Illustration by William Waggoner

Anatomy of a Failure

National Heritage Life Insurance Co. was brought to its knees by a complex series of fraudulent schemes, but policyholders are still standing.

by Sally Whitney

When National Heritage Life Insurance Co. fell on hard times, its supposed savior tuned out to be its destroyer. In a complex plot with twists and turns worthy of a best-selling novel, National Heritage suffered the largest financial failure due to criminal activity in insurance industry history.

But an equally complex effort by insurance regulators and federal authorities uncovered the wrongdoing and, in the end, rescued the policyholders. National Heritage and state guaranty funds repaid policy and annuity holders approximately $420 million. Twelve people have been incarcerated in the case, and the FBI is still searching for one of the leaders of the fraud, who disappeared during jury deliberations.

That the fraud was discovered and the policyholders "made whole" attests to the strength of the state regulatory system, said Donna Lee Williams, insurance commissioner of Delaware, where National Heritage was domiciled. "Asking if you could prevent a case like this is like asking if you could prevent a murder," she said. "You can make as many laws as you want, but there will always be that one individual who will try to cheat the system."

Losses Set the Stage

In the late 1980s, National Heritage, a struggling company operating principally in Florida, was selling mostly universal life policies and some interest-sensitive individual life and annuity products. In 1989, declining sales of single-premium whole-life contracts contributed to a 34% decrease in direct premium income. At the end of the year, the company reported a considerable operating loss and a corresponding 27% reduction in capital and surplus.

By May 1990, the Delaware Insurance Department became concerned about National Heritage's financial condition, including the sufficiency of its surplus. The department threatened to take regulatory action, including the possibility of shutting down the company, if National Heritage didn't raise additional capital.

The civil complaint filed by Williams describes a series of developments that initiated the cascade of events that eventually led to National Heritage's downfall. Earlier that year, a group including David Davies, Lambert Aloisi and Patrick Smythe created Tri-Atlantic Holdings Ltd., a Delaware corporation with principal places of business in Phoenix and Orlando. In June, Davies, a director of Tri-Atlantic, sent a letter to Lifeco Investment Group, National Heritage's parent company, proposing that Tri-Atlantic provide $4 million in liquid assets to satisfy regulatory requirements in exchange for a controlling interest in Lifeco and National Heritage.

National Heritage needed help, so the company accepted the offer. On June 29, 1990, Lifeco agreed to sell 52.3% of its common stock to Tri-Atlantic. Unbeknownst to those in charge of Lifeco, however, Tri-Atlantic Holdings did not have $4 million. But Davies, Aloisi and Smythe had a plan.

Hiding a Shortfall

First, Davies took $540,000 from a trust fund he controlled and wired that sum to a Tri-Atlantic bank account in Orlando, the complaint said. Then he opened a securities account for Tri-Atlantic and deposited $525,000 of the $540,000 from the trust fund. He used the $525,000 to buy $4.5 million worth of U.S. Treasury Notes on margin.

To square the Lifeco stock purchase with the Delaware Insurance Department, Davies submitted a filing, backed by a letter on the letterhead of a securities brokerage firm, saying the bonds were owned by Tri-Atlantic. But the filing omitted the fact that the bonds were pledged as collateral for the margin loan with which they were purchased.

In August, Davies opened an account at Bank Leumi in New York in the name of National Heritage. He then had National Heritage deposit $3.3 million into the account, supposedly for the purpose of providing capital with which Tri-Atlantic would trade foreign currencies for the exclusive benefit of National Heritage.

Authorities believe Michael Blutrich, a New York lawyer, joined the scheme at this point. Blutrich opened an account in the name of Capital Comparisons at the same bank. Tri-Atlantic wired $1 million to the Capital Comparisons account. Then Davies and Blutrich had Capital Comparisons transfer the $1 million to another Leumi account in Blutrich's name.

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At the Tri-Atlantic-Lifeco closing, Blutrich presented a check for $4 million drawn on the Blutrich account even though there was only $1 million in it. Also at the closing, Tri-Atlantic immediately exercised its control of the boards of directors of both Lifeco and National Heritage and appointed Aloisi, Smythe and Davies as officers and directors of the two companies. The new officers and directors delayed National Heritage's deposit of the $4 million check.

Two days later, Aloisi, Davies and Smythe authorized an agreement for Capital Comparisons to market annuities and act as an "investment conduit" for National Heritage. They then, along with Blutrich, authorized National Heritage to pay Capital Comparisons a "fiduciary deposit" of $3 million. The next step was to transfer the $3 million from the Capital Comparisons account to the Blutrich account, so they could deposit the $4 million check written on the account.

The series of transactions reduced National Heritage's assets by $3 million, so that, in effect, Tri-Atlantic acquired control of the company and Lifeco with National Heritage's own funds.

And that was only the beginning. To conceal the misappropriated $3 million, the new officers and directors created illusory assets on the books, the complaint said. The first of these was an $800,000 investment in a joint venture that had no purpose. Two others were loans of $1 million and $1.2 million. The companies involved in these transactions were controlled by Blutrich, Davies, Aloisi and Smythe. Through a series of account transfers, the money wound up back in another account that Blutrich opened for Capital Comparisons at Bank Leumi.

Davies, with the agreement of the others, withdrew $2.9 million and $100,000 from the new Capital Comparisons account and deposited the amounts into the National Heritage account in order to repay the "fiduciary deposit."

Scheme After Scheme

Once their control of National Heritage was secure, the new officers and directors began a series of loan, stock and bond schemes to prolong the company's life and to continue to loot National Heritage, the complaint said. To date, insurance department and federal investigators have uncovered about 18 schemes perpetrated against National Heritage, and there are probably more, said Fredric Marro, who is general counsel for National Heritage Life in liquidation.

A typical loan scheme, as described in the civil complaint, involved lending money to a front company controlled by Blutrich, Davies, Smythe and often others who made one-time appearances

Weiss

Inflated Values: *Investigators said Windsor Plumbing and the vacant lots in Wallkill, N.Y., pictured above were fraudulently appraised far above their actual values to facilitate schemes against National Heritage Life Insurance Co. Perth Commercial Properties, a dummy company, borrowed $4.9 million from National Heritage to make the purchases, based on an appraisal that said the properties were worth $7.5 million.*

in the overall production. The loans were secured by a real estate mortgage, but the market value of the real estate was substantially lower than the principal amount of the loan. For example, a $2.5 million loan was made to purchase a horse farm with a true value of $499,999. National Heritage carried the loan as a $2.5 million asset, and the extra money went into an account controlled by Smythe.

To hide the discrepancy, certain appraisers mailed grossly inflated appraisals to National Heritage, including a letter reporting that a nearby city wanted to purchase the horse farm for a municipal golf course and National Heritage could make a substantial profit.

A Legitimate Attempt

Following their purchase of National Heritage, the new officers and directors attempted to increase premium income by offering a new single-premium deferred-annuity product. The product was successful, increasing net premiums written from $4.2 million in 1989 to nearly $24 million in 1990. Annuity and fund deposits increased from 37% of premium income in 1989 to 85% in 1990. The expanded annuity sales also changed the demographics of National Heritage's policyholders. At the time it was placed in rehabilitation in 1994, National Heritage had more than 28,000 policy and annuity holders whose average age was 65.

The increase in premium income and the decline in investment income caused an insufficient spread. "Now they had to turn to prominent brokers and investment advisers to recommend investments to cover the spread needed on the increased premium," said George Piccoli, deputy receiver for National Heritage. This effort failed through bad investments, creating an even bigger hole to fill, he said.

Well-Kept Secrets

Between 1990 and 1993, National Heritage officials, including the controller and chief financial officer, filed appropriate reports with the Delaware Insurance Department, but the financial executives were unaware that the reports contained fraudulent information. "The good people did what they were supposed to do," Marro said. Smythe, Aloisi and the others had such tight controls that the loop was closed at all points, Piccoli said. Most of the assets, including collateral for the loans, were controlled by outsiders.

In the case of the inflated appraisals, some of the appraisers were nationally certified, so they were assumed to be honest. In other cases, legitimate appraisals were altered before they ever got to National Heritage, so even when second appraisals were requested, they appeared to be the same, Piccoli said.

Throughout the multiple schemes, the perpetrators were so accomplished that the counterfeit documents were amazingly convincing, Marro said. Also, timing was critical. In many cases, purchases were timed so that mortgage payments weren't due when the examiners looked at the books, so the lack of payments didn't throw up a red flag, he said.

The heavy involvement of attorneys was key to keeping the fraud concealed as long as it was, said Judy K. Hunt, assistant U.S. attorney in the Middle District of Florida U.S. Attorney's Office. Hunt and Assistant U.S. Attorney Thomas W. Turner prosecuted the case. "One-fourth of the people convicted in the case were attorneys, and other attorneys were involved but given immunity for various reasons," she said. The theory behind the importance of attorneys in the deception was that most business people believe business lawyers are ethical and won't steal corporate money. Also, if there were any questions, the lawyers could invoke attorney-client privilege. Smythe testified at his trial that "we couldn't have done it without the lawyers," Hunt said.

Smells Like a Rat

In 1994, the Delaware Insurance Department decided to do a full-scale examination of the company. "It was probably the right time in the cycle of examinations, but the department was going in regardless," Piccoli said. "There had been enough complaints and suspicions to warrant it." When the examiners began demanding corroborating validations of collateral securing the supposed loans, no one was able to produce the documents. It became obvious that something was wrong.

On May 25, 1994, Williams placed National Heritage in receivership and hired a team of attorneys to try to recover lost assets. "Our initial goal was to rehabilitate the company," Piccoli said. Spending the money up front to hire good attorneys to hunt for the assets was critical to being able to pay policyholders in the end. "Most receivers don't want to spend money, but you have to," Piccoli said.

Federal Authorities Move In

As the schemes developed, an informant alerted the U.S. Attorney's Office about improprieties in loans arranged by Davies. Not long after the tip, Williams advised the office that the insurance department was finding irregularities in National Heritage's transactions, Hunt said. Consequently, federal authorities began their own investigation. Over the next five years, the FBI and the Criminal Investigation Division of the Internal Revenue Service joined the investigation. In 1995, a joint task force was formed, which ultimately investigated and prosecuted crimes involving people acting in Arizona, Texas, Illinois, New York and Florida.

At times, the investigators were at odds because of different agendas, Marro said. The federal investigators needed to prosecute criminals, and the insurance investigators needed to recover funds. At one point, when a criminal trial was under way in Florida, the judge demanded that the insurance investigators stay away from certain schemes until the trial was over, Marro said.

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Deputy Receiver for National Heritage

The findings of the investigations differed on some of the details, such as whether Aloisi, Smythe and Davies actually delayed depositing the $4 million check drawn on the Blutrich account or were able to take advantage of a bank holiday, but the results were the same, Hunt said. "We were looking for criminal culpability, so we had to be very concerned with the minutiae," she said. The U.S. attorney's office filed three criminal indictments and negotiated numerous other plea agreements.

After the bogus loan schemes, Blutrich, Smythe and others who joined the undertakings at various times moved on to mortgage and stock schemes, according to Williams' civil complaint. But as the scams multiplied, it became more and more difficult to conceal the missing assets.

In December 1993, the group devised a scheme that they thought would cover up all of the other schemes, Marro said. By that time, they had been joined by Lyle Pfeffer, Keith Pound and Shalom Weiss, who headed companies that were later named defendants in the case.

"Think of the big guys in this case as puppeteers," Piccoli said. "First Smythe is pulling the strings. Then he brings in Blutrich, who starts pulling the strings. And then Blutrich brings in Weiss, who starts pulling the strings."

In the mortgage-backed bond scheme, as it was called in the civil complaint, National Heritage recorded the purchase of 21 series of 1993 8.5% registered collateralized mortgage debentures on its books for more than $118 million. To convince the National Heritage investment committee to buy the bond, Pound told them, among other things, that it had a face value of $126 million and was secured by a pool of mortgages having even greater value. In fact, only $60 million went toward the investment, Marro said, and many of the mortgages were nonperforming, meaning that they were 90 days or more past due. Also, mortgages with outstanding principal balances of more than $3 million were listed twice, thus inflating the face value of the bond. The bond was issued by National Housing Exchange Inc., a North Carolina corporation formed for the exclusive purpose of issuing it.

The scheme created the appearance that National Heritage had acquired a $126 million asset for $118 million, thus concealing the crippling effect that prior diversions of funds had had on National Heritage's financial condition, the complaint said. "Keith Pound was supposedly a mortgage expert," Marro said. "I think they really believed he could get those mortgages performing again and make back some of the money they had taken."

Along with the mortgage-backed bond scheme, however, Pound, Weiss, Blutrich and others set up a plan to service the mortgages for their own benefit rather than the benefit of National Heritage. "The amazing thing about that was that Pound was still refusing to give up those servicing fees even as he was being tried and sentenced," Marro said.

Sixteen Convictions

As more schemes were discovered and more evidence compiled, prosecutions began. Three corporations and 13 individuals, including Davies, Smythe, Blutrich, Pfeffer, Weiss and Pound, have been convicted. Aloisi pleaded guilty to fraud charges, but the court declared him incompetent.

Weiss and Pound received the most severe sentences. U.S. District Court Judge Patricia C. Fawsett sentenced Weiss to 845 years in prison. She also imposed a criminal fine of $123.4 million and ordered him to pay National Heritage $125 million in restitution. Pound received a sentence of 740 years in prison and was ordered to pay $133.9 million in restitution. Technically, Fawsett was unable to impose life sentences for the specific crimes charged, so she fashioned sentences for which Weiss and Pound were required to serve the maximum terms for most of their crimes consecutively, according to the U.S. Attorney's Office.

Weiss, Pound, Smythe, Pfeffer and Blutrich were considered the major players in the hoax, but Smythe, Pfeffer and Blutrich received lighter sentences because they pleaded guilty, Hunt said.

At Weiss's sentencing, Hunt told the judge that although many involved in the case were corrupt, Weiss was the most sinister because he drew in people who otherwise would never have become involved in crime.

All those given prison terms are currently incarcerated, except Weiss, who disappeared during jury deliberations. The FBI and Williams have posted rewards collectively in excess of $100,000 for information leading to his capture. Because they cooperated in an unrelated organized-crime investigation, Pfeffer and Blutrich are seeking reductions in their 25-year sentences, which they are serving in the federal witness-protection program.

Saving the Policyholders

An important facet of prosecutions in a case like this is deterrence, Marro said. "We want to keep people like this out of business," he said. But for the insurance investigators, the challenge continued after the convictions to recover the money for the policyholders.

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Guaranty funds in the 23 states where policyholders resided paid about $400 million to cover policies and annuities to a maximum of $100,000 cash-value benefit and

Policyholder's Story: The Smoking Pie Chart

Aubrey Highsmith thought annuities with National Heritage Life Insurance Co. were a good investment in 1991. The agent selling the products was convincing and provided glowing reports about the company and its financial condition, said Highsmith, a retired member of the U.S. Air Force. So he and his wife, Nita, bought a total of five National Heritage annuities.

Things went well for a few years. Then, after the original agent died, another agent suggested Highsmith convert his annuities into new annuities with National Heritage. Highsmith asked to review the company's assets. The new agent produced a pie chart indicating National Heritage had invested nearly 50% of its assets in real estate.

"That's when my ears perked up. I had read that insurance companies usually only invest about 15% in real estate," Highsmith said. He questioned the 50%, but the agent assured him it was all prime commercial real estate. Highsmith was not convinced. In 1995, he began withdrawing as much as he could from the annuities each month.

Meanwhile, Delaware Insurance Commissioner Donna Lee Williams had discovered severe problems with National Heritage's assets and placed the company in receivership. State guaranty associations became responsible for the National Heritage policies up to a maximum of $100,000 in cash value benefit in most states and were required by law to pay interest rates indexed to Moody's corporate bond rate.

The state of Texas, where Highsmith lived, initiated its guaranty fund in December 1994, so everything he withdrew was counted against his $100,000 maximum per annuity, Highsmith said. He was unable to get out quickly enough.

"It's been a mess," Highsmith said. Between the interest he and Nita lost on their accounts because of lower interest rates on the guaranty-covered portion and no interest on the amount that was in the National Heritage estate, Highsmith estimates they lost $50,000 to $60,000.

"I'm sort of like Will Rogers. When you get in that state, I'm not so interested in the interest. I just want my principal back," Highsmith said. "I never expected to even get my principal back, but I have," he said.

Williams negotiated an agreement with the state guaranty associations so that after a certain amount of recovered assets was paid to the funds, 50% of additional recovered assets would be used to repay policyholders for the amount of their policies that exceeded the associations' $100,000 cash value limit. Highsmith was one of those policyholders. "We were close to being the highest [National Heritage] investors in Texas," he said.

For the most part, Highsmith was pleased with the way the liquidation was handled. The guaranty associations negotiated an agreement for Metropolitan Life Insurance Co. to assume most of the policies, including Highsmith's annuities. He and Nita left their policies with MetLife for a while, but have now withdrawn the money and invested it elsewhere, he said.

Highsmith's main complaint about the liquidation proceedings was the way cash surrender values were used as a basis of coverage. "I wasn't satisfied with the way they figured it, but sometimes you can't buck city hall," he said.

Highsmith has learned two lessons from his experience with National Heritage Life: Don't have accounts that exceed the state guaranty maximum and don't believe everything an agent tells you. The whole affair has "put white hairs in this 81-year-old head," he said.

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—Fredric Marro, General Counsel

$300,000 death benefit in most states, said Frank O'Loughlin, attorney for the National Organization of Life and Health Insurance Guaranty Associations National Heritage Task Force. The organization negotiated a contract for Metropolitan Life Insurance Co. to assume all of the policies except one block of single-premium ordinary life policies, which were transferred to Madison National Life Insurance Co.

Nearly 95% of the policies assumed by Metropolitan Life were annuities, so the guaranty associations transferred $396 million in notes and cash to MetLife as reserves to back up the annuity liabilities, O'Loughlin said. Madison National Life received $5.5 million in notes and cash.

The guaranty associations affected by the insolvency maintained the policies from the time of the liquidation in 1995 until the new insurance companies assumed the policies in 1996. During that period and after the new companies assumed them, policyholders who wished to cancel their policies were subject to the surrender charges in their original policies.

By law, the interest rates the guaranty funds paid on the policies were indexed to Moody's corporate bond rate, so National Heritage customers who held policies with very high interest rates received lower rates after liquidation, O'Loughlin said.

After the assumption agreements closed, MetLife and Madison were able to offer a market rate of interest. Consequently, only a few policyholders cashed out, O'Loughlin said.

Repaying policyholders for assets that went beyond the limits was solely the responsibility of National Heritage Life. "Commissioner Williams was determined that the uncovered portions of the policies would be paid off as well as the covered portions," Marro said. Normally, most money that National Heritage recovered would go to pay off the guaranty funds, with only a small portion going to pay policyholders the uncovered amounts. Williams negotiated the percentages with the guaranty funds, so that after a certain amount was paid to the funds, half of everything that was recovered would go to the policyholders until they had been fully repaid. "To the best of my knowledge, this kind of negotiated agreement is unprecedented," Williams said.

All policyholders were repaid completely by July 2000, Piccoli said. National Heritage paid about $20 million of the total, Marro said.

Finding the Funds

Recovering National Heritage's stolen assets has not been an easy or glamorous job, Piccoli said. "It's months and months of plowing through stacks of papers looking for any irregularities in all of National Heritage's transactions," he said.

For example, National Heritage money was used to purchase a group of about 600 loans and cooperative properties, but titles for half of the co-ops allegedly never made it to the company, Marro said. There also were apartments that were mortgaged at much less than they were worth, so National Heritage had to prove its interest in them was greater than what the books showed. In another instance, there was evidence that National Heritage had made a loan to Scores Entertainment Inc., a New York corporation and nightclub controlled by Pfeffer and others. The loan had been repaid, but litigation revealed that National Heritage money also contributed to the purchase of the nightclub, which featured exotic dancing.

The challenge is to find where the money went and then prove that it belongs to National Heritage, Marro said. "Very often we run up against bona fide purchaser defenses," he said. "Litigators are faced with the argument that an alleged innocent party purchased National Heritage's asset, not knowing it was stolen. It often requires a protracted legal process to prove the current holders of the asset are merely nominees or the same parties," he said.

"On top of these problems here in the states, it has become apparent that a great portion of the proceeds of their criminal endeavors have been secreted offshore, and we are confronted with the complexity of administering U.S. justice in foreign domains," Marro said.

Investigators are continuing to search for hidden assets. To make sure the participants pay the court-ordered restitution, investigators are searching through their individual assets, past banking securities transactions and, in many instances, attorney escrow accounts.

Also, many of the defendants were continuing their fraudulent activities even while they were on trial, Marro said. For example, prosecutors were being given fake documents manufactured the week before. "The FBI was wiretapping Scores for another reason when they learned about the bogus NHL documents," Piccoli said.

In another case, the defendants were pursuing a fire claim on a property National Heritage was trying to recover, Marro said. In some cases, the attorneys and appraisers had malpractice or errors and omissions insurance, and National Heritage has been able to collect on claims against those policies, he said.

The National Heritage case has prompted no changes in the Delaware insurance regulatory and oversight process, Williams said. "We hope this case is an example of how well states are going to stand up to those who want to cheat the system," she said.

Piccoli said this is a case where the regulatory process worked: "We don't need new regulations. We just have to aggressively enforce the ones we have." BR