing that, on 4/15/99, Malibu Trust wired \$5 million to one of Sam Wyly's personal checking accounts); BA093059-60 (showing, on 4/27, Sam Wyly wrote a check for \$4.2 million from this checking account, wrote additional checks from 4/15 to 4/30, and wired \$1.1 million to another account on 5/6/99).

<sup>1394</sup> See BA147443; PSI00037184.

<sup>1395</sup> See, e.g., PSI00037184, PSI00037211-45, 38917-29 (showing gradual withdrawals from the Trust's security account, each of which matched deposits into the Trust's checking accounts). See also 3/20/01 memo from Ms. Hennington and Ms. Boucher to Sam Wyly (PSI\_ED00005492-93)(stating the Malibu property cost about \$1 million per year in "mortgage payments, taxes, insurance and upkeep"). One Wyly family office employee raised questions about how to treat the offshore funds in the family's internal financial records. An email asked whether the offshore funds used to pay for renovation costs should be treated as "rental income" or "loans." 5/3/99 email from Ms. Alexander to Elaine Spang (HST\_PSI005494). See also 4/14/99 email between them (HST\_PSI089321). Handwritten notations on this email state in part: "Security Capital – unrelated lender – [illegible] step transaction doctrine ... foreign co.'s owned by Trustees' Wyly family trusts." The "step transaction doctrine" is a tax doctrine used by U.S. courts to analyze whether a transaction should be treated as a sham for tax purposes. It appears that at least one Wyly family office employee wondered whether this doctrine might be applied to the offshore funds used to pay the Malibu property's construction and operating costs.

Capital. Each month, from May 1999 to January 2002, the Malibu Trust wire transferred \$51,877 offshore to Security Capital, for a total of about \$1 million.<sup>1396</sup>

In 2001, Sam Wyly decided to sell the Malibu property. Ms. Hennington and Ms. Boucher warned him that unless he sold it for at least \$10 million, he would owe money from the transaction, because he would have to repay the first and second mortgages on the property as well as significant real estate taxes.<sup>1397</sup> In September 2001, Mr. Wyly apparently signed papers agreeing to sell the house and its furnishings to a third party for \$8.1 million. Ms. Boucher described the \$8.1 million as “a good price,” but noted “the shortfall from taxes will be tough to cover.”<sup>1398</sup> The Malibu sale apparently closed on February 13, 2002, which is also the date when the Sam Wyly Malibu Trust supposedly paid Security Capital \$7.8 million to satisfy the outstanding loan.<sup>1399</sup>

The Malibu property is an example of U.S. real estate that was pledged as security for a loan from a Cayman shell corporation, Security Capital, that sent millions of untaxed, offshore dollars into the United States for Sam Wyly’s personal use. The loan also paid for the Malibu property’s renovation and operating costs for more than two years. In 2002, when the property was sold to a third party, Mr. Wyly sent over \$7 million back offshore as repayment of the Security Capital loan. The fact that Sam Wyly was able to obtain an \$8 million loan on real estate already encumbered by another loan, and was able to use the bulk of this cash for his personal use, is further evidence of Wyly ability to direct the use of the offshore assets.

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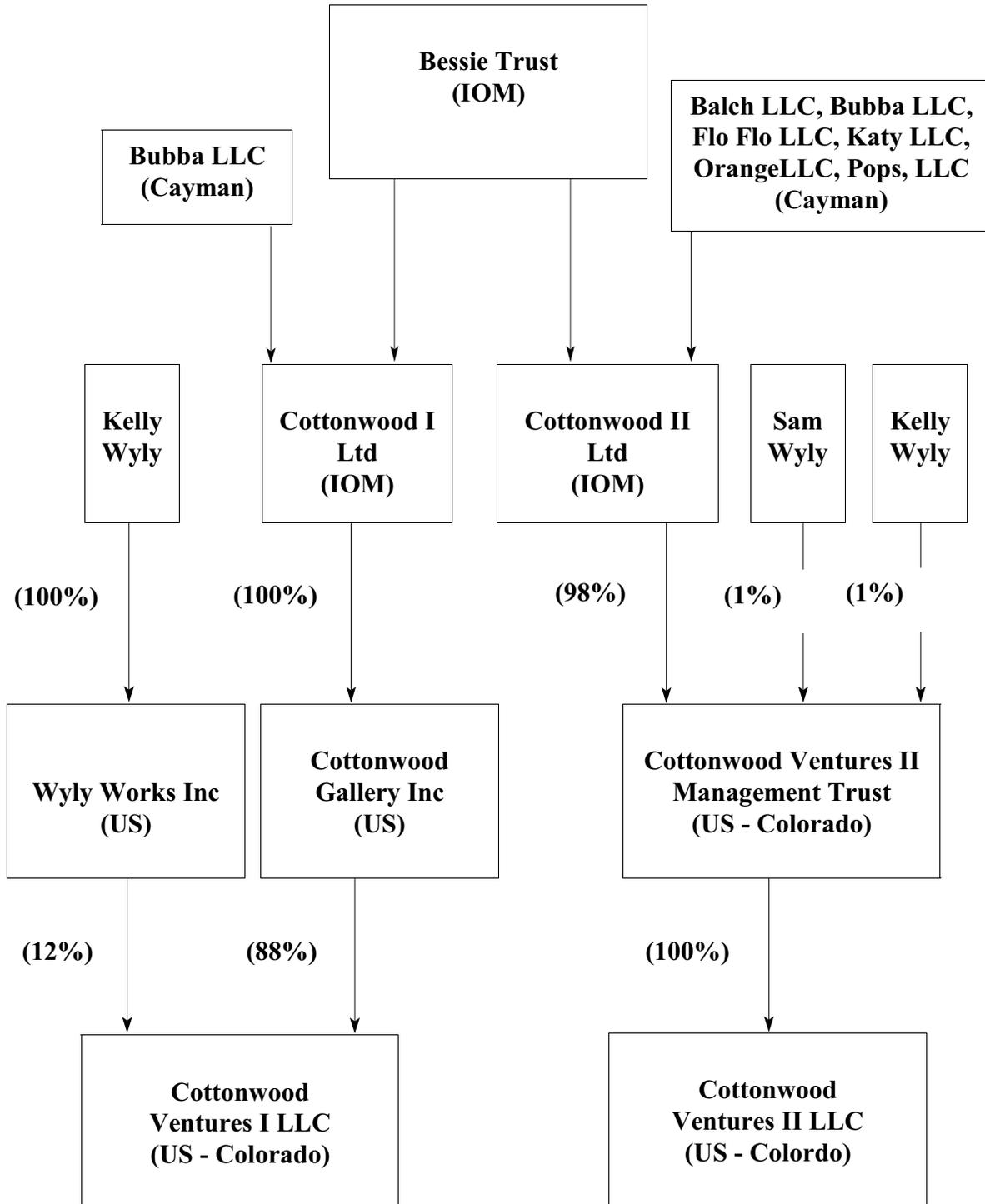
<sup>1396</sup> See, e.g., bank documents showing that, from 5/14/99 to 1/14/02, the Sam Wyly Malibu Trust made regular monthly payments of \$51,877 via wire transfers to Security Capital. (Mizuho000250-52; 313-15; 377-79; 921-23; 942-44; 975-77; 1005-07; 1011-13; 1122-24; 1127-29; 633-35; 663-68; 681-83; 1270-72; 717-19; 735-37; 741-43; 15105-09; 15166-70; 1080-82; 15183-92; 15199-203; 15225-29; 15247-51; 15294-98; 15310-15; 15332-36; 15343-47; 15110-14). See also mortgage amortization schedule (HST\_PSI089333-34)(specifying \$51,877 payments). Security Capital presumably made similar “loan” repayments to Locke and Moberly.

<sup>1397</sup> See, e.g., 3/20/01 memo from Ms. Hennington and Ms. Boucher to Sam Wyly (PSI\_ED00005492-93); PSI\_ED00005464, 5856 (related emails).

<sup>1398</sup> 9/11/01 email (PSI\_ED00014240). In January 2002, Ms. Hennington and Ms. Boucher met personally with Sam and Evan Wyly about funding issues related to the Malibu property. 1/15/02 emails (PSI\_ED00009008, 9018-19).

<sup>1399</sup> See, e.g., Bickel & Brewer Security Capital Chart (identifying repayment date); 2/5/02 email identifying repayment date (PSI\_ED00009191-92); undated document entitled, “SW Family Offshore Cash Flow Analysis” (PSI\_ED00014305) (showing, under “Offshore known cash inflows”: “Malibu loans repaid 7,800,000”). But see undated document entitled, “SW Family Domestic Cash Flow Analysis” (PSI\_ED00014307)(showing, under “Domestic known cash outflows”: “Malibu payoff 2,286,000”).

## Cottonwood Ventures Funding Structure



## Cottonwood Ventures Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
8/10/2000	Greenbriar, Ltd	\$2,000,000	Cottonwood Gallery, Inc	8/11/2000	\$1,990,000	Cottonwood Ventures I, LLC
11/20/2000	Audubon Asset, Ltd	\$400,000	Cottonwood Gallery, Inc	11/21/2000	\$400,000	Cottonwood Ventures I, LLC
1/16/2001	Cottonwood I, Ltd	\$300,000	Cottonwood Gallery, Inc	1/16/2001	\$300,000	Cottonwood Ventures I, LLC
2/16/2001	Cottonwood I, Ltd	\$40,000	Cottonwood Gallery, Inc	2/20/2001	\$40,000	Cottonwood Ventures I, LLC
3/14/2001	Cottonwood I, Ltd	\$75,000	Cottonwood Gallery, Inc	3/19/2001	\$75,000	Cottonwood Ventures I, LLC
11/20/2003	Cottonwood I, Ltd	\$183,000	Cottonwood Gallery, Inc	11/20/2003	\$183,000	Sam Wyly
12/23/2003	Cottonwood I, Ltd	\$50,000	Cottonwood Gallery, Inc	1/29/2004	\$50,000	Cottonwood Ventures I, LLC
<b>Cottonwood I Total</b>		<b>\$3,048,000</b>			<b>\$3,038,000</b>	
8/10/2000	Greenbriar, Ltd	\$5,880,000	Cottonwood Management Trust	8/11/2000	\$5,990,000	Cottonwood Ventures II, LLC
4/18/2001	Greenbriar, Ltd	\$1,000,000	Cottonwood II, Ltd	4/19/2001	\$1,000,000	Cottonwood Ventures II, LLC
9/10/2001	Sarnia Investments, Ltd	\$1,500,000	Cottonwood II, Ltd	9/11/2001	\$1,500,000	Cottonwood Ventures II, LLC
9/14/2001	Cottonwood Ventures II, LLC	\$1,500,000	Cottonwood Management Trust	9/14/2001	\$350,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	10/25/2001	\$100,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	11/20/2001	\$450,000	Cottonwood Ventures II, LLC

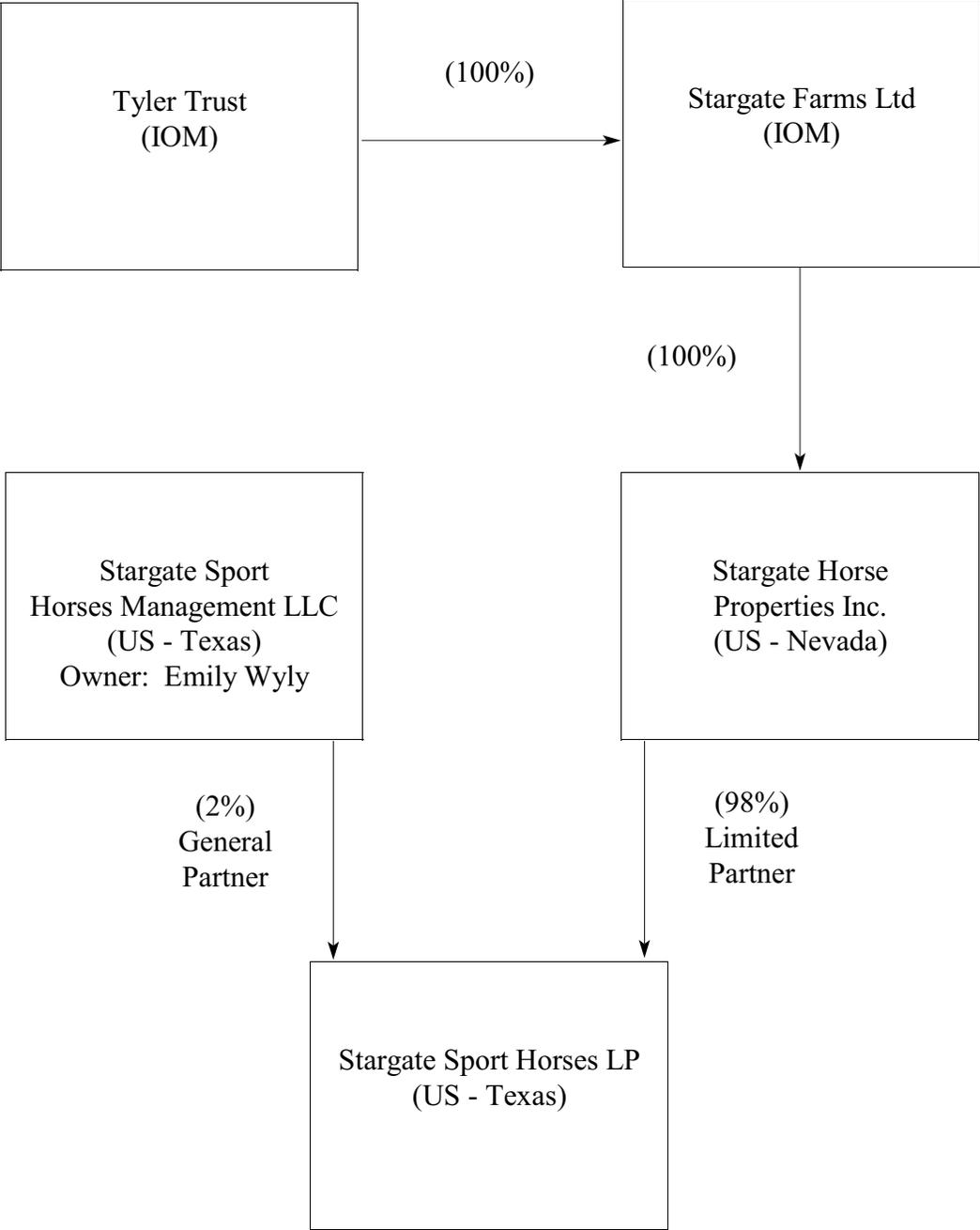
## Cottonwood Ventures Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
			Cottonwood Management Trust	12/28/2001	\$550,000	Cottonwood Ventures II, LLC
			Cottonwood II, Ltd	1/25/2002	\$500,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	3/18/2002	\$120,000	Cottonwood Ventures II, LLC
4/12/2002	Cottonwood II, Ltd	\$50,000	Cottonwood Management Trust	4/19/2002	\$50,000	Cottonwood Ventures II, LLC
4/24/2002	Cottonwood II, Ltd	\$200,000	Cottonwood Management Trust	4/29/2002	\$200,000	Cottonwood Ventures II, LLC
5/8/2002	Cottonwood II, Ltd	\$200,000	Cottonwood Management Trust	5/21/2002	\$200,000	Cottonwood Ventures II, LLC
8/2/2002	Cottonwood II, Ltd	\$20,000	Cottonwood Management Trust	8/2/2002	\$20,000	Cottonwood Ventures II, LLC
8/27/2002	Cottonwood II, Ltd	\$200,000	Cottonwood Management Trust	9/3/2002	\$100,000	Cottonwood Ventures II, LLC
11/20/2002	Cottonwood II, Ltd	\$300,000	Cottonwood Management Trust			
10/8/2003	Cottonwood II, Ltd	\$20,000	Cottonwood Management Trust	10/8/2003	\$20,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	11/20/2003	\$10,000	Cottonwood Ventures II, LLC
11/20/2003	Cottonwood II, Ltd	\$549,000	Cottonwood Management Trust	11/20/2003	\$549,000	Sam Wyly
12/19/2003	Cottonwood II, Ltd	\$50,000	Cottonwood Management Trust	12/23/2003	\$50,000	Cottonwood Ventures II, LLC
3/8/2004	Cottonwood II, Ltd	\$50,000	Cottonwood Management Trust	3/8/2004	\$50,000	Cottonwood Ventures II, LLC
3/24/2004	Cottonwood II, Ltd	\$100,000	Cottonwood Management Trust	3/25/2004	\$50,000	Cottonwood Ventures II, LLC

## Cottonwood Ventures Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
			Cottonwood Management Trust	4/20/2004	\$30,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	6/17/2004	\$20,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	7/2/2004	\$10,000	Cottonwood Ventures II, LLC
7/7/2004	Cottonwood II, Ltd	\$50,000	Cottonwood Management Trust	7/15/2004	\$25,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	12/15/2004	\$16,000	Cottonwood Ventures II, LLC
12/21/2004	Cottonwood II, Ltd	\$50,000	Cottonwood Management Trust	12/21/2004	\$20,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	3/2/2005	\$20,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	4/12/2005	\$20,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	4/19/2005	\$20,000	Cottonwood Ventures II, LLC
			Cottonwood Management Trust	5/9/2005	\$30,000	Cottonwood Ventures II, LLC
<b>Cottonwood II Total</b>		<b>\$10,219,000</b>			<b>\$10,570,000</b>	
<b>Cottonwood Total</b>		<b>\$13,267,000</b>			<b>\$13,608,000</b>	

# Stargate Horse Farm Funding Structure



## Stargate Horse Farm Offshore Funding

Date	By Order Of	Amount	To	Date	Amount	To
1/3/2001	Elysium Ltd.	\$2,500,000	Stargate Horse Properties Inc.	1/4/2001	\$2,490,000	Stargate Sport Horses LP
4/5/2001	Elysium Ltd.	\$750,000	Stargate Horse Properties Inc.	5/24/2001	\$750,000	Stargate Sport Horses LP
8/20/2001	Stargate Farms Ltd.	\$700,000	Stargate Horse Properties Inc.	8/28/2001	\$700,000	Stargate Sport Horses LP
10/24/2001	Stargate Farms Ltd.	\$1,000,000	Stargate Horse Properties Inc.	11/16/2001	\$1,000,000	Stargate Sport Horses LP
<b>2001 TOTAL</b>		<b>\$4,950,000</b>			<b>\$4,940,000</b>	
1/30/2002	Soulieana/Stargate Farms Limited	\$1,000,000	Stargate Horse Properties Inc.	2/1/2002	\$1,000,000	Stargate Sport Horses LP
3/22/2002	Soulieana/Stargate Farms Limited	\$1,000,000	Stargate Horse Properties Inc.	4/1/2002	\$1,000,000	Stargate Sport Horses LP
5/8/2002	Elysium/Stargate Farms Limited	\$1,000,000	Stargate Horse Properties Inc.	5/14/2002	\$1,000,000	Stargate Sport Horses LP
5/23/2002	Elysium/Stargate Farms Limited	\$1,000,000	Stargate Horse Properties Inc.	6/18/2002	\$1,000,000	Stargate Sport Horses LP
8/9/2002	Elysium/Stargate Farms Limited	\$750,000	Stargate Horse Properties Inc.	8/19/2002	\$750,000	Stargate Sport Horses LP
11/15/2002	Soulieana/Stargate Farms Limited	\$500,000	Stargate Horse Properties Inc.	11/21/2002	\$500,000	Stargate Sport Horses LP
<b>2002 TOTAL</b>		<b>\$5,250,000</b>			<b>\$5,250,000</b>	

## Stargate Horse Farm Offshore Funding

3/3/2003	Soulieana/Stargate Farms Limited	\$300,000	Stargate Horse Properties Inc.	3/12/2003	\$300,000	Stargate Sport Horses LP
5/27/2003	Soulieana/Stargate Farms Limited	\$100,000	Stargate Horse Properties Inc.	6/5/2003	\$100,000	Stargate Sport Horses LP
6/27/2003	Soulieana/Stargate Farms Limited	\$300,000	Stargate Horse Properties Inc.	7/1/2003	\$300,000	Stargate Sport Horses LP
10/1/2003	Soulieana/Stargate Farms Limited	\$100,000	Stargate Horse Properties Inc.	10/1/2003	\$100,000	Stargate Sport Horses LP
11/13/2003	Soulieana/Stargate Farms Limited	\$300,000	Stargate Horse Properties Inc.	11/21/2003	\$300,000	Stargate Sport Horses LP
<b>2003 TOTAL</b>		<b>\$1,100,000</b>			<b>\$1,100,000</b>	
3/10/2004	Soulieana/Stargate Farms Limited	\$250,000	Stargate Horse Properties Inc.	3/12/2004	\$250,000	Stargate Sport Horses LP
4/8/2004	Soulieana/Stargate Farms Limited	\$250,000	Stargate Horse Properties Inc.	4/13/2004	\$250,000	Stargate Sport Horses LP
6/24/2004	Soulieana/Stargate Farms Limited	\$250,000	Stargate Horse Properties Inc.	7/1/2004	\$200,000	Stargate Sport Horses LP
				9/14/2004	\$50,000	Stargate Sport Horses LP
10/4/2004	Soulieana/Stargate Farms Limited	\$250,000	Stargate Horse Properties Inc.	10/6/2004	\$200,000	Stargate Sport Horses LP
<b>2004 TOTAL</b>		<b>\$1,000,000</b>			<b>\$950,000</b>	
<b>GRAND TOTAL</b>		<b>\$12,300,000</b>			<b>\$12,240,000</b>	

## IX. LAW FIRMS AND TAX HAVEN ABUSES

The evidence reviewed by the Subcommittee shows that a battery of law firms was integral to the design and implementation of the tax and offshore structures discussed in this Report. These structures – and the activities and transactions used to implement them – could not have occurred without the vast array of legal counsel employed by the Wyllys as well as the promoters and individuals involved in the POINT transactions. In the case of the Wyllys, there was heavy involvement on the part of, and reliance by the Wyllys on, legal counsel in every facet of the offshore structure, from its design and operation, to the structuring of transactions, to the provision of legal opinions. In the case of the POINT transactions, a law firm collaborated with Quellos on the design of the tax strategy, the structure of the transaction, the creation of entities involved in the transaction, and the issuance of legal opinions that indicated the strategy was more likely than not to be valid under the tax code. Without a legal opinion, the promoter would not have been able to sell such an aggressive strategy to sophisticated clients.

The Subcommittee’s access to documentary evidence from the law firms was limited, and representatives of the law firms were constrained with respect to some of the matters they could discuss, because much of the material was subject to claims of attorney-client privilege. It was therefore difficult to determine in many instances all of the facts the law firms used in formulating their opinions and advice, and precisely what advice the law firms actually provided to their clients. Nonetheless, the Subcommittee was able to obtain sufficient evidence to document the critical role played by law firms and to show that the activities and transactions reported in previous sections took place with heavy involvement of and reliance on legal counsel.

**Wyly Legal Counsel.** U.S. legal counsel played key roles in the development and implementation of the Wyllys’ offshore structure, from moving assets offshore, to designing mechanisms through which these assets could be leveraged, to structuring transactions, to providing legal opinions and advice on how to operate the offshore entities with respect to U.S. tax and securities law.<sup>1400</sup> Wyly representatives told the Subcommittee that U.S. legal counsel was routinely consulted about transactions relating to the offshore structure. The evidence reviewed by the Subcommittee supports that assertion, indicating that U.S. lawyers helped identify and negotiate with offshore service providers to establish and manage the Wyly-related offshore entities, devised ways to move Wyly assets offshore – and then transfer them back to the United States – and drafted the paperwork necessary to implement these transactions.

According to Wyly representatives interviewed by the Subcommittee, the ideas for the Wyllys’ offshore structure took shape in 1991, at an offshore planning seminar – attended by Sharyl Robertson – given by David Tedder, of the California law firm Pratter, Tedder & Graves. According to a document referencing Ms. Robertson’s notes and a workbook handed out at the seminar, “the foundation behind any transaction should be estate planning,” some of the goals of

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<sup>1400</sup> Written presentation to the Subcommittee by Wyly legal counsel describing the role of legal counsel in these matters (5/15/06).

which are to eliminate inheritance tax and reduce income tax whenever possible.<sup>1401</sup> After the seminar, the Wyllys apparently worked with Mr. Tedder, who, along with another California lawyer, Michael Chatzky, helped the Wyllys establish the offshore trusts and corporations.<sup>1402</sup>

The transfer of the Wyllys' stock options and warrants to Nevada corporations in exchange for private annuity policies, which were then assumed by foreign corporations, was the first step in sending the Wyllys' assets offshore. In April 1992, the Wyllys and ten related Nevada corporations, formed and directed by Ms. Robertson, received opinions from Pratter, Tedder, & Graves, with apparent help from Mr. Chatzky. These opinions concerned federal income tax treatment relating to the acquisition by the Nevada corporations of Michaels Stores and Sterling Software options and warrants in exchange for the issuance of private annuities to the Wyllys, as well as the subsequent assumption by foreign corporations of the obligation to make the annuity payments. The firm concluded and advised the Wyllys and the corporations that these exchanges and assumptions of obligations would not be taxable events in 1992 and that the subsequent exercise of the securities by the obligators would likely not generate a taxable event to the annuitants.<sup>1403</sup> However, the opinion letters appear to have relied on an incomplete set of facts that did not truly represent the situation. For example, the opinions did not consider whether the stock option transfers were between related parties. Under Section 83 of the tax code, a stock option transfer between related parties would have required stock option exercise gains to be attributed to the original option holder.

Also in 1992, Jackson & Walker, a Texas law firm, provided legal services relating to the transfer of stock options and warrants to several of the Wyly-related offshore corporations, confirming for Michaels Stores that the IOM corporations were "the lawful owners of the options and warrants ... and that Lorne House Trust Limited has full power and authority to provide notice of exercise."<sup>1404</sup> Jackson & Walker also provided Lorne House with information on SEC filing requirements for the Bulldog Non-Grantor Trust and the Pitkin Non-Grantor Trust relating to their holdings of securities of Sterling Software and Michaels Stores.<sup>1405</sup> In addition, Sharyl Robertson indicated in a letter to Lorne House that Jackson & Walker could provide Lorne House with an opinion in 1992 stating that securities held by several Wyly-related offshore corporations were not subject to any SEC Rule 144 volume limitations and that the securities in no way needed to be aggregated with securities held by the settlors of the trusts,

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<sup>1401</sup> 6/12/91 notes from a seminar attended by Ms. Robertson and the workbook handed out at the seminar (PSI\_ED00042362-97).

<sup>1402</sup> 4/10/92 letter from Mr. Chatzky to Mr. Tedder and Michael French (PSI-WYBR00270). Subcommittee interviews of Ms. Robertson (3/9/06) and Mr. French (4/21/06).

<sup>1403</sup> See, e.g., 2/28/92 letter from Pratter, Tedder, & Graves to Sam Wyly (PSI-WYBR00219-241); 2/28/92 letter from Pratter, Tedder, & Graves to Charles Wyly (PSI-WYBR246-268); and 4/2/92 letter from Pratter, Tedder, & Graves to Roaring Creek Limited (Nevada) (PSI-WYBR00125-141).

<sup>1404</sup> 5/7/92 letter from Jackson & Walker to Michaels Stores (PSI-WYBR00274-76).

<sup>1405</sup> See, e.g., 4/22/92 memorandum from Jackson & Walker to Lorne House Trust Limited/Ronnie Buchanan (PSI-WYBR00271-72).

who were Sam and Charles Wyly.<sup>1406</sup> An opinion was apparently never provided, but the Wyly-related offshore entities continued to represent themselves as not subject to SEC reporting and resale requirements that prevent issuing corporations and their affiliates from transferring company shares through private transactions not open to the investing public and then reselling those securities on public exchanges.

Additional evidence suggests that Charles Lubar, of the London office of Morgan, Lewis & Bockius, a Philadelphia-based law firm, was also involved in the original formation of the trusts. In a 2001 email, for example, Michelle Boucher explained to Keeley Hennington that Mr. Lubar “is a partner at Morgan, Lewis, and Bockius in London ... and has been involved with the original structuring of the trusts.”<sup>1407</sup> In 1994, Mr. Lubar provided a memorandum to Michael French on the creation of an Isle of Man trust using a non-U.S. grantor and “the U.S. federal income tax treatment of U.S. citizen beneficiaries” of such a trust.<sup>1408</sup> Under U.S. tax law for trusts at that time, very favorable tax treatment was afforded to foreign grantor trusts, and that opinion served as the basis for the creation of four foreign grantor trusts benefitting the Wyly family. However, the legal opinion was based on several facts that did not truly represent the complete situation, such as the representation that the foreign grantors would exercise control of the trust assets, when, in fact, the trust assets were under the direction of the Wyllys and their representatives. Morgan Lewis billing records indicate that Morgan Lewis provided “professional services ... in connection with analysis of foreign trust for US tax purposes and private annuity transactions arising therefrom” to Sam and Charles Wyly as late as 2003.<sup>1409</sup>

After having been involved in providing the legal opinions for the original formation and asset transfers in 1992, Michael Chatzky helped expand the Wyllys’ offshore structure in 1996, again providing the Wyllys with legal opinions stating that the transfer of stock options to a foreign corporation in exchange for an annuity was not a taxable event. The opinions also concluded that once the foreign corporations exercised the options, it was not likely a taxable event for the person who originally held the options.<sup>1410</sup> These opinions had the same key omissions as the 1992 opinions that provided the basis for the stock option transfers to the Nevada corporations. Again, they failed to analyze whether the transactions were stock option transfers between related parties under Section 83. Mr. Chatzky provided additional opinions for the Wyllys in November 1996, this time concerning stock option-annuity swaps in light of a 1996

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<sup>1406</sup> 4/27/92 letter from Ms. Robertson to Lorne House Trust Limited (PSI00126713).

<sup>1407</sup> 9/5/01 email from Ms. Boucher to Ms. Hennington (PSI\_ED00014217).

<sup>1408</sup> 2/15/94 memorandum from Mr. Lubar to Mr. French (PSI00117520-24).

<sup>1409</sup> See, e.g., 9/30/03 invoice from Morgan Lewis to Charles Wyly (PSI00038348) and 5/16/03 invoice from Morgan Lewis to Sam Wyly (PSI00038355).

<sup>1410</sup> See, e.g., 2/22/96 memo from Mr. Chatzky to The Tallulah International Trust discussing Sam Wyly Michaels Stores stock option exchange (PSI00131205-24); 3/7/96 memo from Mr. Chatzky to the Woody International Trust discussing Charles Wyly Sterling Software stock option exchange (PSI00132210-31); and 2/18/96 fax from Ms. Boucher to Mr. Buchanan describing the transaction and indicating that “a legal opinion to the effect that this transaction is not taxable under U.S. tax law will be obtained from the attorneys preparing the documentation” (PSI-WYBR00314).

change in U.S. tax law imposing additional taxes on transfers to foreign trusts, including offshore trusts “dominated” by a U.S. settlor or beneficiary.<sup>1411</sup> Again, Mr. Chatzky concluded that the 1996 transactions were non-taxable events.

Also in 1996, the Dallas office of Jones, Day, Reavis & Pogue started to become very active in Wyly-related offshore activities and transactions, specifically with respect to the pursuit of domestic business ventures financed by the Wyly-related offshore entities. For example, the firm played an active role in carrying out the March and December 1996 private placement of Michaels Stores options and shares sold to some of the offshore corporations.<sup>1412</sup> Jones Day also filed SEC Schedule 13Ds for Sam and Charles Wyly, including one, filed January 5, 1996, in which the Wyls expressly disclaimed ownership of Sterling Software options and underlying shares held by the offshore trusts.<sup>1413</sup> In addition, one Jones Day attorney apparently helped with the organization of Green Funding I, LLC,<sup>1414</sup> which was used by the Wyly offshore structure as a flow-through entity to send offshore funds to a private business venture – Green Mountain Energy Company – that had been acquired by the Wyls.

Further, in 2001, when Lehman Brothers began to question whether one of the offshore corporations, Devotion, should be treated as a corporate affiliate of Michaels Stores due to the involvement of Sam Wyly in both companies, Robert Estep of Jones Day, as counsel to Michaels Stores, was actively involved. Circumstances surrounding this matter suggest that while Jones Day, as counsel to Michaels Stores, took the public position that Devotion was not an affiliate, Mr. Estep had a different view. Specifically, according to an internal Lehman Brothers email discussing a meeting that was held on the Devotion issue, “Bob [said] that Devotion is not considered an affiliate by Michaels Stores. However, he also indicated that he did not necessarily agree with that determination.”<sup>1415</sup>

From 1997 to 2003, the law firm Meadows Owens also played key roles in the design and operation of the Wyly offshore structure.<sup>1416</sup> Rodney Owens, a Meadows Owens named

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<sup>1411</sup> See, e.g., 11/27/96 letters from Chatzky and Associates to Tallulah International Trust (PSI00131258-92) and Woody International Trust (PSI00132257-97).

<sup>1412</sup> See 3/28/96 letter from Jones Day to Lorne House discussing Fugue Ltd.’s purchase of shares of Michaels Stores common stock (PSI00136301).

<sup>1413</sup> 1/5/96 Schedule 13D by Sam and Charles Wyly regarding Sterling Software; see also 2/12/98 letter from Jones Day to Amy Browning discussing amendments to Forms 13D filed by Sam and Charles Wyly (MSNY014682).

<sup>1414</sup> 7/31/97 Certificate of Formation of Green Funding I, LLC, signed by Jones Day counsel John McCafferty (PSI-WYBR00469).

<sup>1415</sup> 10/5/01 internal Lehman Brothers email (CC037563)(emphasis in original).

<sup>1416</sup> See, e.g., 11/2/00 email from Ms. Boucher to Ms. Robertson (PSI-WYBR00603); 5/31/01 email from Ms. Boucher to David Harris (PSI-WYBR00640)(“Keeley and I are also looking at a structure that Rodney Owens outlined to us, which builds on the partnership concept you introduced in January. It is a ‘frozen LLC’, whereby the 1992 trust would put up 95% of the funds, for a fixed return preference interest in the LLC, and [the] 1994 trust would put up 5% for a ‘common’ interest in the LLC.”).

partner, was involved in the formation of the six Cayman sub-funds of the Isle of Man trusts. According to a May 8, 2001 fax from Michelle Boucher to Sam Wyly, “The IOM trustees have agreed to a structure that we are comfortable with and Rodney Owens is approving the final documentation. ... The sub funds will be Cayman LLCs as subsidiaries of the IOM trusts. ... They exist as a sub fund via an informal understanding with the trustees whereby we account for these entities separately and liaise with particular family members regarding the underlying assets.”<sup>1417</sup> Mr. Owens also played a key role in advising on ways to shift trust assets from the Wyly-related trusts established in 1992, to the Wyly-related trusts established in 1994, which would yield more favorable tax benefits to the beneficiaries.

Mr. Owens and another Meadows Owens attorney, Charles Pulman, were also instrumental in setting up a U.S. trust structure enabling the Wyly-related offshore entities to provide between 95-99 percent of funding for real estate that would be used almost exclusively by Wyly family members. The formation of this structure apparently was designed to facilitate the purchase of real estate by the Wyly offshore trusts while allowing the property to be used by the Wyly family without categorizing the purchases as trust disbursements.<sup>1418</sup>

Mr. Owens was also involved in the sale by Charles Wyly of two Colorado properties to Quayle, Ltd, which involved the formation by Quayle of two U.S. corporations. According to Sharyl Robertson, “This is a non-reportable item by the Trusts and the U.S. parties. Rodney is doing the legal work.”<sup>1419</sup> In addition, Mr. Owens helped establish the Woody Creek Ranch Management Trust, through which Isle of Man funds flowed for Wyly real estate interests,<sup>1420</sup> and apparently provided advice regarding booking funding movements with respect to Little Woody Creek Ranch “from Devotion to La Fourche to Little Woody Creek Ranch as return of capital and then investment.”<sup>1421</sup>

In addition, according to Lehman Brothers, Mr. Owens served as counsel for Devotion and the Wyls with respect to Devotion’s affiliate status, and apparently represented in discussions with Lehman Brothers’ legal counsel that Devotion was not an affiliate when Lehman Brothers raised questions about a prepaid forward sale of Michaels Stores stock by Devotion.<sup>1422</sup> At one point, the key Lehman broker, Louis Schaufele, informed Ms. Hennington that he needed “to get an email or letter from your stateside attorney that Devotion LTD is not an affiliate.” Four days later, Ms. Hennington wrote to Mr. Schaufele, asking if they ever “[got] a

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<sup>1417</sup> 5/8/01 fax from Ms. Boucher to Sam Wyly (PSI00078291-92).

<sup>1418</sup> 9/21/99 email from Ms. Robertson to Ms. Boucher (MAV07688-89).

<sup>1419</sup> 8/19/99 email from Ms. Robertson to Ms. Boucher (PSI-WYBR00529).

<sup>1420</sup> 10/1/99 Woody Creek Ranch Management Trust Agreement, prepared by Mr. Owens (BA120713-40).

<sup>1421</sup> 12/9/99 email from Ms. Boucher to Ms. Robertson (“I also asked [Rodney] to confirm how we handled the Soulieana/Tyler/Gorsemoor/Stargate Loan Funding transaction. The Trustees have booked it all through as intercompany/intertrust advances .... I want to be sure we’re okay taxwise showing it that way.”)(MAV007788).

<sup>1422</sup> 10/5/01 internal Lehman Brothers email (CC037563). Subcommittee interview of Lehman Brothers (7/27/06).

good answer on this or is Rodney still thinking?”<sup>1423</sup> Lehman Brothers requested but never received a written legal opinion from Meadows Owens on whether Devotion was an affiliate for Rule 144 purposes.

Mr. Owens also represented several other Wyly-related offshore corporations as U.S. counsel. Letters indicate that he served as counsel for Elyisum, Moberly, and Atlantis in 2001. SBC Communications had notified the Wyls that it intended to file a Form 1099 with the IRS with respect to a \$74 million purchase of stock options from the offshore corporations as part of its acquisition of Sterling Commerce. Mr. Owens sent letters to SBC contending that as foreign corporations in the Isle of Man, “it is not appropriate for SBC to file a Form 1099, or any other reporting papers regarding this transaction, because [the corporation] is a foreign corporation and the income from the purchase of the stock options is not subject to U.S. taxation.”<sup>1424</sup>

Mr. Owens also closely consulted with Isle of Man attorneys and trustees regarding how to cure long-standing defects that were identified in the Plaquemines Trust, Bulldog II Trust, and Pitkin II Trust. He consulted with Isle of Man counsel on the best approach to correct the defects and, when a course of action was determined, wrote to the trustee, concurring with the trustee’s “assessment that the consent of the beneficiaries should be unnecessary and indeed inappropriate for these purposes .... we would, in fact, prefer that notice of such procedures be limited to only the Trust Protectors if at all possible.”<sup>1425</sup>

Along with the structuring of entities involved in the offshore funding of real estate, Meadows Owens counsel, Mr. Pulman, also appears to have been involved in providing services to the Wyls with respect to their efforts to avoid disclosure of beneficial ownership information by the offshore entities to Bank of America. After repeated transactions triggered anti-money laundering systems at National Financial Services – the broker that provided clearing services to Bank of America – NFS pressed Bank of America to identify the beneficial owners of the Wyly-related offshore trusts. For nearly a year, the offshore entities declined to provide the information, and repeated demands and deadlines were ignored. According to Mr. Schaufele, who had moved from Lehman Brothers to Bank of America by this time, Mr. Pulman served as the offshore entities’ U.S. counsel and represented Devotion in this matter.<sup>1426</sup> Mr. Pulman and Mr. Schaufele discussed the matter by phone and Mr. Schaufele forwarded Mr. Pulman a long email written by Bank of America’s legal counsel analyzing the Patriot Act and concluding that the only way to keep the Wyly-related accounts open without the beneficial ownership information was to make an exception for these accounts.<sup>1427</sup>

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<sup>1423</sup> 10/8/01 emails between Mr. Schaufele and Ms. Hennington (CC012927).

<sup>1424</sup> 1/26/01 letters from Mr. Owens to SBC Communications (PSI-WYBR00612-13, 16-17).

<sup>1425</sup> 12/28/98 letter from Mr. Owens to David Harris (MEOW01-02).

<sup>1426</sup> Subcommittee interview of Mr. Schaufele (7/26/06).

<sup>1427</sup> 5/26/04 email from Mr. Schaufele to Mr. Pulman (BA080202)(“Charles thanks for the call.”).

Although many key documents and issues with respect to the offshore structures could not be provided to, or discussed with, the Subcommittee because of claims of attorney-client privilege, the log of privileged documents provided by Meadows Owens further demonstrates that Mr. Owens and Mr. Pulman – and the law firm, in general – communicated with the Wyly representatives and offshore trustees on an ongoing basis, and were heavily involved in providing legal services with respect to the Wyllys’ offshore structure.<sup>1428</sup> Specifically, the logs indicate that Mr. Owens was involved in matters relating to several of the offshore trusts, including the Tyler Trust, the Ginger Trust, and the Red Mountain Trust, as well as providing services related to Security Capital loans, Irish Trust, and protector issues. The logs also indicate that Mr. Pulman provided legal services to the Wyllys from 2003 through 2005 with respect to such matters as foreign trust planning and the Bulldog Trust.

According to representatives from Meadows Owens, although a number of employees would have been involved in providing services with respect to the Wyllys’ trust structure under Rodney Owens, most communications with the Wyllys and their representatives went through Mr. Owens.<sup>1429</sup> They further explained that Mr. Owens generally kept the work compartmentalized among the employees that worked beneath him, and as a result, no one except for Mr. Owens would have been privy to the larger, overall picture. In addition, although the Subcommittee found evidence that Mr. Owens represented several of the offshore corporations, according to representatives from Meadows Owens, the firm never issued an engagement letter for this work, as was normal practice, and never billed the offshore corporations for any work.<sup>1430</sup>

According to the Wyllys’ representatives, the Wyllys also received legal assistance with respect to transactions involving pass-through loans made by the offshore corporations to Security Capital, and subsequently by Security Capital to various Wyly family interests. Specifically, Meadows Owens and Jones Day each played roles in helping with the organization, development, and operations of Security Capital.<sup>1431</sup>

**POINT Transaction Legal Counsel.** U.S. law firms were also instrumental in the development and implementation of the POINT strategy. Several firms were involved in providing legal opinions to their clients with respect to these transactions, and the clients relied on these opinions to provide assurance that the strategy was in line with U.S. tax laws. The clients’ own legal advisers were also involved in helping to facilitate these transactions.

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<sup>1428</sup> See 7/7/06 and 7/14/06 letters from Meadows Owens’ legal representative to the Subcommittee, enclosing privilege logs identifying communications with the Trustees that were withheld on the basis of “Attorney Work Product.”

<sup>1429</sup> Subcommittee interview of Meadows Owens (7/7/06).

<sup>1430</sup> Id.

<sup>1431</sup> See 1/26/06 letter and attachments from Wyly legal counsel, Bickel & Brewer, responding to Subcommittee questions about the establishment, operation, and “loans” issued by Security Capital, first attachment at 2, Chart entitled, “Professionals Involved In Development and Oversight.”

Quellos engaged Cravath, Swaine & Moore to help it analyze the structure of the POINT transaction to ensure it was compliant with provisions of the tax code. Lewis Steinberg, a Cravath attorney, provided input and collaborated with Quellos – the promoter of the strategy – on the economics and structure of the strategy.<sup>1432</sup> Quellos consulted with Mr. Steinberg on the strategy’s design and on the crafting of legal opinions for clients.<sup>1433</sup> One of the clients, Robert Johnson, engaged Cravath to provide him with formal legal opinions regarding the tax consequences of the POINT strategy. Mr. Steinberg indicated to the Subcommittee that he would have considered his clients to be both Mr. Johnson, who relied on the legal opinions in going forward with the transaction, as well as Quellos, which had relied on him to help analyze the transactions using his tax expertise to help ensure the transaction was legally compliant and that the tax advantages of the transaction were legal under the tax code.<sup>1434</sup> According to Mr. Steinberg, as was normal practice, he shared drafts of his legal opinions with Mr. Johnson’s advisors and Quellos in order for them to provide feedback to him so that he could confirm that the facts on which the opinions were based were accurate.<sup>1435</sup> Mr. Steinberg prepared opinions on three other POINT transactions as well. It is unclear, however, whether he was provided with a complete set of facts. For example, in response to an email from Euram’s John Staddon seeking assurance that the client was fully aware of the book-entry nature of the share trading between the two IOM companies, Quellos’ Chuck Wilk explained that “Lew Steinberg does not address the share exchange in his opinion because according to him the client should not know how the shares were contributed.”<sup>1436</sup> When asked about this email exchange, Mr. Steinberg did not know what it referred to and explained that he did not know how the shares had been contributed.<sup>1437</sup> Further, he emphasized that, in conducting his analysis and coming to the conclusions in his legal opinions, it would not have mattered how the shares had been contributed. He explained that, at that time, he knew of no facts that would have called into question the nature or legitimacy of the transaction.

Another law firm, Bryan Cave, was involved in Haim Saban’s purchase of the POINT strategy. Attorneys from Bryan Cave provided tax opinions with respect to the strategy for Mr. Saban and helped draft the factual representations on which the opinion was based, as well as transactional documents to help implement the strategy. The legal opinions prepared by Bryan Cave<sup>1438</sup> were based on extensive factual representation statements signed by various persons,

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<sup>1432</sup> 12/17/99 email from Chuck Wilk (PSI-QUEL13317).

<sup>1433</sup> Subcommittee interview of Mr. Steinberg (7/26/06); See also 12/1/99 email from Jeff Greenstein to Mr. Wilk (PSI-QUEL11572).

<sup>1434</sup> Subcommittee interview of Mr. Steinberg (7/26/06).

<sup>1435</sup> Id.

<sup>1436</sup> 4/4/00 emails between Mr. Wilk and Mr. Staddon (PSI-QUEL22476).

<sup>1437</sup> Subcommittee interview of Mr. Steinberg (7/26/06).

<sup>1438</sup> U.S. Federal Income Tax Opinion to Titanium Trading Partners LLC (KS-00001092-152); U.S. Federal Income Tax Opinion to Silverlight Enterprises LP (KS-00001226-92).

including Mr. Saban.<sup>1439</sup> However, according to Mr. Saban, he did not read these statements before signing them.<sup>1440</sup> Further, after having now read some of the representations, Mr. Saban told the Subcommittee he could not have attested to the facts if he had read them at the time and that some of the representations were completely inaccurate. Bryan Cave also prepared an opinion on a second POINT transaction. Like Mr. Steinberg, the attorney for Bryan Cave was not aware of the nature of the underlying transactions between Jackstones and Barnville.

The Cravath opinion stated that the taxpayer expected to earn a substantial pre-tax return in relation to the potential income tax benefits generated by the strategy.<sup>1441</sup> The Bryan Cave opinion stated that the taxpayers expected to realize a short-term, pre-tax profit, even taking into account transaction costs, without comparing the size of the anticipated profits to the tax benefits.<sup>1442</sup> However, as addressed in previous sections of this Report, profit/loss projections developed by Quellos for the POINT strategy clearly showed that the prospect of any profit (after accounting for costs) was very remote and was dwarfed by the size of the tax loss to be generated by the strategy.

Both law firms received substantial fees for their work on the POINT strategy. Cravath received at least \$125,000, and Bryan Cave received about \$1.3 million.<sup>1443</sup>

**Analysis of Issues.** The review conducted by the Subcommittee raises serious questions about the independence of the Wyly-related offshore trusts and the legitimacy of the transactions involved in the POINT strategy. Throughout the development and implementation of these structures and transactions, law firms were critical advisors, providing expertise and advice and opining that the entities and their activities were legitimate. In a number of instances, opinions and advice provided by the law firms discussed in the Report relied on incomplete or erroneous sets of facts that did not accurately reflect the true circumstances, raising concerns with respect to the legitimacy of the conclusions reached in the opinions. Further, in one instance, a law firm

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<sup>1439</sup> See, e.g., Haim Saban Representation Certificate attached to Bryan Cave Tax Opinion to Titanium Trading Partners LLP (KS-00001158-62).

<sup>1440</sup> Subcommittee interview of Mr. Saban (7/19/06).

<sup>1441</sup> U.S. Federal Income Tax Opinion to Robert W. Johnson from Cravath, Swaine & Moore (PSI-RWJ000246)(“As a result of the Purchase, Investor anticipates earning an annualized pre-tax return on its net purchase price for the SPV membership interests, taking into account interest expense on the Loan and transaction expenses (including any expenses associated with the Collar, the Loan or the Purchase), that is substantial (attributable to the earnings on the Collateral and the upside potential with respect to the Stocks) in relation to the potential U.S. Federal income tax benefits attributable to the built-in loss in the Stocks held by SPV. While Investor is aware of such potential U.S. Federal income tax benefits, one of Investor’s purposes in acquiring the SPV membership interests is to earn this attractive pre-tax return.”).

<sup>1442</sup> U.S. Federal Income Tax Opinion to Titanium Trading Partners LLC (KS-00001137)(“The TTP members expected to realize a short-term, pre-tax profit on owning an interest in TTP, even taking into account transaction costs.”).

<sup>1443</sup> These legal fees were paid through Quellos, and are included as part of the total fees provided to Quellos discussed in the Report. Accordingly, the legal fees should not be added to the Quellos fees in estimating total fees for a transaction.

collaborated with the promoter in the development of a tax shelter strategy and the production of a favorable opinion letter rendered to several clients who purchased the tax shelter from the promoter.

The evidence reviewed by the Subcommittee raises serious questions about what facts the law firms used in formulating and providing their opinions, services, and advice; what advice was actually provided to the clients in some circumstances; and whether the firms had adequate practices in place to identify and review client matters that could pose significant controversies. At issue is whether, and to what extent, professionals – including lawyers – have an obligation to evaluate the facts underlying the transactions on which they opine and advise.

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