On The Cover/Top Stories

Leaky Shelters

Janet Novack, 04.11.05

Gary M. Kornman was in business to educate people about how not to pay taxes. For some of his ultrawealthy clients it was an expensive education.

Gary M. Kornman, A Dallas Lawyer, Insurance agent, estate planner and self-styled tax "educator," called two top sidekicks on a Sunday afternoon in October 2000. He asked them to fly with him that night on his private JetStar II to a meeting in the Hamptons with a Connecticut prospect with perhaps a billion in capital gains to shelter. It was a long-shot sales call, but it paid off. By mid-2001 the Connecticut client had paid Kornman's company, Heritage Organization LLC, $29 million for what could be the largest individual tax shelter ever sold. He had also agreed to fork over another $15 million if the three-year period during which the Internal Revenue Service could challenge the shelter passed without trouble. It's unlikely he paid that $15 million; the IRSconsiders the "Heritage Strategy" a variant of the banned "Son of Boss" shelter and is demanding back taxes and penalties from users.

Two sources identify the client as Lawrence Flinn Jr., now 69, an investment banker turned satellite TV entrepreneur who ranked 150th on The Forbes 400 in 2000, with an estimated net worth of $1.8 billion. Flinn declines to comment. "I like to be a private person, and I don't discuss my finances with anybody," he says. But in a court filing a Heritage lawyer refers to the client as "LF," and Flinn, his wife and two Flinn partnerships are listed as creditors of Heritage, which filed for bankruptcy last year after its former president, W. Ralph Canada Jr., won a $6.2 million arbitration award--based largely on his claim that Kornman welshed on a promise to pay him 15% of the Connecticut client's fees.

Flinn, who now calls Hobe Sound, Fla. home, is in good company on the creditors list, which includes billionaires and centimillionaires from Hawaii to Rhode Island. Among them: Silicon Valley real estate/venture capital billionaire Carl E. Berg; StarTek founder A. Emmet Stephenson Jr.; Malcolm G. Chace III, a former rich-lister and a member of Berkshire Hathaway's board; and Bruce and Robert Toll, who between them own $1.3 billion of Toll Brothers stock. (Bruce did a small shelter; Robert says he decided against it at the last minute.)

Sheltering is a big business in this tax-obsessed country. Shelter vendors span a huge range, from white-shoe law and accounting firms selling very complex investments that might hold up in court, all the way down to seedy one-man outfits promoting secret offshore bank accounts that are clearly illegal. The IRS is currently investigating in the neighborhood of 1,000 shelter promoters. Son of Boss was used by thousands of taxpayers to escape $6 billion plus in tax, the IRS says.

Senate hearings, IRS enforcement actions and client lawsuits have exposed the role prominent accounting and law firms such as KPMG, Ernst & Young, PricewaterhouseCoopers, BDO Seidman, Jenkens & Gilchrist and Sidley Austin Brown & Wood played in promoting borderline tax shelters. But the secretive 61-year-old Kornman has remained in the shadows. His contracts--crafted to head off all suits--stated Heritage wasn't offering legal or accounting services or even advice clients could rely on.

Promoters like Kornman thrived before the large firms got involved and are likely, as a group, to outlast them, feeding off tax code complexity and clients' willingness to suspend skepticism to save tax. Without well-known law and accounting firm names to protect, they can shut down one tarnished business and move on to the next. Often more is questionable about their operations than just their tax advice. In August Kornman's home was raided by the Federal Bureau of Investigation, suggesting a criminal investigation is under way.

Indeed, Kornman might even be considered typical of the smaller operators were it not for the size of his fees and the wealth of his clientele. According to Heritage's bankruptcy statements it had been averaging more than $30 million in fees a year and was "quite profitable" before filing.

What's extraordinary is how Kornman, the son of a Florence, Ala. jewelry store owner, got through so many gilded doors. Over more than two decades he spent $40 million (or so he told Ralph Canada) building a database containing information on 30,000 wealthy targets. At Heritage he employed 120 researchers, "initiators" (cold-callers), salesmen, number crunchers and support personnel--all, he boasted, with IQs of 140-plus--and all to snare at most a dozen rich clients a year.

More names on the Heritage creditor list: Sallie Mae Chief Executive Albert L. Lord; the Lorberbaums, who control $1.2 billion of stock in carpetmaker Mohawk Industries; and the Sands family, which has built Constellation Brands into the world's biggest wine producer. None would comment on their dealings with Heritage. Some others on the list, such as Jon B. Lovelace, retired head of Capital Group, which manages the huge American Funds family, say they paid Heritage's standard $22,500 fee to hear details of Kornman's ideas--in Lovelace's case, for estate planning--but didn't become full clients.

Robert E. Lorton, chairman of his family's World Publishing, which owns the *Tulsa World*, says Kornman's "foot-in-the-door-man" called repeatedly and even sent him a Leatherman tool. "I said, ‘Oh heck, you sent me a Leatherman. I guess I better talk to you.'" Kornman flew to Tulsa a half dozen times in 2003 to make the pitch in his "smooth, Southern style," Lorton recalls. The publisher paid the $22,500 to hear details of Kornman's ideas, which supposedly eliminated all estate tax, but finally turned him down. "It sounded soooo good, but it was too good to be true," Lorton says, "and it was too damn expensive."

How expensive? Heritage's standard charge was 25% of projected tax savings for income tax shelters and up to 6% of the first $200 million of assets included in an estate plan, with the percentage falling to 0.5% of assets exceeding $2 billion.

"I thought he had something to sell," says former Lowe's Cos. Chief Executive Leonard G. Herring, who counts himself a satisfied Kornman estate planning customer but won't discuss what he paid. He left Lowe's board in 1999 with $150 million in stock but had done only "nominal estate planning" before Heritage called. As a retailer, he adds, he appreciated Kornman's sales skills, which got him moving on a plan. Kornman's estate planning may well hold up better than his income tax shelters, but we can't say. Estate plan weaknesses can stay hidden until a client dies. And we don't know what methods Kornman uses; his "crisis consultant" says his techniques are "proprietary."

But clients have other reasons to worry. The Securities & Exchange Commission alleges in a civil suit filed last year that Kornman traded on inside information gleaned while courting two prospects. One was California billionaire Alfred E. Mann, founder and then chief executive of MiniMed; the other was Dallas hotel/casino owner Jack E. Pratt. According to the SEC, Mann told Kornman confidentially in a February 2001 meeting that MiniMed had a suitor and there was a 70% chance a deal would go through. Two days later Kornman bought 6,600 MiniMed shares for his $20 million hedge fund at $38. In May 2001 Medtronic announced it would acquire MiniMed at $48.

Kornman wouldn't talk to FORBES, and during the bankruptcy case has asserted his Fifth

Amendment right to stay mum to avoid self-incrimination. Since the FBI raid, he fears making a statement prosecutors might seize upon, says his attorney, Jeffrey Tillotson. "He watched with great horror the Martha Stewart fiasco," Tillotson says. In court papers Kornman's lawyers maintain there was nothing improper about his stock trading, asserting he had no fiduciary duty to clients and that Mann wasn't yet a client anyway. "Kornman was nothing more than a salesman plying his trade, or at least trying to do so," they say.

There's more: According to the SEC, Heritage "required its employees to surreptitiously record telephone conversations and face-to-face meetings with clients and prospective clients." Former employees say the tapes were transcribed, with tidbits added to the client database. In a letter to FORBES Tillotson says "it is my understanding that Heritage's policy was to record clients only with their knowledge and consent," except for some recording of sales calls to prospects "for quality assurance" with Heritage making "every effort to follow all applicable state laws."

Meanwhile two Heritage clients, Publix Super Markets Chairman Howard M. Jenkins and Daniel E. Koshland Jr., a Levi Strauss Co. heir on The Forbes 400 list in the 1990s, say Kornman misled them in business deals. Koshland, an 85-year-old scientist and philanthropist, became an estate planning client of Kornman's in the mid-1990s. Impressed, he says he later gave Kornman money to help him take a company public. Instead, Koshland says, his family partnership ended up owning 5% of private Heritage Organization LLC--which he didn't want to invest in and couldn't even get partnership returns from. "I wrote him a letter saying I'd like the money back, but I never heard from him," adds Koshland. "He was charming and smart. I liked him … I really trusted him completely." (Court documents show Koshland's partnership has $15 million invested in Heritage.)

Jenkins, 53, owns 6.5 million shares (now worth $415 million) in his family's supermarket chain and has passed a similar number of Publix shares on to heirs. Kornman became his "personal confidante" and professional adviser after helping him with estate planning in 1995, he says. In May 1999 he paid Kornman $15 million for a tax shelter. That same month, after a rushed trip from Florida to Las Vegas in Kornman's private jets (with a Dallas stop to switch planes and get barbecue), Jenkins lent a Kornman-affiliated company $42 million to buy Vegas' Maxim Hotel & Casino. Jenkins now says Kornman misled him about the deal; Jenkins is part of a protracted three-way court battle over the Maxim's quick failure, with the men who originally brought Kornman into the deal charging he misled them, too, to take control of the casino himself. Kornman denies any wrongdoing and is suing Jenkins for failing to make a promised $25 million equity investment in Maxim. (Alexander Chae, a lawyer in Houston who represents Jenkins, says Jenkins backed out as soon as he realized Kornman had misrepresented things.)

After the casino deal soured, Jenkins figured he'd better get an independent opinion on the tax shelter. The result: He never claimed it on his tax return, he had his lawyer report Kornman to the IRS and he sued Heritage and Kornman for fraud and racketeering. Kornman's lawyers respond there was no fraud because the contract Jenkins signed stated the tax results were "uncertain."

As for Canada, Kornman has cross-sued him in Jenkins' shelter case and asserts in bankruptcy court filings that he is misusing what he learned at Heritage in his current career as a partner at Deary Montgomery DeFeo & Canada in Dallas. His specialty there: representing buyers of failed tax shelters in their suits against the accounting and law firms and banks that promoted the shelters. Canada's lawyers, citing confidentiality restrictions in his employment contract with Heritage, say he can't comment.

Say this for Kornman: He chugged his own tax Kool-Aid--by the gallon. For 1999 Kornman family entities reported $103 million of losses generated, the IRS alleges, by the same Son of Boss method he promoted. In 2000, 11 Kornman family companies reported losses in excess of $50 million each. Kornman contends in court filings that all these losses were proper and not Son of Boss shelters. (In Son of Boss, cash or a security and an offsetting liability are contributed to a partnership, but--using a hypertechnical interpretation of the word "liabilities"--the liability isn't counted and the contributor gets an inflated tax basis. When he sells his partnership interest, he books a big loss. In Kornman's case a short position in Treasury notes was used.) So did Kornman really have $650 million in income to shelter? No way. But capital losses can be carried forward forever.

In some ways Kornman was a natural in the world of high-end estate and tax planning, where secrecy, the creation of layers of corporate entities and legal manipulation are routine. For decades he himself has operated through dozens of companies, holding as few assets as possible in his main business. Heritage leased its computers and conference tables (and, Kornman insists, its precious customer database) from other Kornman family entities, presumably leaving less for creditors.

Before he married his second wife, Elizabeth, in 1992, Kornman required her to sign a prenuptial agreement waiving any claim to his assets, even if she helped his business grow, and entitling her to only $10,000 for each year of their marriage. He had the signing videotaped, including the part where her lawyer advised her not to sign. Since she was a Heritage employee, he also had her sign a cohabitation agreement--retroactive to the day they moved in together--waiving any sexual harassment claims. Kornman instructed her never to accept a delivery at their home, lest it be a process server, she says. Their marriage was annulled after seven months.

The ex-Mrs. Kornman, as well as ex-employees, describe Kornman as a master manipulator fascinated by his college major of psychology. He required employees to take personality tests and asked potential clients to do so, too. "He's very disarming. His great gift is finding your button," his ex-wife says.

Kornman, his ex recalls, was always worried that someone might, through litigation or even violence, "come get his treasure." He owned a gun cache and insisted she carry a gun when jogging in their upscale suburban Dallas neighborhood. After Sept. 11 Kornman put $4 million of cash in a bank safe-deposit box and removed it only shortly before Heritage filed for bankruptcy, according to testimony by his son Michael.

Heritage employees were required to sign a 52-page contract that blocked them from holding other jobs in insurance or tax planning anywhere in the U.S. for three years after leaving Heritage. Employee claims had to be arbitrated by an impossible-to-assemble panel of three chief executives, each paid at least $300,000 a year and each owning at least 50% of a Texas corporation with revenues of at least $30 million. (In Canada's case, a court appointed three former judges instead.) Kornman continues to enforce the contract. In December Financial Marketing Services--which he says owns his database--sued a former Heritage employee for misusing its trade secrets.

Heritage's standard contract for clients was similarly one-sided, stating that they couldn't tell anyone about its ideas and that if they used the ploys, they owed Heritage's hefty fees, even if the strategies turned out to be widely known. The contract Heritage presented to Alfred Mann required arbitration of disputes by a panel of three executive officers of investment banks with revenues of more than $500 million a year.

Kornman himself quit Heritage shortly before it filed for bankruptcy, leaving his son Michael in charge, and formed a new estate planning company. Kornman had never signed an employment contract with Heritage but hired some ex-employees who had. Citing such apparent conflicts, lawyers for Canada, Jenkins and other ex-clients successfully argued for a trustee to take charge at Heritage. In January that trustee sued to reverse Heritage's transfer to a separate company (run by Michael) of a $5.4 million note from a client's company. The transfer, the trustee charged, was done "with actual intent to hinder, delay or defraud" Heritage's creditors. (The Kornmans deny it.)

Clearly, Kornman has made ample use of his legal training. But he never had a conventional law practice. Robert L. Potts, chancellor of the North Dakota University System, grew up in the same town and graduated with Kornman from the University of Alabama Law School in 1969. During a long conversation on a field trip, Potts recalls, "He told me, ‘I'm not interested in practicing law. I'm going to go out and do deals.'" After law school Kornman sold life insurance and estate planning to physicians and small businessmen. But he aimed for richer clients. To impress one prospect, he rented a helicopter.

Yet in 1982, during his first, contentious divorce, Kornman claimed the couple's community property, including shares of his business, had a negative net worth. In the mid-1980s, facing lawsuits from an Arizona insurance/estate planning client and an insurance company involved in that same case, he took three companies (named Whitehall) into bankruptcy. His Whitehall Organization Inc. stopped making rent payments on its Dallas offices--and seemed to have no business other than subleasing the space to yet another Kornman entity. In 1988 the bankruptcy trustee moved to end bankruptcy protection for all three Whitehall units, declaring that the "inability of the Whitehall Organization to collect a penny of rent" from more than 30 tenants--all apparently Kornman entities--was "inexplicable."

Kornman's ventures with others have typically ended badly. There was, for example, his short-lived deal with author/investment guru Harry S. Dent Jr. Dent says Kornman approached him and suggested they start a hedge fund together, which would attract money from Kornman's "very, very wealthy clients" and make investments based on Dent's ideas. Recalls Dent, "We figured, if somebody has very wealthy clients, they must know what they're doing." Dent and Kornman each put a few million into a fund as a test. Dent says he ended the venture in 1999 after less than a year because Kornman kept trying to renegotiate a bigger share of the fees for himself.

Meanwhile Kornman was moving from estate planning into income tax shelters. His sales job was made easier by the big accounting firms' heavy promotion of push-the-edge shelters and a then-spreading attitude among the rich that anything that might technically "work" was okay. James K. Schuler built Hawaii's Schuler Homes, took it public and then sold it to D.R. Horton in 2002. When Heritage first pitched him a shelter, he thought "it didn't seem right." Then he was offered similar Son of Boss shelters by two big accounting firms, lending the ploy some legitimacy. A friend recommended Heritage, and he liked its low profile. "I said, ‘Gary, how many of these transactions are you doing a year? Are you wholesaling it out like the accounting firms?' And he said, ‘We do it for a very select clientele.'"

Schuler says he paid Heritage something "under $10 million" and he doesn't blame Kornman for what he considers a decision by the IRS to change the rules retroactively. "You and I know that tax shelter structures are not new. They've been around for years," Schuler observes. "Good accountants, good CPAs and good tax attorneys--it's their job to find those little loopholes for their clients. If it works, terrific. If it doesn't work, what's the worst thing that's going to happen? I'm going to pay my taxes." He's now in settlement talks with the IRS. "I'm a good American citizen. I made the money and I'll pay my tax and I'll move on," he concludes.

Not all clients are so forgiving of Kornman or so financially able to move on. A few who sold their businesses for $20 million to $40 million are devastated. Chicago tax attorney Robert McKenzie, now helping two Kornman clients negotiate with the IRS, fumes: "His sales techniques were despicable. His contracts were despicable. He's refused to assist the taxpayers who have been involved in resolving their problems." Some clients have sued or plan to sue the lawyers and accountants who worked with Kornman. Suing Heritage is trickier because it's in bankruptcy and it's unclear how deep--or where--Kornman's own pockets are.