

Section 4-1

**THE PROSECUTION'S
MISREPRESENTATION OF STATUTES
AND REGULATIONS IN CREATING
ACCOUNTING EVIDENCE**

What The Illinois Administrative Code Says about PFTAs

The core of Segal's prosecution is an allegation that Segal misused the money in a trust account.

A foundational problem with this is that an Illinois Insurance Broker's **PFTA bank account**, the account Segal is accused of misusing, **is not a "trust" account.**

The Illinois regulations define the PFTA as a special fiduciary account does not use the words 'trust account'. Though the regulation names it a premium trust fund account, the regulations do not treat it as a trust account as that term is understood in common law.

Instead, **it is a commingled account** containing both customer premium payments and other brokerage funds. Because it is a commingled account, it cannot, as a matter of law, be a "trust" account. Furthermore, **"trust" or "impress" accounting principles cannot be applied to a commingled account.**

Illinois statute provides clear definitions as to broker's collection accounting, premium payments receipt and penalties associated with loss

The Illinois Legislature specifically chose the term "fiduciary capacity", not "trust", when drafting the statute.

Nowhere in the Illinois statute does the word, "trust" or "trust accounting" appear.

In section (b), the statute provides that **once a premium payment has been received by the broker from the insured, it is considered "paid"** to the carrier. No loss or risk of loss is allowed after a premium is paid.

District court ruled there was no loss.

Illinois Compiled Statutes 215 ILCS 5 Illinois Insurance Code. Section 500-115

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(215 ILCS 5/500-115)

(Section scheduled to be repealed on January 1, 2017)

Sec. 500-115. Financial responsibilities.

(a) Any money that an insurance producer, limited line producer, temporary insurance producer, business entity, or surplus line producer receives for soliciting, negotiating, effecting, procuring, renewing, continuing, or binding policies of insurance shall be held in a fiduciary capacity and shall not be misappropriated, converted, or improperly withheld. An insurance company that delivers to any insurance producer in this State a policy or contract for insurance pursuant to the application or request of an insurance producer, authorizes the producer to collect or receive on its behalf payment of any premium that is due on the policy or contract for insurance at the time of its issuance or delivery and any premium that becomes due on the policy or contract not more than 90 days thereafter.

(b) An insurer that issues a policy of insurance shall be deemed to have received payment of the premium if the insured paid any insurance producer requesting the coverage. The insurer shall be responsible to the insured for any return premium.

(c) In the case of open accounts receivable with the balance payable to an insurance producer within a specified period of 90 days or less, where the balance is not fully paid within that period, a late charge not exceeding 1.5% per month may be added by the insurance producer to the unpaid balance to induce payment of the premium.

(d) If an insurance producer or surplus line producer knowingly misappropriates or converts to his or her own use or illegally withholds fiduciary moneys in the amount of \$150 or less, he or she is guilty of a Class A misdemeanor for a first offense and a Class 4 felony for subsequent conversions, misappropriations, and withholdings of that nature. If an insurance producer or surplus line producer knowingly misappropriates or converts to his or her own use or illegally withholds premiums in excess of \$150, he or she is guilty of a Class 3 felony.

(Source: P.A. 92-386, eff. 1-1-02.)

The regulations covering PFTA deposits are covered in section 3113.40 (a)-(f).

a) All collected insurance premiums must be deposited into PFTA bank account.
There is no requirement to maintain a separate PFTA for each insurer.

c) Trial records show all NNIB receipts of collected premiums and other revenue are deposited in the PFTA (Ref: Tr. 651)

f) **Broker's other revenue funds are permitted to be deposited as non-premium receipts-commingled account. Permitted commingled account proves as a matter of law that PFTA is not a trust account.**

Section 3113.40 Premium Fund Trust Account

- a) All licensees required to maintain a PFTA, pursuant to subsection (c), shall establish and maintain a PFTA in a financial institution. All resident and quasi-resident licensees required to maintain a PFTA pursuant to this Section shall maintain such PFTA with one or more financial institutions located within the State of Illinois and subject to the jurisdiction of the Illinois courts. Licensees are not required to maintain a separate PFTA for each insurer unless required by an insurer(s).
- b) All licensees required to maintain a PFTA, pursuant to subsection (c), shall certify at each license renewal or reinstatement date that premiums are held in a PFTA. The account must be designated as a Premium Fund Trust Account on the bank records and those words shall be displayed on the face of the checks of that account.
- c) A PFTA must be established and maintained if a licensee:
 - 1) Holds any premiums for 15 days or more before remitting to an insurer or other licensee.
 - 2) Deposits any collected premiums into a financial institution account or other account or uses the premiums, even though the premiums are remitted within 15 days.
- d) The absence of a PFTA does not relieve the licensee of the obligation to hold the premiums in a fiduciary capacity, and the premiums shall not be used for purposes other than those authorized by this Part.
- e) All licensees who maintain or are required to maintain a PFTA must deposit all premiums received into the PFTA.
- f) Non-premium monies received by the licensee for soliciting, negotiating, effecting, procuring, renewing, continuing or binding policies of insurance may be deposited into the PFTA. Examples of non-premium monies are service fees, policy fees, late charges, inspection fees and surplus lines premium taxes.

[Reference-Illinois Compiled Statute 215 ILCS sec 500-115]

The regulations covering PFTA disbursements are covered in section 3113.40.

Specific categories of disbursements are allowed

Any disbursement from the PFTA to other than a carrier, a customer, or an insurance broker (including NNIB) would constitute a misappropriation of funds.

h.6) NNIB is the licensee, therefore it is entitled to received PFTA disbursements.

Any disbursement from the PFTA to other than a carrier, a customer, or an insurance broker (including NNIB) would constitute a misappropriation of funds. No evidence was presented that any inappropriate disbursements were made.

lawfully withdrawn.

h) The following disbursements may be lawfully withdrawn from the PFTA:

- 1) Net or gross premium remittances due other licensees or insurers. Claims payments or reinsurance premiums when offset at the direction of the insurer may be transferred to another account;
- 2) Return premiums due insureds;
- 3) Commissions due the licensee, net of any financial institution fees or service charges, or commissions due another licensee only when the commission withdrawal is matched and identified with premiums previously deposited into the PFTA;
- 4) Non-premium monies when matched and identified with prior non-premium PFTA deposits;
- 5) Interest or other revenue which the licensee is authorized to retain.
- 6) Withdrawals pursuant to subsections (h)(3), (4) and (5) must be made payable to the licensee or another licensee.

[Reference-Illinois Compiled Statute 3113.40]

The regulations establishing the required balance in the PFTA at any particular time are covered in section 3113.40.j

Reconciling the use of the PFTA is strictly a cash in-cash out accounting statutory methodology.

j) The PFTA balance in the financial institution shall at all times be the amount deposited less lawful withdrawals. If the balance in the financial institution is less than the amount deposited less lawful withdrawals, the licensee shall be deemed to have misappropriated fiduciary funds and to have acted in a financially irresponsible manner.

[Reference-Illinois Compiled Statute 3113.40]

- The balance in the PFTA must remain above the amount of premium payments actually received that have not yet been remitted to the carriers. Accounts receivable and accounts payable do not figure into the math.
- **This is the only lawful method prescribed by the Illinois legislature and the only method to be used in reconciling PFTA use.**
- **Noncompliance is defined as misappropriation.**

The regulations covering interest earned on PFTA funds are covered in section 3113.40(k)

The interest earned on the PFTA account belongs to the broker further supporting non-trust accounting.

The prescription of the insurance brokers being entitled to all interest earned on the PFTA account provides further evidence PFTA is not a trust account.

Interest income to the principle follows the Illinois law as to ownership of the funds.

- k) All licensees may place PFTA funds in interest bearing or income producing assets and retain the interest or income thereon, provided the licensee obtains the prior written authorization of the insurer on whose behalf the funds are to be held. The written authorization from the insurer shall be on a form the same as Exhibit A or other written form signed and dated by the licensee and the insurer. Employing the use of specialized techniques or strategies which incur additional risks to generate higher returns or to extend maturities is not permitted. Such prohibited techniques include but are not limited to the use of financial futures, options, or other derivatives, swaps, synthetic assets, margin purchases, short sales, pledging or other encumbrance of PFTA assets or balances, and when issued trading. In addition to savings and checking accounts in a financial institution, a licensee may invest in the following assets:
- 1) Direct obligations of the United States of America or U.S. Government agency securities with maturities of not more than one year.
 - 2) Certificates of deposit, with a maturity of not more than one year, issued by financial institutions which are members of the FDIC or the FSLIC.

[Reference-Illinois Compiled Statute 3113.40]

Prosecution inappropriately applies trust accounting principles to create the appearance of an unacceptable use of the PFTA

The Prosecution had all of the books, records, bank statements, and computers of NNIB for over two years prior to trial.

- The Prosecution presented not one disbursement drawn on the PFTA bank account not permitted under the regulations.
- Not one single check or wire transfer from NNIB's PFTA bank account to anyone other than a carrier, a customer or an insurance broker was presented in court.
- Not one single check or wire transfer from NNIB's PFTA bank account was proven and supported not coming from NNIB's portion of the commingled PFTA regular bank account.
- The government continues to ignore state statutes of regulations on their face as to the PFTA not being a trust account and cites no legal authority for its position as to the money in the PFTA as other people's money. Under harmless error analysis the record and statute rendered the Prosecution's evidence in dispute.
- The PFTA is merely an ordinary bank account, or accounts, containing money belonging to the broker, encumbered by a fiduciary obligation to remit insurance premium payments to the carriers when due. As a commingled account, it contained not just customer premium payments, but commissions, fees, and service charges earned by NNIB. Every dollar received by NNIB was legally deposited into the PFTA.
- Such a commingled account cannot be analyzed by the "impress" or "trust" accounting procedures that are applicable to a trust account.

Prosecution's own witnesses found accounting at NNIB to be transparent

Accountant testified "no hidden companies, secret accounts, or offshore entities."

Tr. 1140:19-1141:9, Perez cross by Cognetti

Q. And was there an attempt on the part of Near North to book all the transactions relating to Mr. Segal's draw account?

A. I believe so, yes.

Q. So all those records were transparent. They were on the books and records of Near North, correct?

A. Yes.

Q. There's no -- no hidden company someplace that you found for Near North, did you?

A. No.

Q. No flow of money to a secret account someplace. Did you find any flow of any money to some secret account someplace?

A. I don't recall finding anything of that nature.

Q. No flow of money to some secret company hidden offshore someplace. You didn't find anything of that, did you?

A. Don't recall finding anything of that nature either.

All NNIB transaction coded honestly.

Tr. 1720, Kendeigh cross by Brier

Q. So there was never any effort by any of your superiors at Near North to hide anything.

A. That's true, yes.

Q. And, in fact, to the best of your knowledge, there was no information that was intentionally miscoded or hidden, correct?

A. That's correct, yes.

No one tried to mislead anyone.

Tr. 1721, Kendeigh cross by Brier

Q. He never told you to hide what -- whatever the books were reflecting in terms of a potential deficit, did he?

A. We -- we never sent out financials.

Q. Right.

A. And that was at his direction that we didn't.

Q. So there was never anything prepared that you're aware of where someone intentionally tried to mislead anyone.

A. That's correct.

Prosecution's own witness refutes Prosecutor's vouching that there were negative balances in the PFTA bank account and allegations that any customer or carrier suffered a loss.

No negative cash balances in PFTA.

Tr. 2932, Poogenburg redirect by Hogan

Q. Were you aware that they were oftentimes -- and by oftentimes, I mean frequently during that latter six months that Mr. Brier referred to -- in a negative cash position on a daily basis?

A. I guess it would depend on which specific account you were talking about. Some accounts will run negative balances.

Q. Chicago PFTA, how about that?

A. I didn't know they were running daily.

Q. Negative cash balances.

A. Negative, no.

Prosecution's own witnesses found accounting at NNIB to be transparent

No bounced checks.

All insurance was paid.

All insureds were covered.

Tr. 2405-2406, Senese recross by Cognetti

Q. Okay. Now, Mr. Hogan asked you about the potential of bounced checks, and I want to quickly go through. You never bounced a check. You said that yesterday.

A. No.

Q. All the insurance companies were always paid.

A. Correct.

Q. And all the insureds always got their insurance.

A. Correct.

The Prosecution's rush to judgment just 'took for granted' that money was missing and Prosecutor's own witnesses testified that no effort was made to determine where the allegedly missing or borrowed money went.

The Prosecution's own witness testifies that, incredibly, the Prosecution has no way to know if money was missing so they simply "took for granted" that it was.

Tr. 2959, Capel direct by Hogan

Q. Was there an effort made to determine what had happened to the money that Near North was out of trust?

A. No.

Q. Why not?

A. I think it -- the -- I think there was a feeling it was -- there was no way to know. Essentially the condition of the financial records that the process of figuring that out, given the time constraints we were working on and given really what we were trying to accomplish, that that wasn't something that people had enough resources to -- to address at that point.

Q. It was just taken for granted that there was a \$20 million hole that needed to be plugged?

A. Correct.

Prosecution's witness cannot identify where the presumed-to-be-missing money went, further refuting Prosecution's false allegation that money from the PTFA was used to expand NNIB and avoid financing

Tr. 2893, Poggenburg direct by Hogan

Q. Were you ever able to trace where all the money went, where the deficit had stemmed from?

A. No.

Forensic accountant affidavit and testimony confirms the PTFA regulations and refutes Prosecution's misapplication of statute

Andrew Lott confirms the face of the regulations and indicates that the prosecution's accounting evidence falls outside the meaning of the Illinois Administrative Code and GAAP.

Affidavit: Andrew R. Lotts, Vice-President and CPA Fanco Data Systems, 6/7/05

What we have found in comparing our working papers with the documents offered and admitted in trial is that due to the lack of reliable numbers from NNIB the PFTA surplus/deficit calculation method of taking the cash and receivables and subtracting the insurer payables, with inaccurate detail, results in a faulty number that is unacceptable within the meaning of the Illinois Administrative Code Section 3113.40 Premium Trust Fund Account and further violates generally accepted accounting principles and standards.

“...take cash that is held to benefit... and compare to the cash that you have...difference is what your [PFTA] position is.”

-Andrew R. Lotts, Vice-President and CPA Fanco Data Systems

This is not the manner in which Prosecutor's accounting evidence was calculated.

Tr.5918; Lotts direct by McNulty

A. In a brief nutshell, to calculate a Premium Fund Trust Account at its very core is to take cash that is held to benefit -- that has come in from clients, from the insureds, and compare that to the cash that you have, and the difference is what your trust position is.

Incomplete/Incorrect Statement of Law

The government argued in closing:

Tr 5227:22 - 5228:18 (government - closing).

I expect that Mr. Reidy may -- and Mi. Cognetti, too -- may argue to you that the money that was coming in to Near North from commissions and from particularly direct-bill commissions, was theirs to use. It was appropriately earned by Near North, and it could be used for their operating purposes.

But that isn't so. It just plain isn't so. And common sense, something that you should apply to the facts in this case, will tell you so. And why is it not so? Because if you're \$10 million out of trust and you have a deficit of \$10 million and you're obligated by the law to keep that trust fund in balance, then every single nickel that comes into that fund, every nickel that comes into that account from whatever source belongs to the account and must be held in a fiduciary duty on behalf of the carriers and the customers until the account is in balance, and it never was at Near North.

So, for effect, every single nickel that was coming into Near North from whatever source, for all those years, was obligated to be held in trust; and, conversely, every single nickel that was spent by Near North for all of those years for whatever purpose was essentially a misappropriation, an embezzlement, and a crime.

By ignoring the law, the government creates criminal conduct out of nothing. First, the government's analysis is based upon the applicability of the concept of a "cumulative deficit" in a PFTA. The "surplus" or "deficit" in a PFTA at the point in time of any particular point in time (i.e. the close of business on June 30, 2001), is not the starting point for a PFTA use reconciliation for the following day. A PFTA use reconciliation for the following day (i.e. July 1, 2001) will have different amounts for cash in bank and premium amounts collected from customers that have not yet been remitted to carriers during the current billing cycle.

Not only are there changes in cash receipts and disbursements, there are also changes in the insurance payables, for example, from changes in policy terms during the underwriting process. The only statutorily-defined "misappropriation" requires a statutory PFTA use reconciliation combined with an improperly-drawn check.

The government never presented such evidence at trial.

Incomplete/Incorrect Statement of Law

The core of the government's argument is:

Tr. 5227:22 - 5228:5 (closing - government).

I expect that Mr. Reidy may -- and Mr. Cognetti, too -- may argue to you that the money that was coming in to Near North from commissions and from particularly direct-bill commissions, was theirs to use. It was appropriately earned by Near North, and it could be used for their operating purposes. But that isn't so. It just plain isn't so. And common sense, something that you should apply to the facts in this case, will tell you so.

This is a flat-out misstatement of the law. The Illinois PFTA law and regulations do not impose any restrictions whatsoever in the uses to which a broker may put non-premium receipts. The prosecutor simply misrepresented Illinois law to the jury. Near North could legally use non-premium moneys, without restriction, for any otherwise-lawful purpose.

The government makes the point that all money goes into the PFTA. (While technically true that all money eventually found its way into the PFTA under Near North's monetary policies, some of it went into the PFTA directly and some was first deposited into the operating account and then transferred into the PFTA for overnight investment purposes.) The government portrayed the legally permissible commingling of funds (50 Ill. Admin. Code § 3113.40(f)) in the PFTA as a violation of 50 Ill. Admin. Code § 3113.40(i) ("The PFTA shall not be used as a general operating account or claim payment account."):

Tr. 932:22-25 (AUSA Kendall)

All revenue received by NNIB went directly into the PTA, and each day withdrawals were made to replenish the operating fund to its zero balance. In essence, all expenses were paid from the PTA through the operating fund.

The government's continual refusal to acknowledge that 50 Ill. Admin. Code § 3113.40(£) specifically authorized the deposit of non-premium money into the PFTA (i.e. "commingling") confused the jury as to the correct statement of law to the detriment of Segal. The question that the government never answered was, assuming that it was legal to deposit non-premium money into the PFTA, how was a broker supposed to get those funds back out?

The government argues that every nickel that came into Near North needed to be deposited into the PFTA and retained there. The government ignores the fact that non-premium moneys don't have to be deposited into the PFTA in the first place. Assuming arguendo, that on a particular day that the PFTA had a negative use reconciliation -- if Near North received a \$1 million direct-bill commission check, deposited it into the operating account, and simultaneously issued a \$1 million check to purchase new computer equipment -- the purchase of the new computer equipment would not be a "misappropriation" of the PFTA funds as the \$1 million would have had nothing to do with the PFTA. It was the government's burden at trial to establish: 1) that on a particular day, that the PFTA use reconciliation, as defined by Illinois regulations was negative; and 2) that on that day an improper withdrawal was made from the PFTA. The government offered no such proof.

Incomplete/Incorrect Statement of Law

The offense charged is a highly-technical violation of an Illinois insurance accounting regulation. Such a charge cannot be established without completing the extremely precise accounting calculations and reconciliations established by the Illinois statutory and regulatory scheme.

The government combined their inapposite theory of "cumulative deficit" with non-statutory PFTA use reconciliation methodology, and the disparagement of Near North's commingling of premium and non-premium funds in the PFTA (even though such commingling is expressly authorized by statute/regulation) to convict Segal of a "crime" that the government never proved actually happened.

But if you believed that "every nickel" that Near North spent was proof of criminal conduct, as the government argued in closing, it is no wonder that Segal is in prison.

Statutory PFTA Use Reconciliation Analysis

The starting point for an Illinois PFTA use reconciliation analysis must be the Illinois statutes and regulations. Andrew Lotts explains the requirements in his affidavit:

Affidavit of Andrew Lotts, p. 3.

A licensee and business entity shall maintain a Premium Fund Trust Account (PFTA) balance in a financial institution which is not less than the amount of net premiums deposited until such net premium amount is paid to the respective company in compliance with 50 Ill. Admin. Code 3113.40. Based on my experience of reviewing the accounting records of NNIB it could not be put more simply that the PFTA relates to the ability to reconcile premiums actually received and not remitted to the carriers at a given point of time. Nothing else should be taken into consideration. It is the amounts collected on receivables billed at that time that have not been remitted. Our findings reinforce the requirement that all deposits going into the PFTA have to be analyzed as to their source.

Lotts' statement of the statutory/regulatory requirements of a PFTA use reconciliation are supported by the testimony of every Government witness who testified about PFTA use reconciliation methodology.

Government witness Heitzman confirms, the reading of the statute and regulation set forth by Lotts:

Tr. 2164:5-25 (Heitzman - cross by Reidy).

Q. Now, in calculating the premium fund trust, you did not have available to you, did you, the precise kind of accounting that premium fund trust requires under the Illinois regulations that you read?

A. We had the regulations, but they didn't address precise accounting calculations.

Q. Well, it indicates that it's required under the regulations that the accounting be kept sort of policy by policy, right?

A. Yes.

Q. So that the broker is entitled to extract from the bank account the commission that's associated with a particular premium, right?

A. I believe that's correct, yes.

Q. And so to do true Premium Fund Trust Accounting, you have to be tracking it that way, isn't that right?

A. I -- I don't know if you have to be tracking it that way or not, but Q. Okay. But the regs that you read and saw indicate that that's how the accounting has to go, right?

A. They indicated that -- that that is how the accounting went, yeah.

The "policy-by-policy" phraseology used by Heitzman and Reidy corresponds to the Lott's statement that "all deposits going into the PFTA have to be analyzed as to their source."

Statutory PFTA Use Reconciliation Analysis

Government witness Tom McNichols confirms the statutory methodology for performing a PFTA use reconciliation analysis:

Tr. 2642:10-15 (McNichols - cross by Reidy).

Q. And in order to have an actual Premium Fund Trust Accounting calculation, it's necessary for the books to have tracked each incoming -- or each receivable with each payable and keep track of where the commissions went and only release the commission moneys at a time when the payment has been received by the customer, et cetera, is that right?

A. That's correct.

McNichols further confirms that the methodology employed by McNichols in performing a PFTA use reconciliation was not the statutory methodology:

Tr. 2642:17-20 (McNichols - cross by Reidy).

Q. And so this way of doing it, looking basically at cash and receivables versus payables is a way of estimating where the premium fund trust is?

A. At best.

McNichols does not claim to have used the methodology prescribed by the Illinois statute and regulations.

Government witness Marcotte confirms the source-cash-tracking methodology of PFTA use reconciliation specified by the statute and admits that his methodology is different from the statutory methodology:

Tr. 2028:14 - 2029:11 (Marcotte - cross by Reidy).

Q. And in order to actually keep track of a Premium Fund Trust Account, you have to do different and more detailed accounting than appears in this, is that right?

A. Yes.

Q. And you have to match commissions to individual policies, is that right?

A. Yes.

Q. And if you have non-PFTA -- or non-premium moneys deposited into the PFTA, when you withdraw them, you have to match them to the deposit that shows they were a non-premium PFTA when they're withdrawn, right?

A. Correct.

Q. So it requires matching what's taken out with what went in, is that correct?

A. Yes.

Q. And none of that occurs in your schedule. Your schedule is just sort of a ballpark test of looking at the premium fund trust situation, is that right?

A. Yeah, I don't know what you mean by a ballpark test. I guess, you know, this was the calculation that we did that was looking at it as a summarized level based on the detail, and all of that stuff you just referred to should be taken into account in total on this calculation by my understanding.

Statutory PFTA Use Reconciliation Analysis

Government witness Norm Pater confirms the policy-by-policy nature of the PFTA use reconciliation specified by the Illinois statutes and regulations, admitting that his methodology is different from the statutory methodology:

Tr. 2905:20 - 2906:3.

Q. To the extent that the Illinois premium Fund Trust law requires that you actually do that, that you take a look at your PFTA requirement on a policy-by-policy basis and you break out the premium that's been paid to you by the client that you're required to hold and then also break out the commission on a policy-by-policy basis, would you agree, sir, that the kind of calculation that you have come up with here is something that provides an estimate?

A. Absolutely an estimate.

The testimony of defense witnesses confirms the statutory methodology for performing a PFTA use reconciliation. Andrew Lotts testified consistently with his affidavit:

Tr. 5918:12 - 5919:1 (Lotts - direct by McNulty).

Q. And do you have an understanding, sir, of how a Premium Fund Trust Account is calculated here under Illinois regulations and the laws that govern insurance brokerage operations in Illinois?

A. Very much so, yes.

Q. And what is your understanding sir, real briefly, if you could, as to how that -- those premium fund trusts are to be calculated to determine if they are in good balance?

A. In a brief nutshell, to calculate a Premium Fund Trust Account at its very core is to take cash that is held to benefit -- that has come in from clients, from the insureds, and compare that to the cash that you have, and the difference is what your trust position is. So you take a look at what you owe the carriers, and that's based on the cash that's held that's come in on a very basic core.

Ms. Martensen, who became acting CFO of Near North in September of 2001 confirmed the statutory requirement:

Tr. 6006:14-17 (Martensen - direct by McNulty).

Q. In essence, does the PFTA law in Illinois require that a brokerage keep the funds that are paid for premiums from a customer and hold them until they are paid to a carrier?

A. Yes, it does.

All of the witnesses, both government and defense witnesses, are in agreement as to the statutory and regulatory requirements for analyzing the use of funds in a PFTA. There is no disagreement that a broker is in full compliance with the Illinois statute and regulation if, at all times, the 3 cash maintained in the broker's PFTA in a financial institution equals or exceeds the insurance premium payables associated with each customer premium payment actually collected from the customer.

Statutory definition of misappropriation

The financial responsibilities for the handling of premium funds collected from customers by an insurance broker are set forth by Illinois statute as follows:

Sec. 500-115. Financial responsibilities.

(a) Any money that an insurance producer, limited line producer, temporary insurance producer, business entity, or surplus line producer receives for soliciting, negotiating, effecting, procuring, renewing, continuing, or binding policies of insurance shall be held in a fiduciary capacity and shall not be misappropriated, converted, or improperly withheld.

An insurance company that delivers to any insurance producer in this State a policy or contract for insurance pursuant to the application or request of an insurance producer, authorizes the producer to collect or receive on its behalf payment of any premium that is due on the policy or contract for insurance at the time of its issuance or delivery and any premium that becomes due on the policy or contract not more than 90 days thereafter.

215 ILCS 5/500-115. The statute, as enacted by the Illinois Legislature, uses the word "misappropriated," but does not define how a misappropriation of funds will be determined. The Legislature left the implementation details to the Illinois Department of Insurance to develop through the Illinois regulatory process.

The Illinois Department of Insurance regulations implementing the statutory scheme are found at 50 Ill. Admin. Code § 3113.40. The relevant provisions of the Code requires that a Premium Fund Trust Account (PFTA) be established at a financial institution. §3113.40(a). The Code requires that the account "must be designated as a Premium Fund Trust Account on the bank records." § 3113.40(b). The Code requires that all premium funds be deposited into the PFTA (§3113.40(e)) and permits non-premium moneys to be deposited into the PFTA (§ 3113.40(f)).

The Insurance Code specifies that the following disbursements may be lawfully withdrawn from the PFTA:

1) Net or gross premium remittances due other licensees or insurers; 2) Return premiums due insureds; 3) Commissions due the licensee, net of any financial institution fees or service charges, or commissions due another licensee only when the commission withdrawal is matched and identified with premiums previously deposited into the PFTA; 4) Non-premium monies when matched and identified with prior non-premium PFTA deposits; 5) Interest or other revenue which the licensee is authorized to retain; 6) Withdrawals pursuant to subsections (h)(3), (4) and (5) must be made payable to the licensee or another licensee.

50 Ill. Admin Code § :3113.40(h). The regulations create a co-mingled account, from which the licensee may use the portion associated with "premium" receipts exclusively for paying carriers (or other licensees). Non-premium funds must be paid to either the broker -- or to another licensee.

Statutory definition of misappropriation

The Code then defines a "misappropriation" as follows:

The PFTA balance in the financial institution shall at all times be the amount deposited less lawful withdrawals. If the balance in the financial institution is less than the amount deposited less lawful withdrawals, the licensee shall be deemed to have misappropriated fiduciary funds and to have acted in a financially irresponsible manner.

50 Ill. Admin. Code § 3113.40(j). Forensic Accountant Andrew Lotts testified as to the manner in which a PFTA is to be reconciled per the Illinois regulatory scheme:

Tr. 5918:12-23 (Lotts - direct by McNulty).

Q. And what is your understanding, sir, real briefly, if you could, as to how that -- those premium fund trusts are to be calculated to determine if they are in good balance?

A. In a brief nutshell, to calculate a Premium Fund Trust Account at its very core is to take cash that is held to benefit -- that has come in from clients, from the insureds, and compare that to the cash that you have, and the difference is what your trust position is.

In other words, the regulations required the balance in the PFTA to represent at least the amount of premium funds actually collected that have not yet been remitted to the insurance carriers.

The definition of "misappropriation" under Illinois law represents the classic interplay between a legislative body and the regulatory agency charged with implementing the statute. The Supreme Court has made it clear that the regulatory interpretations of a statute by the agency responsible for its implementation are authoritative and controlling in interpreting a statute:

If Congress has left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit.

In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.

Statutory definition of misappropriation

Chevron U.S.A. v. Natural Res.Def.Council, 467 U.S. 837 843-44 (1984). The relationship between the U.S. Congress and federal agencies is directly analogous to the relationship between the Illinois Legislature and Illinois Agencies. In finding a "misappropriation" of funds from an Illinois PFTA, a court may not substitute its own judgment as to the proper methodology of defining and determining the existence of a "misappropriation" for the definition and methodology set forth by the Illinois Department of Insurance through the Illinois regulatory process, unless that interpretation is "arbitrary, capricious, or manifestly contrary to the statute." Even then, principles of dual-sovereignty and federal-state comity suggest that it such a challenge to the interpretation of Illinois law is properly the function of the Illinois courts -- not the federal courts.

No one, however, has suggested that the regulations set forth by the Illinois Department of Insurance in defining a "misappropriation" are "arbitrary, capricious, or manifestly contrary to the statute." No one has even argued that the Illinois regulatory methodology for the definition of the "misappropriation" of funds from a PFTA is even "unreasonable."

The Illinois Department of Insurance regulations are therefore controlling and "a court may not substitute its own construction of [the PFTA] statutory provision."

Government witnesses, forensic testimony are in agreement that a PFTA use reconciliation cannot have an accounting impress cumulative trust balance calculation.

The facts of the record provide the false, invalid government theory that once the PFTA use reconciliation is negative, any disbursement is considered use of other people's money

Forensic accounting testimony on cross examination:
“The use reconciliation balance changes from day-to-day”

Tr.5961-5962 Lotts cross by Polales

Q. The deficit changes from day-to-day, is that right?

A. At any given day, it can be a different number, but it wasn't always a deficit.

Q. Right. But I asked you about a deficit.

A. And my answer is is that it was not always a deficit, so I wouldn't want to answer it in that broad of terms.

Q. The deficit changes from day-to-day when it's in deficit in the PFTA, isn't that right?

A. If one is in deficit, yes, it does change.

Prosecution's witness Marcotte rejects the prosecution's idea that a cumulative balance makes sense:

“...rolling forward doesn't make sense.”

Tr.2032, 11-16 Marcotte cross by Reidy

So if you look at the trust calculation today and tomorrow, it may not flow the way you would think it would because they would have other funds coming in and out of there that would be unrelated to the payables, which would change the calculation balance. And so rolling forward the balance doesn't -- doesn't make sense.

Prosecution's witness Marcotte testifies that analysis is independent of every other day.

Tr.2032-2033 Marcotte cross by Reidy

Q. And did you indicate during that description that when you stop and take a snapshot on a single day, let's say 12-31 – or rather October 19th of 1999, that you can have anomalies in the calculation because there could be cash flowing in or cash flowing out on that very day that is not typical?

A. Yeah, I wouldn't say anomalies. The calculation would change day to day based on the activity going through the pertinent information for the calculation; but it could also be skewed and change irregularly because of other cash coming in and out unrelated to the calculation.

Prosecution understands the PFTA is not a trust accounting impress balance.

Forensic accounting testimony on cross examination:

“The deficit changes from day-to-day”

“...it [The PTFA] was not always a deficit...”

Tr.5961-5962 Lotts cross by Polales

Q. The deficit changes from day-to-day, is that right?

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Q. Right. But I asked you about a deficit.

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Prosecution's witness testifies that analysis is independent of every other day.

Tr. 2033, 1-5 Marcotte cross by Reidy

The calculation would change day to day based on the activity going through the pertinent information for the calculation; but it could also be skewed and change irregularly because of other cash coming in and out unrelated to the calculation.

Prosecution's witness testifies that PFTA trust ratio calculation could fluctuate "quite a bit".

Tr. 779:24-780:4 Pater cross by Reidy

Q. And it is fair to say that the state of the PFTA could fluctuate under your calculation, your trust ratio calculation, quite a bit on a month-to-month basis.

A. It could, but the calculation was consistent.

Q. You mean the method of calculating it was consistent.

A. The method of calculation was consistent, correct.

The Prosecution conflates use of operating and PFTA accounts and cherry picks political contribution data in an effort to add emotionally charged, political taint

The government was in possession of all books and records for Near North for the two year period prior to trial. The government had everything.

In spite of having a complete set of Near North accounting records the Government did not present a single check drawn against Near North's PFTA that was not authorized by the statutes/regulations as to payee- (i.e. there were no checks to other than carriers, customers, Near North, or other licensed insurance producers). Instead, the government presented false testimony and conclusory documents to create a false impression of regulatory noncompliance.

The Government never clarified to the jury that the "segregation" of funds required by the PFTA regulations was a segregation by use not a segregation by deposit. In other words, the PFTA regulations provide for a fungible, commingled account from which withdrawals must be made in a segregated fashion.

As Norm Pater finally explained on cross examination:

Tr 732:15-21 (Pater - cross by Reidy).

You would have a check labeled operating account, and that -- you would have a check labeled premium trust account. If you were paying insurance carriers, you'd send them a premium trust account check which would be drawn against the premium trust account. If you were paying the rent, you'd use an operating account check.

While the operating account was a zero-balance account, funded on demand by presentation of checks to the operating account, the "transfers" from the PFTA to the operating account were one of the categorically permitted disbursements from the PFTA.

Although all operating expenses were paid out of the operating account, because it was a zero-balance account funded by the PFTA, the Government argued, and government witnesses repeatedly testified that all expenses were paid from the PFTA. That inaccuracy might be excused if it were not so prejudicial. The manner in which the testimony was solicited and argued was designed to create in the minds of the jurors the clearly false impression that the PFTA was being used as an operating account in violation of Illinois statutes and regulations.

To add insult to injury, the Government cherry picked specific operating expenses to maximize the political taint of their presentation. The government chose as their illustration of Near North's "operating" expenses allegedly coming from the PFTA selected political contributions -- especially highlighting those likely to elicit the maximum emotional response from the jury.

For the years 1994-2002, Near North made political contributions of \$649,143. Had checks for political contributions been drawn on the PFTA account, that would have been a clear statutory/regulatory violation. But the checks didn't come from the PFTA -- they came from the Operating Account. The Government's example would have been better served by picking a different accounting category -- say charitable contributions -- which during that same time period came to \$3,227,683, dwarfing the magnitude of the political contributions. Again, had any of those contributions come from the PFTA it would have been a statutory/regulatory violation.

Or, the government could have used one of a plethora of emotionally-neutral accounting examples including rent, utilities, employee salaries, or office supplies. Writing a check for those items from the PFTA account would also have been a violation. The fact is that none of the disbursements was illegal because none of the checks were written against the PFTA.

To cover their lack of proof, the government substituted a value judgment with respect to emotionally-charged political contributions for proof of accounting impropriety.

The Prosecution conflates use of operating and PFTA accounts and cherry picks political contribution data in an effort to add emotionally charged, political taint

Prosecution presents ~\$650,000 in political contributions paid from operating account over an 8-year period in an effort to add political taint to Segal and NNIB's prosecution.

Prosecution ignores more than \$3.2 million in charitable contributions from same operating account during the same period.

Total Political Contributions for the years 1994 - 2002	\$572,883.00
Reclasses due to coding errors	<u>\$76,260.00</u>
Total Political Contributions	<u>\$649,143.00</u>

Total Regular Contributions for the years 1994-2002	\$3,283,303.00
Reclasses due to coding errors	<u>(\$35,620.00)</u>
Total Regular Contributions	<u>\$3,227,683.00</u>

Prosecution's own witness agrees that the only lawful statutory use reconciliation method for reconciling PFTA is not that used by the prosecution's own exhibits

Prosecution's own witness testifies that the Prosecution's approach does not conform to the statutory-specified method of accounting.

Tr.2163, 5-25 Heitzman cross by Reidy

Q. Now, in calculating the premium fund trust, you did not have available to you, did you, the precise kind of accounting that premium fund trust requires under the Illinois regulations that you read?

A. We had the regulations, but they didn't address precise accounting calculations.

Q. Well, it indicates that it's required under the regulations that the accounting be kept sort of policy by policy, right?

A. Yes.

Q. So that the broker is entitled to extract from the bank account the commission that's associated with a particular premium, right?

A. I believe that's correct, yes.

Q. And so that to do true Premium Fund Trust Accounting, you have to be tracking it that way, isn't that right?

A. I -- I don't know if you have to be tracking it that way or not, but --

Q. Okay. But the regs that you read and saw indicate that that's how the accounting has to go, right?

A. They indicated that -- that that is how the accounting went, yeah.

Tr.2164, Heitzman cross by Reidy

Q. Okay. And so under those circumstances, there's no way to go through and do the policy-by-policy accounting using the bank accounts then, right?

A. I don't know if there is or not, but --

Q. You certainly didn't see one when you were working at Near North, I take it.

A. We did not look for one, no.

Q. Now, you were -- that is, you McGladrey & Pullen, were working pretty extensively with the managing directors at Near North?

A. Yes.

Q. And who were they that you worked with?

A. Jeff Ludwig, Dana Berry, Matt Walsh, Devra Gerber were the managing directors.

The "policy-by-policy" phrasing confirmed by Heitzman and Reidy corresponds to Lotts' statement that "all deposits going into the PFTA have to be analyzed as to their source."

Tr.2642, McNichols cross by Reidy

Q. And in order to have an actual Premium Fund Trust Accounting calculation, it's necessary for the books to have tracked each incoming -- or each receivable with each payable and keep track of where the commissions went and only release the commission moneys at a time when the payment has been received by the customer, et cetera, is that right?

A. That's correct.

Q. And so this way of doing it, looking basically at cash and receivables versus payables is a way of estimating where the premium fund trust is?

A. At best.

Prosecution's own witness agrees that the only lawful statutory use reconciliation method for reconciling PFTA is not that used by the prosecution's own exhibits

Prosecution's witness further confirms the methodology employed by his own exhibit is not the statutory use reconciliation methodology. Witness further confirms that none of what's required for proper PFTA accounting is in the evidence created by the Prosecution.

Tr.2028-2029, Marcotte cross by Reidy

Q. And in order to actually keep track of a Premium Fund Trust Account, you have to do different and more detailed accounting than appears in this, is that right?

A. Yes.

Q. And you have to match commissions to individual policies, is that right?

A. Yes.

Q. And if you have non-PFTA -- or non-premium moneys deposited into the PFTA, when you withdraw them, you have to match them to the deposit that shows they were a non-premium PFTA when they're withdrawn, right?

A. Correct.

Q. So it requires matching what's taken out with what went in, is that correct?

A. Yes.

Q. And none of that occurs in your schedule. Your schedule is just sort of a ballpark test of looking at the premium fund trust situation, is that right?

A. Yeah, I don't know what you mean by a ballpark test. I guess, you know, this was the calculation that we did that was looking at it at a summarized level based on the detail, and all of that stuff you just referred to should be taken into account in total on this calculation by my understanding.

"Absolutely an estimate."

Prosecution's witness confirms further that the method he used to create evidence is not the statutory method and does little more than estimate numbers.

Tr.2905:20-2906:3 Poggenburg – cross by McNulty

Q. To the extent that the Illinois Premium Fund Trust law requires that you actually do that, that you take a look at your PFTA requirement on a policy-by-policy basis and you break out the premium that's been paid to you by the client that you're required to hold and then also break out the commission on a policy-by-policy basis, would you agree, sir, that the kind of calculation that you have come up with here is something that provides an estimate?

A. Absolutely an estimate.

There can be no estimates based on the unverified, unreconciled and un-aged accounting components adopted and embellished by the Prosecution from the Takeover Group's accounting exhibits.