

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

PHL Variable Insurance Company,

Plaintiff,

v.

MEMORANDUM OPINION
AND ORDER
Civil No. 08-572 (MJD/SRN)

Lucille E. Morello 2007
Irrevocable Trust, by and through
its trustee, BNC National Bank,
Jeffrey Chiaro, David Claus,
Cambridge Management Group, Ltd.,
and Cambridge Financial Group, Ltd.,

Defendants,

v.

New Stream Insurance, LLC,

Intervenor-Third Party Plaintiff,

v.

PHL Variable Insurance Company,

Third Party Defendant.

David T. McDowell, Thomas F.A. Hetherington, and Jarrett E. Ganer,
Edison, McDowell & Hetherington LLP and Stephen P. Lucke and Bryan Keane,
Dorsey & Whitney, LLP, Counsel for Plaintiff and Third Party Defendant.

Diana J. Vogt, Sherrets, Boecker & Vogt LLC, Counsel for Defendant, the
Lucille E. Morello 2007 Irrevocable Trust.

Edward T. Wahl and Amber N. Bowman, Faegre & Benson LLP, Counsel for Intervenor and Third Party Plaintiff.

This matter is before the Court upon the joint motion of Plaintiff PHL Variable Insurance Company (“Phoenix”) and Defendant the Lucille E. Morello 2007 Irrevocable Trust (the “Trust”) (the “Settling Parties”) for entry of partial judgment. Intervenor New Stream Insurance, LLC (“New Stream”) opposes the motion.

Factual Background

On March 6, 2007, the Trust applied in writing to Phoenix seeking a life insurance policy for Lucille E. Morello (“Morello”). The application contained the following affirmation:

I have reviewed this application, and the statements made herein are those of the proposed insured and all such statements made by the proposed insured in Part I or and in Part II of this application are full, complete, and true to the best knowledge and belief of the undersigned and have been correctly recorded.

The Trust application represented that Morello had a net worth of \$33,995,250 and income in excess of \$800,000 per year. When Phoenix received the Trust application, it also received a complete Statement of Client Intent form (the “SOCI”), which acknowledged that some of the policy premiums would be

borrowed from CFC of Delaware, LLC (“CFC”). (Ganer Aff. Ex. A (Regels Aff., Ex. 3).) The SOCI represented that there was no intent to transfer an interest in the policy to a third party and that the policy was intended for estate conservation purposes. (Id.) Because of the size of the policy sought, a third-party inspection report was completed in order to confirm the veracity of the representations made in the Trust application. (Id. (Regal Aff., Ex. 4).) Examination Management Services, Inc. (“EMSI”) was engaged to complete this report.

EMSI representative Doug McCarthy thereafter spoke with Morello. During this conversation, Morello told McCarthy to talk with her son, Defendant Jeffrey Chiaro, and her financial advisor. (Id. Ex. C (EMSI Depo., Ex. 2 (Audio File “Lucille Morello Recording”).) Thereafter, McCarthy called Chiaro, who verified that Morello’s assets were valued at \$34 million and that her annual income was \$800,000. (Id. (“Audio File “Jeffery Chiaro Recording”).) Chiaro thereafter told McCarthy that his mother’s CPA was John Abrams, and her investment consultant was Defendant David Claus. (Id.) McCarthy spoke with Claus who also verified the information contained in the Trust application. (Id. (Audio File “Dave Claus Recording”).)

The representations by Chiaro and Claus were also consistent with a financial statement provided to Wholesale Life Insurance Brokers (“WLIB”), an insurance broker that placed the Phoenix Policy. (Id. Ex D (Burns Dep. Ex. 1).) This financial statement purports to provide a breakdown of Morello’s assets and liabilities demonstrating a net worth of \$34 million, and is signed by John Abrams of Abrams Financial Services. (Id.) Bruce Burns submitted the application to Phoenix, along with a producer’s report, indicating Morello had a net worth of \$34 million. (Id., Ex. A (Regels Aff. Ex. 5).)

Phoenix’s underwriter relied on the Trust application, financial statements and confirmations gathered as part of the application process in determining that Morello qualified for the insurance policy issued. (Id. (Regels Aff., Ex. 6).)

Phoenix thereafter issued life insurance policy number 97521157 (the “Policy”) to the Trust, with a \$10 million death benefit. The Trust paid insurance premiums in the amount of \$518,562.00. After the Policy was in place, Phoenix paid commissions to two insurance agents: \$370,771.83¹ to Rick Smith of The Producers Group Advantage, for whom Bruce Burns acts as a sub-producer; and

¹This amount represented \$168,532.65 in commissions and \$202,239.18 in expense allowance payments.

\$199,6346.37² to William Stansbury of Life Insurance Concepts, Inc., an affiliate of CFC. (Id. Ex. F (Affidavit of Nancy Turner, ¶ 2).)

Morello died within two years of the issuance of the Policy, which was during the Policy's contestability period. After an investigation was conducted, Phoenix discovered that the Trust application included fraudulent information.

Background of the Fraud

Morello's son, Jeffery Chiaro, is a 47 year old part-time hairdresser and landlord in the Chicago area. (Id. Ex. H (Chiaro Dep. 41-42, 46, 69-70, 74-75).) In 2006, he was approached by one of his hair clients, Jason Mitan, about the possibility of obtaining insurance coverage on his mother. (Id. at 45-46.) Mitan is a disbarred lawyer, with a felony conviction for tax evasion and bankruptcy fraud. (See In re W. Jason Mitan, 75 Ill.2d 118 (Ill. 1979); United States v. Mitan, 966 F.2d 1165 (7th Cir. 1992).) David Claus is one of Mitan's business associates, and Mitan put Morello in contact with Claus. (Id. Ex. H (Chiaro Dep. 49-50).) Claus is the President and Mitan is the CEO of Cambridge Financial Group, Ltd, an affiliate of another Mitan company, Cambridge Management Group, Ltd.

²This amount includes \$90,748.35 in commissions and \$108,898.02 in expense allowance payments.

(“Cambridge”). (Id. Ex. I (Claus Dep. 23).)

Claus contacted Morello with an offer to provide her with free life insurance, with the understanding that any insurance policies placed would eventually be sold to third parties. (Id. at 34-35; 102.) Claus enlisted the services of WLIB to act as Cambridge’s insurance broker. (Id. at 28-29; Ex. D (Burns Dep. 93-94).) Claus also provided WLIB and Chiaro with the financial statement allegedly drafted by a CPA named John Abrams. (Id. Ex. I (Claus Dep. 63-66).) However, the Illinois Department of Financial and Professional Regulation has no record of a John Abrams or of his accounting business. (Id. Ex. M.)

Cambridge requested that WLIB obtain as much standard rate insurance coverage as possible, purportedly to preserve Morello’s estate. (Id. Ex. D (Burns Dep. 51-53).) Ultimately, the Trust obtained the following life insurance policies: Phoenix issued \$10 million in coverage; The Metropolitan Life Insurance Company issued \$175,000 in coverage (“Metropolitan Policy”); and the Protective Life Insurance Company issued \$8 million in coverage (“Protective Policy”). (Id. Exs. O and P.) Morello had a heart attack and was in the hospital on September 28, 2007, at which point WLIB closed its file. (Id. Ex. D (Burns Dep. Ex. 2).)

In the meantime, Claus and Chiaro were working with financing companies to establish trusts that would own the policies sought on Morello's life. (Id.) A total of four trusts were established, but only two ultimately used. The Trust at issue here named BNC National Bank ("BNC") as trustee and Claus as trust protector. (Id. Ex S (BNC Depo. Ex. 2).) Another trust was drafted with respect to the Protective Policy (the "Protective Trust"). The Protective Trust was designed to allow for an early transfer of the trust's beneficial interest - which would allow it to sell the Protective Policy to investors without disclosing the change to the insurance company. (Id. Ex. D (Burns Dep. 49); Ex. I (Claus Dep. 126-27).) Less than a month after the Protective Policy was issued, it was sold to an investor for \$268,873.31. (Id. Ex. H (Chiaro Dep. Ex. 9).) This purchase price was paid directly to Claus's bank account. (Id. Ex. U). Cambridge Management in turn paid Morello and Chiaro \$74,608.00. (Id. Ex. I (Claus Dep. 128).) Ultimately, it was the plan to sell the Phoenix Policy as well. (Id. Ex. H (Chiaro Dep. 146-47).)

CFC entered into a Term Financing Facility Agreement with the Morello Trust. (Bowman Aff. Ex. A.) Per this agreement, CFC loaned \$542,062 to the Morello Trust, which included the \$518,562 to pay the premium on the Policy;

\$10,00 to be paid back to CFC as an origination fee; \$4,000 to BNC as trustee fees; and \$2,000 to be paid to the law firm that drafted the trust agreement. (Id. p. 37.)

Although New Stream did not take an assignment of the financing agreement until June 2009, Phoenix asserts that New Stream was involved in this agreement from the outset, as evidence by the Note Purchase Agreement between CFC and New Stream dated June 9, 2006. (Id. Ex. B.) Phoenix further asserts that New Stream was the source of the \$542,062 CFC loaned to the Trust for purposes of the Policy premiums. (Ganer Aff. Ex. S (Disbursement Form, attached to BNC Dep., PHL 02805-2807).)

In November 2007, attorney Stephen McMullen wrote to Phoenix advising that he represented the estate of Lucille Morello and all interested parties regarding the Policy. (Id. Ex. A (Regels Aff. Ex. 10).) In December 2007, BNC submitted paperwork related to the claim, along with an affidavit from CFC stating that the amount owed to CFC, subject to collateral assignment, was \$604,048. (Id. (Regels Aff., Ex. 9).)

Through the routine investigations conducted by the insurance companies following Morello's death, many discrepancies were revealed which ultimately lead to the discovery of the fraud. For example, in February 2007, before Phoenix

received the Trust application from Morello, Morello and her husband executed a Confidential Living Trust Fact Finder which detailed the couples' assets. (Id. Ex. V.) This document shows that the Morello's had assets of approximately \$800,000 - not \$34 million as represented in the Trust application. In addition, the Morello's tax returns for the years 2004-2006 showed an average income of \$31,476.33, as compared to the \$800,000 amount listed in the Trust application. (Id. Ex. Y.)

Phoenix thereafter brought this action, seeking rescission of the Policy and damages arising out of and relating to the fraud resulting in the Policy's issuance.

Joint Motion for Partial Judgment

In their joint motion to enter partial judgment, the Settling Parties stipulate that the Trust made material misrepresentations on the Trust application regarding Morello's net worth and income, and that such material misrepresentations were willfully false or intentionally misleading.

Subsequent to the initiation of this lawsuit, the Trust's trustee, BNC, purported to resign as trustee. Defendant Claus, as the designated trust protector, represents that he has the authority to act on behalf of the Trust in settling this litigation. Claus, individually and as the trust protector, and Chiaro,

the Trust's sole beneficiary, have agreed to settle this litigation.

Pursuant to the terms of the settlement, the parties have agreed to the following: 1) that judgment be entered in favor of Phoenix; 2) that the Trust take nothing by way of its claims against Phoenix; 3) that Phoenix policy number 97521157 is rescinded ab initio; 4) that no recovery exists under the Policy and that death benefits will not be paid; 5) that Phoenix shall offset the Premium Amount tendered to the Court against the aforementioned damages suffered by Phoenix to partially offset the damages suffered, including attorneys fees and costs; and 6) that the rescission of the Policy, is in all respects, effective and binding notwithstanding Phoenix's retention of the Premium Amount.

I. Right to Return of Premium Where There is Actual Fraud on Part of Insured

New Stream opposes the joint motion for partial judgment, arguing that the remedy of rescission typically requires that each party return to their pre-contract position. Hatch v. Kulick, 211 Minn. 309, 1 N.W.2d 359, 360 (1941) (rescission requires restoration of the status quo). As applied in this case, New Stream asserts that if the Policy is rescinded, Phoenix would have to return the premium paid for the Policy.

Pursuant to Minnesota law, a life insurance policy should be declared void when there is a statement made, in procuring the insurance, that is willfully false or intentionally misleading. Peggy A. Lebus v. Northwestern Mut. Life Ins. Co., 55 F.3d 1374, 1377 (8th Cir. 1995); Useldinger v. Old Rep. Life Ins. Co., 377 N.W.2d 32, 36 (Minn. Ct. App. 1985). Here, there is no dispute between the Settling Parties that willfully false and intentionally misleading statements were contained in the Trust application with the intent to deceive the insurer. Accordingly, the Policy should be declared void.

In addition, under Minnesota law, where the insurer is induced to enter into a contract for insurance by the actual fraud of the insured, the insurer is not required to return the premiums paid. Taylor v. Grand Lodge A.O.U.W. of Minn., 96 Minn. 441, 453, 105 N.W. 408, 413 (1905). A contrary rule would be an invitation to commit fraud.

If all moneys thus voluntarily paid can be recovered or must be returned by the insurer as a condition precedent to pleading the fraud as a defense, a party who contemplates obtaining insurance by false representations may well feel that he is taking no chances of loss, but is entering upon a transaction in which he stands to gain large returns without any possibility of endangering his investment. If the fraud is never discovered, the beneficiary under the policy which will be issued to him will receive the full benefit of the contract. If it by chance is discovered, his estate will receive back all that has been paid by the guilty party, and the trouble and

expense attending upon the transaction will be thrown upon the innocent party.

Id.

Under the particular facts of this case, the Court finds that rescinding the Policy, without any premium refund, is an appropriate remedy and consistent with Minnesota law. Should Phoenix be required to make the Trust whole - the party that has admitted to including willfully false statements in the Trust application with the intent to deceive - would, as the Court found in Taylor, be an invitation to fraud.

This case is similar to the facts set forth in Lincoln Life and Annuity Co. of N.Y. v. Teren, No. 37-2008-83905 (Cal. Sup. Ct. Aug. 27, 2009)(Ganer Aff. Ex. DD.) In that case, the court found that the Teren Trust and Trustee were not entitled to a return of premiums paid on the life insurance policies owned by the Teren Trust, where the application for insurance included false statements and was supported by a fraudulent document.

Accordingly, having considered the Settling Parties' agreement to this Partial Judgment and the applicable law, the Court finds as follows:

1. The Court has subject matter jurisdiction over this matter and personal jurisdiction over the Trust;
2. The Settling Parties stipulate that there is an actual case or controversy which will be resolved by this Partial Judgment and the Court finds that an actual case or controversy exists which is properly resolved by the entry of this Partial Judgment;
3. The Settling Parties stipulate that the Trust applied in writing to Phoenix for the issuance of a life insurance policy insuring the life of Lucille Morello;
4. The Settling Parties stipulate that the Trust application represented that Lucille Morello had a net worth of \$33,995,250 and income of \$800,000;
5. The Settling Parties stipulate that in response to the Trust application, Phoenix issued policy number 97521157, with an issue date of March 23, 2007, to the Trust (the "Policy");
6. The Settling Parties stipulate that insurance premiums in the sum of \$518,562.00 were paid on account of the Policy (the "Premium Amount");
7. The Settling Parties stipulate that Lucille Morello died on October 20, 2007, within two years of the Policy's issue date;

8. The Settling Parties stipulate that the Trust submitted a claim to Phoenix seeking payment of the Policy's death benefit;

9. The Settling Parties stipulate that Phoenix sought to rescind the Policy by filing this action;

10. The Settling Parties stipulate that through this action, further sought the recovery of damages suffered as a result of the Policy, including commissions paid to its sales agents and administrative, attorneys' fees, and internal costs associated with the issuance and servicing of the Policy;

11. The Settling Parties stipulate that the Trust made material misrepresentations on the Application regarding Lucille Morello's net worth and income;

12. The Settling Parties stipulate that the material misrepresentations were willfully false or intentionally misleading;

13. The Settling Parties stipulate that Phoenix has suffered damages as a result of the Policy's issuance in an amount equal to or exceeding the Premium Amount;

14. Entry of judgment is proper as to all Phoenix's claims against the Trust and all the Trust's claims against Phoenix; and

15. There is no just reason to delay entry of judgment as to all Phoenix's claims against the Trust and all the Trust's claims against Phoenix.

It is therefore ORDERED, ADJUDGED, and DECREED that:

1. Judgment is entered in favor of Phoenix and against the Trust;
2. The Trust takes nothing by way of its claims against Phoenix;
3. Phoenix policy number 97521157 is rescinded, *ab initio*, no longer exists, and is completely without legal effect;
4. No recovery exists under the Policy, at law or in equity, and the Policy's death benefits will not be paid to the Trust, the Trust's beneficiary, the Trust's creditors, or any other entity or individual;
5. Phoenix shall retain the Premium Amount to partially offset the damages it has suffered, including its attorneys' fees and costs incurred in this litigation;
6. The rescission of the Policy is in all respects effective and binding notwithstanding Phoenix's retention of the Premium Amount;
7. This Partial Judgment is binding on all of the Trust's successors and assigns;
8. The Court denies all relief not granted in this judgment; and

9. The Court directs the clerk to enter this JUDGMENT as to all of Phoenix's claims against the Trust and as to all of the Trusts claims against Phoenix.

Date: March 2, 2010

s/ Michael J. Davis

Michael J. Davis

Chief Judge

United States District Court