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State blames financial adviser for funeral fund's collapse

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The Illinois secretary of state's office is blaming a Merrill Lynch financial adviser for the collapse of a pre-need funeral trust that's supposed to pay for funerals for tens of thousands of state residents.

In a notice of a hearing to be held May 20, the secretary of state's office levels scores of charges against Springfield-based Merrill Lynch investment adviser Edward Schainker, saying he failed in his fiduciary duties while generating millions of dollars in revenue for his employer, which profited even as the funeral fund tanked.

Illinois proved such fertile ground for Merrill Lynch that Schainker during the 1990s started pitching the same investment plans to funeral directors in Alabama and Mississippi, with the blessing and knowledge of his superiors, according to the state.

Schainker's lawyer denies any wrongdoing. He said his client, who has been cooperating with investigators, is looking forward to a public hearing before a hearing officer.

"We've given the secretary of state truthful information," said Carl Draper, "The charges don't reflect the truthful answers that have been given to them. I think it's important to get all the facts out on the table. We look forward to May 20."

The Illinois Funeral Directors Association, which is being sued by funeral home directors in an action akin to a shareholders' lawsuit against a corporation, declined comment.

Millions in premiums

The state's charges center on life insurance policies sold by Schainker that insured the lives of IFDA insiders and funeral home directors. Proceeds from the policies were supposed to pay for funerals, but the policies were poor investment tools, the state says, and Schainker served as the IFDA's investment adviser while also selling policies to the association and collecting premiums.

In the notice of hearing, the state says life insurance policies sold in Illinois and other states generated millions of dollars for Merrill Lynch, and Schainker and his colleagues made sure higher-ups knew it.

"The funeral directors associations are an integral part of our current business, as well as our plans for future growth (and I might add significant revenue for Merrill)," wrote Mark A. Summer, a salesman who helped sell policies, in a 2006 e-mail to unnamed Merrill Lynch officials.

Noting that Merrill Lynch had collected more than \$6.3 million in premiums during the first three quarters of 2006 from policies sold in Illinois and two other states, Summer urged the company to increase compensation for himself and Schainker. At the time, the Illinois pre-need fund was running a deficit of about \$40 million and was under scrutiny from state regulators.

While the trust fund generated millions of dollars in commissions and management fees for the IFDA, consumers who bought funeral contracts got none of the earnings and had nothing to gain from investing money in high-risk/high-reward instruments, the state says. Under state law, consumers must be told if money from pre-need contracts is invested in life insurance, but neither Schainker nor the IFDA made required notifications, according to the state.

The state says Schainker earned commissions from sales of life insurance policies to IFDA while also serving as IFDA's financial adviser, and the policies he sold had higher rates of compensation than other financial products. The tax-exempt policies Schainker sold required regular premium payments, and the policies could not be liquidated without substantial tax liabilities, which benefited Merrill Lynch and Schainker, the state says.

"(T)he continuous payment of premiums to maintain the contracts ... ensured a continued and reliable stream of income to Schainker and Merrill Lynch, Merrill Lynch Life Insurance Company and Merrill Lynch Life Agency," the secretary of state's securities division contends. "Lastly, the investments in insurance contracts made it more difficult for the Trusts to transfer their brokerage and advisory business away from Merrill Lynch and Schainker without incurring substantial surrender or tax liabilities."

Bad investments

The policies were bad investments for the trust, in part because they couldn't be liquidated to pay for funerals when the need arose, according to the state. The IFDA, acting on Schainker's advice, bought more than 300 life insurance policies from seven issuers, paying nearly \$88.3 million in premiums, including more than \$32 million to Merrill Lynch Life Insurance Co., the state alleges.

Schainker and IFDA illegally solicited permission to insure funeral home directors by offering them free \$25,000 life insurance policies, paid for with trust money, if they allowed IFDA to insure their lives, the state says.

The state says Schainker didn't tell IFDA what kinds of investments were being made. As recently as last summer, the state says, Schainker told IFDA officials and funeral home directors that no money was invested in a form of life insurance that can't be liquidated or borrowed against without tax consequences, the state alleges. In fact, the state says, IFDA's trust had 88 such policies, and those policies jeopardized the trust's tax-exempt status.

Furthermore, the state says, Schainker used Illinois as an example to funeral directors in Mississippi and Alabama, telling them that his investment strategy had a guaranteed rate of return, even though that wasn't the case.

Draper says his client operated within the rules of Merrill Lynch. William Halldin, Merrill Lynch spokesman, declined to say whether Schainker followed company rules, or whether Merrill Lynch was aware that Schainker was allegedly offering guaranteed returns.

In addition, Schainker performed no actuarial studies to determine whether life insurance policies on funeral home directors would generate sufficient money to pay for funerals when consumers died, according to the state.

"Fundamentally, there was no economic or actuarial correlation between the life expectancies of the insured and the pre-need contract purchasers," state regulators say in the notice of hearing.

In 2001, the fund had a deficit of more than \$10.3 million, according to the secretary of state, and the deficit only got worse. In 2006, the state comptroller's office, which regulates the pre-need funeral industry, notified IFDA that the deficit was \$39 million and that the situation was intolerable. Last fall, the fund's value was written down by \$59 million to balance the books.

Rather than paying fixed benefits, the policies purchased by funeral directors pay out based on the performance of investments made with premium money.

Lawyer: IFDA to blame

Draper said IFDA is to blame for any shortfalls in the pre-need trust and that IFDA officials received monthly statements showing how funds were invested.

IFDA, not Schainker, decided how much to invest in stocks as opposed to money markets and other low-risk instruments, Draper said. Instead of re-investing when times were good, Draper said, IFDA siphoned money out of the fund. In a lawsuit against IFDA, funeral home directors say the association paid interest to funeral directors with money in the fund, even when the fund was running a deficit.

"Ed Schainker gave the best investment advice he could give, but he couldn't make the market perform the way people want," Draper said. "Were there times when the amount of growth and the value of the fund exceeded expenditures? There certainly were, and funeral home directors reaped a significant benefit. They (IFDA) spent money without investing it. ... They gave bigger returns to the funeral directors than they needed to."

The state says money from new pre-need contracts was used to pay premiums on existing insurance policies beginning in 1997. But IFDA pitched its trust fund to funeral home directors who sold contracts by emphasizing low-risk investments, according to state regulators who quoted from an IFDA sales brochure:

"We will invest your funds predominately in quality, fixed income securities, such as U.S. Treasury securities, government agency obligations, certificates of deposit, corporate bonds, etc. A portion of the funds will also be placed in equities or mutual funds."

Funeral home directors who are suing IFDA quote from the same brochure in their lawsuit. At least one thing is different: In their lawsuit filed more than two months ago, funeral home directors say the fund is worth about \$300 million and contains money from 49,000 state residents. But the secretary of state last week said the fund is worth \$200 million and has funds from "over 44,000" contract purchasers.

Ed Wallace, attorney for funeral home directors who say they're on the hook for any shortfalls, said he doesn't know why the numbers are lower in the state's paperwork.

"That's disappointing to hear," Wallace said. "We'd better find out why."

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The charges at a glance

The Securities Department of the Illinois secretary of state's office is charging Edward Louis Schainker, a Merrill Lynch financial adviser with an office in Springfield, with violating six sections of the state's securities law. Schainker, whose license to sell securities and act as an investment adviser was suspended in February, is facing fines of \$10,000 per violation and a ban on selling securities in Illinois. A hearing is scheduled for May 20. Alleged misdeeds include:

* Illegally enticing funeral home directors to allow their lives to be insured by the Illinois Funeral Directors Association in exchange for free \$25,000 life insurance policies, with premiums paid from a pre-need funeral trust fund.

* Failure to tell funeral directors how money was being invested.

* Failure to perform actuarial analyses to ensure money from life insurance proceeds would be available to pay for funerals.

* Failure to tell funeral home directors and funeral contract purchasers that money was being spent on life insurance.

The pre-need funeral trust fund

A pre-need funeral trust fund once administered by the Illinois Funeral Directors Association is in deep financial trouble. After the fund was written down by \$59 million last fall to balance the books, consumers and funeral home directors have sued the IFDA, its officers, Merrill Lynch and Merrill Lynch financial adviser Edward Schainker, alleging financial mismanagement.

The state comptroller's office in 2007 revoked the IFDA's license under which it managed the trust, one year after finding a deficit of nearly \$40 million. Funeral home directors say that they, not consumers, are obligated to make up any shortfalls.

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