Stranger Premium Financing
R. Marshall Jones, JD, CLU
Chartered Financial Consultant

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1. **There is a new investment industry driven by greed—Stranger Premium Financing.**

   It started less than 10 years ago with a few individual cases of "wet ink" viaticals and has grown like a cancer into an international network that provides the funding to fraudulently manufacture new policies of insurance for the sole purpose of owning life insurance policies on the elderly as an investment.

2. **In my opinion, the 2008 versions of "approved" programs are a disguised form of fraudulent nonrecourse premium financing.** They purport to put the insured at risk by having him or her sign a Personal Guaranty to pay up to 25% of the loan balance in the event of default.

   a. August 23, 2007. Comments made by the promoter/agent to the client's attorney and me regarding an "approved" premium financing program with Transamerica: This is a nonrecourse loan because your personal guaranty will only apply in the event of your suicide, fraud, or canceling the policy during the first two years. The agent is a resident of Miami, Florida. The policy was a $3.5 million contract approved with Transamerica. The client was awaiting the attorney's OK to proceed.

      (Note: Transamerica, Hartford, Phoenix, ING, American General, Lincoln and other companies have approved various premium financing programs because they believe the insured is at risk for at least 25% of the loan balance in all events, including default. This allows the promoter-agents to mislead the insurance company regarding the true intention which, in my experience, is always to purchase the policy for the benefit of "stranger" investors.)

   b. 2008. The attorney for a 77 year old client was told by the lender's attorney that Minnesota law and the UCC rules fully protect the insured from liability under the 25% personal guaranty provision. According to the attorney, if the insured fails to repay the loan after two years, the lender will take title to the policy and transfer ownership to the hedge fund which would take the policy in full satisfaction of the lender's loan from the hedge fund.

      (Note: This was a Lincoln policy and the front lender-agent, a Florida resident, did not want to disclose this to the insurance company. I call him a "Front Lender" because the real investors are rarely identified. In this case, it is a nationally recognized hedge fund. The policy was not placed because the client's attorney advised his client that he would be committing fraud if he allowed

Lincoln to issue the policy based on a false understanding that he had 25% personal liability.)

3. **The insurance companies cannot keep up with the constantly changing forms of fraud used to trick them into thinking these are legitimate policies to protect families.**

   Whenever one agent is terminated, the stranger investor groups recruit two more to replace him.

4. **"Front" agents conduct premium financing seminars for promoter-agents who cannot be licensed in the state of Florida.**

   2007. It is our understanding that some notorious non-resident agents are persona non grata with many life insurance companies. We have heard rumors that front agents list themselves on the Agent's Report for 100% of the commission and have a side agreement with the promoter-agents to pay 50% of the commissions within 90 days of the issuance of the premium financed policy.

5. **Agents conduct seminars to attract elderly clients who may be interested in profiting from their "unused insurance capacity".**

   December 2006. A Florida resident agent wrote the following to a 73 year old Florida resident who attended his dinner seminar: "you should also let this letter serve as my written confirmation to you that once the transaction is completed you will be receiving a purchase price equal to 3% of the death benefit of the policy. Additionally, there will be no out of pocket cost to you or any member of your family."

   December 2006. A senior member of the Florida agent's firm wrote the following to the same 73 year old prospective insured:

   a. "As per our phone conversation, enclosed please find the Trust documents which are in need or your signatures." [It was prepared by the "stranger" investor group.]
   b. "Also, please enclose a check in the amount of $3,100 [payable to the trust]. This check **must be your personal check** and **your signature must appear on the check.** We have attached our company check to you in the amount of $3,100 as reimbursement for these Trust document charges."
   c. "Finally,...I will need a copy of any utility bill as proof of your Florida residence."

   Another member of the agent's firm sent a letter with a $200 check to reimburse the 73 year old man for the cost of making a nominal gift to the lender-prepared trust so that the insurance company would think that he was buying the policy for his family.

Note: This 73 year old man attended the seminar with about 200 people. He told me that most of his friends bought and sold their policies for a big profit. He contacted his attorney who retained me to review the transaction. Unlike most of his retiree friends, this man turned down the offer of $90,000 to purchase a $3,000,000 AXA policy and immediately sell the trust's beneficial interest to the "stranger" investors.

6. **With bad premium financing plans, the "Stranger" investors want the elderly insureds to default on the loan after two years so that the investors can acquire the policies without a formal life settlement.**

June 2006. The representative of an out of state Stranger Financing Company told the attorney and me that the elderly Florida insured had no personal liability. He referred us to the paragraph in the document where the trustee might ask the insured for additional collateral and said the following: In the unlikely event that the insured is asked to post collateral, all he has to do is ignore the request. This will trigger an event of default after 30 days and the investors will take over the policy in full satisfaction of the loan.

The non-resident promoter-agent handled the conference call with the elderly client's attorney. In an email to the attorney prior to the call, the lead insurance broker wrote: "The insured's personal assets will never be liened or perfected as a result of this transaction.... If [after 24 months]...the insured chooses not to provide additional eligible collateral, then (the policy) will be foreclosed upon due to an event of defaults."

Note: This was a Hartford Life policy. Hartford is opposed to premium financing when the policy is purchased with the intent to sell it with a life settlement. I called Hartford on June 12, 2007 and was told that this Stranger Premium Financing Company is approved for premium financing. We were told by others that the lender's loan charges were higher than normal to discourage repayment and encourage a life settlement.

7. **The "Stranger" investors use out of state trusts where the laws are more favorable to STOLI transactions.**

2007. I reviewed a Mississippi trust prepared by the attorneys for a Florida-based Stranger Premium Financing Company. The CPA said the elderly Florida client was assured that the 25% Personal Guaranty would not apply, as described above, so that this would be a nonrecourse loan and the policy could be sold after two years for a profit. The commission was paid to a subsidiary agency of the premium financing company.

2007. I reviewed the Minnesota document package for a client's attorney. The elderly client was a Florida resident. We were told that Minnesota was used instead of Georgia because Minnesota allows a direct loan to the Irrevocable Trust (prepared by the lender-investor's legal counsel).

8. **The promoter-agents trick elderly clients into committing fraud.**

   2007. Statement by the promoter to an 82 year old prospective insured at a meeting attended in Boca Raton, Florida: "We don't want you to lie, but the insurance company will not issue the policy unless we coach you on how to answer their questions [on the application and during the Inspection Report interview]."

   July 29, 2007. The 87 year old Florida resident was approved for a $5,000,000 policy and "promised" but not guaranteed a $350,000 to $400,000 profit on his policy after two years. According to the attorney, the non-resident Florida-licensed insurance agent assured him that his client would have no "skin in the game" despite the document's requirement of a 25% guaranty.

9. **Promoters of Stranger Premium Financing hold dinner meetings and seminars to recruit agents and teach them how to get these policies issued and protect themselves from liability.**

   I have studied many applications and situations and, in my opinion, it is impossible to get these policies issued without lying (directly, indirectly, or by omission).

10. **Elderly clients and their families don't realize the risks they are taking when they act as the front person for "stranger" investor groups.**

    When the policy of "free" insurance is purchased via these premium financing schemes, the elderly insured must sign a number of documents that indemnify everyone involved in the transaction if the insured has made any material misstatement or material omission that causes the policy to be rescinded or the death benefit to be withheld. Typically, he or she receives a thick stack of closing documents that must be reviewed and signed in a last minute rush.

    In most cases, the elderly have been reassured by the promoter-agents that they are not doing anything illegal. In many cases, the application is signed in blank and the agent fills out the application to fraudulently mislead the insurance company. In all cases, the promoters tell the client that they have absolutely no risk after 24 months because of the policy's Incontestability Provision.

11. **Premium finance promoters pay "finder's fees" to retirees to introduce them to their friends.**

    The elderly people who participate in these schemes don't think they are doing anything wrong.

12. **The promoters are intentionally seeking life insurance where there is no insurable interest.**

2006. I received a mailing from a Naples, Florida law firm that had been sent to all of their older estate planning clients. The letter on law firm letterhead described the unique asset they could sell—their unused insurance capacity. Clients over the age of 70 were encouraged to sign the enclosed authorizations to find out if they would qualify for nonrecourse premium financing. The letter included an example of the profit the client could make with a life settlement after two years.

2007. A client described how he had helped his elderly father purchase and sell life insurance policies every 24 months for almost 6 years. The third investment insurance tranche was scheduled to reach the two year incontestability period in 2008 and be sold through life settlements. The policies were purchased from two different Florida agents as a result of seminars his father attended regarding his hidden asset—his unused insurance capacity.

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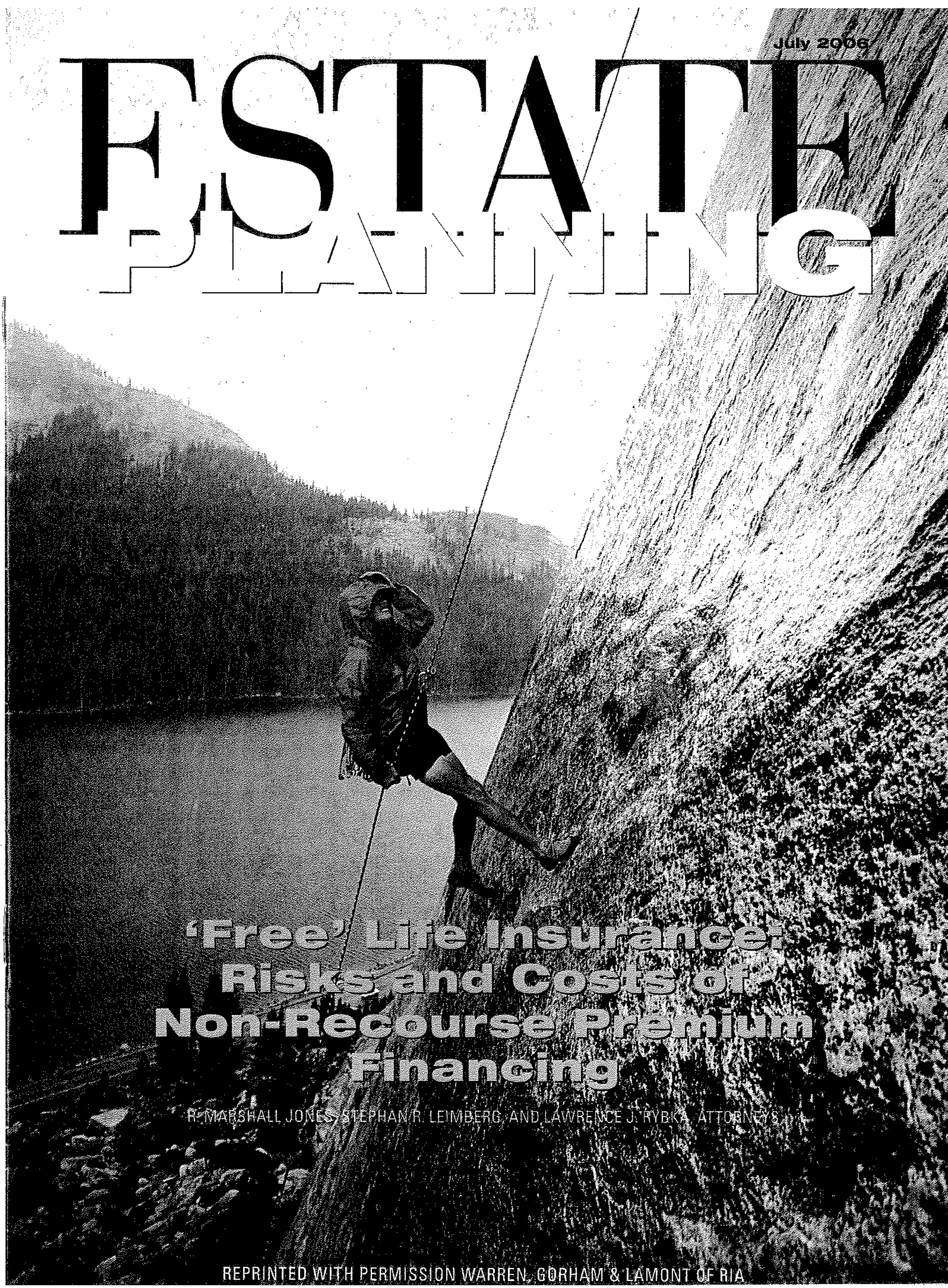
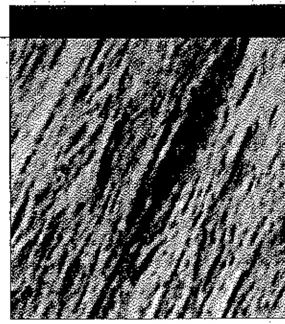
July 2006

ESTATE PLANNING



'Free' Life Insurance: Risks and Costs of Non-Recourse Premium Financing

R. MARSHALL JONES, STEPHAN R. LEIMBERG, AND LAWRENCE J. RYBKA, ATTORNEYS



'Free' Life Insurance: Risks and Costs of Non-Recourse Premium Financing

Non-recourse premium financing arrangements purport to offer insureds 'free' life insurance coverage for two years—but there are risks, including violations of state insurance laws, violations of securities laws, and uncertain tax costs.

R. MARSHALL JONES, STEPHAN R. LEIMBERG, AND LAWRENCE J. RYBKA, ATTORNEYS

Recently, a number of promoters have been offering a new life insurance scheme that promises "free" insurance for two years through various non-recourse premium financing programs. The program is more accurately described as "investor initiated life insurance"[1] because both the initiative for purchasing the policy and the source of funding are from outside investors or lenders who are totally unrelated to the insured. Potential insureds are asking, "Why shouldn't I do it?" and "What have I got to lose?", while advisors, insurance companies, regulatory organizations, and others should be studying the legal, financial, regulatory, and ethical issues involved.

Currently, there are dozens of non-recourse premium financing programs, and promoters are developing new programs and permutations almost daily.[2] Advisors must be able to assess the potentially significant risks of each non-recourse or recourse premium financing program in order to determine if the proposal is better than a free ice cream cone or is an attractive, but dangerous, iceberg that may sink their ship.

This article will (1) explore the iceberg-like features and risks of "free" life insurance arrangements, (2) suggest funding alternatives for clients whose primary objective is to purchase needed life insurance on a cost-effective basis, and (3) provide a checklist to assist advisors as they examine the details of particular "free" life insurance transactions.

The purported major benefit of non-recourse premium financing is to provide the insured with life insurance coverage for two years with no out-of-pocket cost—in other words, "free" insurance. Typically, the insured or the insured's trust[3] uses a loan to purchase life insurance that, in most cases, will

R. MARSHALL JONES is an attorney and President of R. Marshall Jones, Inc., a life insurance consulting firm, and Legacy Solutions Group, LLC, a family wealth planning firm, in West Palm Beach, Florida. He is a non-practicing member of the Florida Bar and holds the designations of Accredited Estate Planner, Chartered Financial Consultant, Chartered Life Underwriter, and Fellow of the Life Management Institute. STEPHAN R. LEIMBERG is an attorney and is CEO of Leimberg and LeClair, Inc., an estate and financial planning software company; President of Leimberg Associates, Inc., a publishing, software, and marketing consulting company in Bryn Mawr, Pennsylvania; and Publisher of Leimberg Information Services, Inc. which provides e-mail-based news, opinion, and information for tax professionals. He is also a former adjunct professor in the Masters of Taxation Program of both Temple University School of Law and Villanova University School of Law. He is a nationally known speaker on the topics of taxation and estate planning, and co-author, with Howard Zaritsky, of *Tax Planning with Life Insurance*. LAWRENCE J. RYBKA is an attorney and CFP®, and is President of ValMark Securities, Inc., an independent broker dealer based in Akron, Ohio, which specializes in working with independent insurance professionals across the U.S. He is a member of the Association for Advanced Life Underwriting ("AALU") and served as the insurance content expert for the CFP® Board of Examiners. Mr. Rybka has lectured and written extensively on estate planning.

be either (1) transferred to the lenders who often have informal arrangements to re-transfer the policy to a group of investors or (2) sold to a life settlement company[4] after the second policy year. Although the insured normally has an option to repay the loan and keep the policy, most programs are deliberately structured to discourage loan repayment and encourage divestiture so that at the end of two years, the policy ownership will be transferred to the lenders in satisfaction of the loan or sold to investors or a settlement company and they—not the insured's selected beneficiaries—will be the recipients of the policy's death benefit.[5] If, as expected, the insured chooses not to retain the coverage after two years, he or she can purportedly "walk away from the loan at no cost" and perhaps enjoy a profit. However, in many cases, the risks may outweigh the rewards.

How does non-recourse financing work?

The mechanics of the typical non-recourse premium financing transaction appear—at least on the surface—to be both relatively simple and benign. But, like an iceberg, a significant, and perhaps the most dangerous, portion of the transaction lies below the surface. It is therefore essential for advisors to carefully review all documents, authorizations, marketing materials, and representations to become aware of the legal, practical, and ethical implications.

Most "free insurance" financing programs are marketed primarily to individuals between age 72 and 85 who have a net worth of at least $5 million and the financial means to acquire large amounts of life insurance.[6] Marketers search for individuals with so-called excess insurability.[7] Ideally, these insureds will have mild health problems that will not be serious enough to discourage the insurance company from issuing a policy at standard or preferred rates, thereby increasing the investors' expected profit. (The sooner the insured dies, the greater the investors' profit!)

A typical 'free insurance' premium financing arrangement

An example of a typical non-recourse premium financing arrangement is shown in Exhibit 1, which depicts the planned sale of a policy to a life settlement company. Although there are many variations of these plans, the following steps provide a typical "above-the-surface" view of what a client and his advisor might see before carefully reviewing the documents.

Step 1. The prospective insured is promised one (or a combination) of the following if he or she qualifies for the program: two years of free life insurance; an up-front cash distribution of 1-1/2% to 3% of the death benefit (or a free luxury car);[8] a portion of the net profits from the expected sale of the policy to a life settlement company after two years or, in some instances, another 1-1/2% to 3% of the insurance benefit when the insured dies.

Step 2. The client secures a non-recourse premium financing loan from the lender to finance a life insurance policy.

Step 3. The proposed insured qualifies for the issuance of a $2 million or larger permanent life insurance policy.

Step 4. The third-party investor group makes or guarantees a non-recourse loan to the non-grantor irrevocable trust created to purchase the policy.

Step 5. As part of the policy purchase, the trust collaterally assigns the policy to the lender.

Step 6. After 24 months or longer, in order to satisfy both the

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1 For additional information about these programs, see Silverman, "Letting an Investor Bet on When You'll Die—New Insurance Deals Aimed at Wealthy Raise Concerns," Wall Street Journal, p. D1 (5/26/05); Leimberg Information Services Estate Planning Newsletters 619, 670, 671, and 676; Davis, "Death-Pool Donations," 143 Tr. & Est. (May 2004); Leimberg, "Stranger-Owned Life Insurance—SOLI: Killing the Goose That Lays Golden Eggs," 32 ETPL 43 (Jan. 2005); Baldwin, "Free Insurance? Caution!," J. Retirement Plan. p. 5 (Mar.-Apr. 2005); Leimberg, "TOLI, COLI, BOLI, and Insurable Interests," 28 ETPL 333 (July 2001); Leimberg Information Services Estate Planning Newsletters 782 ("Proposals on SOLI, CHOLI, and COLI"), 818 ("Bill Attacks Snake Oil Salesmen"), 914 ("New York Insurance Department Opinion on Non-Recourse Insurance Transactions"); and Plevin and Silverman, "Investors Seek Profits in Strangers' Deaths," Wall Street Journal (5/2/06).

2 There are also recourse loan arrangements coupled with special trusts or partnerships designed to accomplish the same objectives.

3 This article refers to the insured as the policy owner. However, many transactions are structured so that the insured's portion of the insurance death benefit is owned by and/or payable to a "non-grantor trust," an irrevocable trust created especially for the premium financing transaction. Other programs may use limited partnerships or limited liability companies, instead of trusts, to own the policy and purportedly insulate the insured from tax and other liabilities.

4 A "life settlement" is the purchase of a life insurance policy by an investor while the insured is alive, and does not involve an insurable interest in the continued life of the insured. The investor benefits only from the insured's death. Typically, the policy owner-seller receives more than the cash surrender value of the policy as the primary inducement to sell the policy.

5 At a minimum, most programs include additional fees and payment requirements that make the repayment option much more expensive than a traditional loan. Even programs that make repayment a reasonable option typically include additional charges to provide the lender-investor with a 15% or greater compounded return.

6 This article later addresses the potential securities issues if the parties to the transaction are not accredited investors or if the promoters fail to comply with applicable securities laws and regulations.

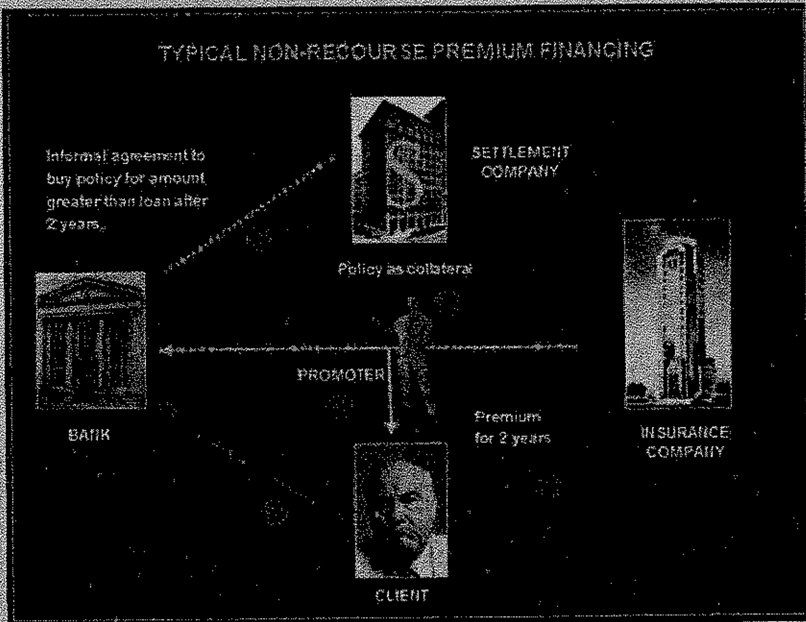
7 The promoters refer to "excess insurability" because they are looking for clients who do not want or feel they have a need to purchase any additional life insurance as part of their personal, business, or estate planning. For example, if the insured has a potential estate tax of $10 million and various insurance companies already have $4 million of life insurance in force on the insured's life, then the insured may have $6 million of excess insurability.

8 One promoter apparently placed a newspaper ad offering qualifying individuals two years of free life insurance and a Bentley!

policy's incontestability provision[9] and state insurance laws regulating the sale of newly issued policies, the insured's trustee chooses from the following options, if available:

1. Repay the loaned premiums with interest along with any cash advances, origination fees, termination fees or other charges; pay all future premiums and keep the policy; or
2. Sell the policy to a life settlement company; or
3. Transfer ownership of the policy to the lenders in full satisfaction of the loan.

EXHIBIT 1
Typical Non-Recourse Premium Financing



What are the risks associated with non-recourse premium financing transactions?

When looking below the surface of a non-recourse premium financing transaction, a thorough review of the mechanics of the transaction may uncover undocumented or ignored elements that may (1) constitute a violation of state insurance law or regulations; (2) raise significant securities regulation and litigation issues; and (3) trigger unexpected tax risk, financial exposure, litigation risk, and, in some cases, potential criminal penalties. When navigating a client through a non-recourse premium financing transaction, advisors should be wary of the icebergs that could sink their ship:

Violations of state insurance laws and regulations

'Free' insurance and the 'insurable interest' rule. Third-party investors offer the insureds two years of "free" insurance because it is illegal for them to purchase insurance on the life of an individual unless the original applicant-owner has an insurable interest at the time the policy is purchased. Without an insurable interest, the policy would be void from inception and the death benefit will not be paid to the investors.[10] To protect the public, all states have insurable interest statutes designed to discourage speculation on an insured's life.[11] Generally, the initial owner and beneficiary must have a strong economic interest in, and benefit from, the continued life of the insured. For example, family members are generally presumed to have an insurable interest in their spouses and parents.

The promoters apparently believe that an initial purchase by the insured, followed by a 24- to 30-month time lapse between the policy's issue date and its subsequent transfer of ownership to the investors (or a life settlement company), will avoid an insurable interest challenge.[12] Nevertheless, legal theories such as "form over substance" or the "step-transaction"

9 Each policy contains a provision that basically says that after the policy has been in force for two policy years, the insurance company may not cancel the policy due to any misstatements or misrepresentations made by the insured.

10 Obviously, courts will examine the actions of the insurer, the insurance agent or broker, and other parties. In some cases, the courts may bar the insurer from asserting a lack of insurable interest if those actions—or failures to act—constitute a waiver by, or an estoppel against, the insurance company.

11 Insurable interest laws vary widely from state to state. A summary of a more liberal and broad insurable interest law reads, in part, as follows: Insurable Interest as to personal insurance means that (1) every person has an insurable interest in him or her self; 2) in the case of individuals related by blood or law, a substantial interest engendered by love and affection; 3) an employer has an insurable interest in an employee to the extent of economic loss; 4) a party involved in an option or contract to purchase or sell a business has an insurable interest in the other parties to the transaction; 5) a trust has an insurable interest in the life of the grantor or anyone else who is treated as owner of such trust for federal or state income tax purposes or in that the trust beneficiaries have an insurable interest in the grantor; 6) a creditor has an insurable interest in an insured's life to the extent of the debt insured. Del. Gen Stat. Title 18 § 2704. See www.leimbergservices.com under State Laws for a summary of every state's insurable interest laws.

12 In addition, the investors intentionally structure the "free" insurance period to extend beyond the two-year contestability provision of the insurance contract and with the intent to avoid running afoul of each state's prohibition against the sale of life insurance as "wet ink" viatical transactions.

or "agency" doctrines may be used to assert that the insurable interest provision was not satisfied and the insurance contract is void.

On 1/9/06, the New York State Insurance Department announced that a proposed premium financing transaction violated the state's insurable interest law and was not permissible under New York Insurance Law.[13] If the insurable interest law is violated, the insured, the insured's trust and estate, and their agents and advisors may become embroiled in unexpected litigation. This could occur either during the insured's lifetime or after death.

Although this is only an Opinion and if binding, only binding in New York State, the authors feel it will be highly persuasive in other jurisdictions. The insured under the facts of that Opinion had a "put," a right to require the put provider, a hedge fund, to purchase the policy from the client at his request on the exercise date and pay an exercise price equal to a pre-determined formula, the sum of which would cover the repayment of the loan by the client, as well as loan interest. Some have claimed that this distinguishes their situation since they don't use "puts." Although the put was clearly a "smoking gun," the authors believe the Office of General Counsel would have concluded that there was a lack of insurable interest even without it.

Fraud and misrepresentation by the insured. The standard life insurance application requires insureds to sign written statements regarding their health, financial circumstances, policy ownership, and the purpose of the insurance. Companies rely on this information as part of their consideration for issuing coverage. The answers to most of these questions become part of the contract.

Most life insurance contracts provide that the policy may not be contested by the insurance company after two policy years.[14] For more than 100 years, the incontestability provision has helped maintain public confidence that the death benefit will be paid as promised to the beneficiaries without delay or challenge. Meanwhile, the provision gives the insurance company a reasonable two-year period to rescind the life insurance contract if it discovers any undisclosed or misrepresented facts that rise to the level of a "material misrepresentation" that would have kept the policy from being issued as applied for.[15] After two years, the validity of the insurance contract may be challenged only in a narrow set of circumstances based on law that varies from state to state.

At this point, the insured may ask, "Why should I care about these issues?" The answer is submerged in the murky fine print in the mound of documents the insured signed—the indemnification provisions for this "free" insurance!

A standard part of "free insurance" premium financing transactions is an indemnification provision whereby the insured agrees to indemnify the lenders and investors for any loss resulting from a material misrepresentation or omission. The insured, or the insured's family, may be liable for the investors' loss—potentially the multi-million dollar death benefit that was not paid to the investors—if any misrepresentation of these items is discovered during the contestable period. If the misrepresentation is intentional and material, it may give rise to fraud that extends beyond the contestable period.

In particular, fraud constitutes one of those narrow circumstances that have allowed companies to contest a policy beyond the two-year period. If the insurance company chooses to contest the policy, these contract provisions could trigger indemnification liability, plus the time and expense of litigation, and the possible charge of felony insurance fraud.

With an allegation of fraud and a subsequent policy contest, the outcome could be even more uncertain if the beneficiary was an investor and the documentation showed a purposeful misrepresentation of true ownership by the insured or an undisclosed intent to transfer the policy from its inception. When misrepresentations and omissions rise to the level of fraud, the insurance company may have a right of rescission that continues beyond the insured's death.[16]

If the insured, the insurance broker, or the insured's advisors fail to answer fully the questions on the applications, medical forms, oral interviews, inspection reports and other documents, the insurance company may be misled into issuing a policy that the insurer can later argue is void and unenforceable.[17] The insured is responsible for verifying these statements before signing the application. If the insurer successfully contests the death claim, the investors may seek to recover from the insured, the trust, or the estate under the investor indemnification provisions regarding material misrepresentations or omissions.

How could this happen? First, there may be a significant risk of mate-

[13] See "Opinion from the Office of the General Counsel," 12/19/05, representing the position of the New York State Insurance Department, published 1/9/06.

[14] Each state has its own incontestability provision designed to assure the payment of benefits on validly issued policies. A typical incontestability clause stops the insurer from contesting the death claim after the policy has been in force for two years. See "The Incontestable Clause in Life Insurance Policies—A Statute of Limitations, But Not a Confession of Judgment," 7 Newark L. Rev. No. 2 (June 1942), for the traditional approach to the question. Also see Link, "Viatical Settlements: What Do the Courts Have to Say?," presentation at the ABA Tort and Insurance Practice Session (1/11/01), for a more contemporary discussion of the issue.

rial or fraudulent misrepresentations and omissions when both the insured and the investors are seeking nothing more than minimum technical compliance with the insurable interest law. In reality, there is only a temporary or nominal "insurable interest" disguising the true intent of the transaction to pass ownership to the investors.[18] An incomplete or misleading answer by the insured or by others on behalf of the insured—though not intentionally fraudulent—may be sufficient to create liability.

Second, the insured may not be aware of his or her representatives' material misrepresentations or omissions even after a careful review of every aspect of the transaction, including every statement in the application. For example, it is standard practice for the insured to provide verbal answers that are recorded by others. On the application and medical forms, the insured's signature is a representation that the information provided is true and correct to the best of the insured's knowledge and belief.

Once it became apparent that many non-recourse premium loans were, in reality, a disguised means of settling new policies with investors, an increasing number of U.S. insurance companies created internal policies to identify and prohibit these transactions. Some companies included new questions in their applications, agent reports, and personal interviews to help identify these transactions and deny coverage. The following are the sort of questions found on the life insurance applications of insurers who disapprove of non-recourse premium financing transactions:

- Is there any intention that any party, other than the owner, will obtain any right, title, or interest in any policy issued on the life of the proposed insured as a result of this application?
- Is there any debt being used to finance this policy? If so, provide complete details as to the terms and parties involved.

Even for those who accept the other risks associated with these transactions, it is certainly unethical and probably criminal for any promoter to "coach" the insured to answer questions in anything other than a complete and accurate manner.[19]

Rebating. Another area of risk to insureds is the use of cash incentives to purchase the policy. The New York State Insurance Department General Counsel Opinion, citing lack of insurable interest for one of these transactions, also made the point that free insurance might constitute an illegal rebate.[20] Most state insurance regulations either prohibit or severely restrict the offer of rebates to clients who buy insurance. The few states that allow this practice require that any rebates fit within specific parameters established by the state. Settled case law holds that life insurance rebates are generally non-deductible by the payor and taxable income to the recipient.[21] Clearly, any offer of cash, cars, or any other similar inducement could constitute a taxable rebate.

In addition to unfavorable taxation, the characterization as a rebate increases the insured's risk of liability. While most insureds may see this only as a technical violation of the law by the person selling the insurance, it has potentially adverse consequences for the owner as well, including the voiding of any professional liability insurance in the transaction. This would make monetary recovery against the broker or agent, in the event of a lawsuit, less likely.

Violations of state insurance statutes on 'wet ink' viaticals. Many states have enacted model statutes prohibiting the sale of life insurance as an investment for the benefit of a disinterested third party. Furthermore, to guard against so-called wet ink viatical transactions (i.e., the sale of a newly-issued policy to a life settlement company "almost before the ink is dry"), the National Association of Insurance Commissioners' ("NAIC") Viatical Settlements Model Regulation has been adopted by a number of states to prohibit the sale of insurance policies within 24 months of the policy issue date.[22] This restriction applies to both policy owners and licensed life insurance agents and brokers. There are two risks involved:

First, unless the state where the policy is issued has provided a written opinion to the contrary, the "free" insurance transaction may be invalid as a "step transaction"

[15] See, e.g., Chawla v. Transamerica Occidental Life Insurance Co., 440 F.3d 639 (CA-4, 2006), *aff'g in part* 2005 WL 405405 (E.D. Va., 2/3/05).

[16] See, e.g., Horowitz v. Federal Kemper Life Assurance Co., 57 F.3d 300 (CA-3, 1995).

[17] It is not sufficient to rely on the promoter's assurances that the insurance company knows all the details and has approved the transaction. Even those relatively few insurance companies that have intentionally allowed policies to be issued with non-recourse premium financing have also refused to "endorse" or "approve" the promoter's program or the specific transaction. The advisor and the insured must confirm and document that full disclosure has been provided in the event the insurance company subsequently decides to file an action to void the contract or deny the death benefit. See SEC v. Mutual Benefits Corp., et al., 408 F.3d 737 (CA-11, 2005), and the accompanying state actions on this case for examples of legal transactions involving fraudulent applications. See also the fraud provisions of the NAIC Viatical Settlements Model Act, ¶ ¶ 1F(1) and 1F(2)(4).

[18] For instance, as the Office of the General Counsel Opinion for the New York State Insurance Department noted, "The policies are arguably not obtained on [their] own initiative as required by New York Insurance Law."

[19] Query: Does the trust or other entity have a *Chawla*-type insurable interest issue? See note 15, *supra*.

[20] See note 13, *supra*.

violation of the state's prohibition of wet ink viatical sales.

Second, the "free insurance" transaction may provide additional grounds beyond contract law for the state or the insurance company to invalidate the transaction as an illegal "intent to settle"—i.e., a disguised, illegal life settlement transaction in violation of the insurable interest rules.[23]

Proving intent can be difficult. It can be expensive to defend, too! What are some of the factors that might evidence an illegal intent to settle? Here are a few:

- The insured's signed authorization permitting a subsequent sale to a life settlement company.
- The almost universal presence of a life expectancy evaluation before the loan is granted to predetermine the value of the policy to the investors.
- The profit motive for the insured and the other investors detailed in a careful reading of the documents.
- Marketing materials describing the insured's financial benefits for allowing the investors to use his or her "excess insurability."
- Letters and e-mails from advisors and promoters detailing the steps to follow to benefit from the transaction.
- The reality that the original "insurable interest" owner rarely—if ever—intends to, or actually does, repay the loan and accrued interest, pay future premiums, and keep the policy.
- The overall facts and circumstances show the insured participated in the investment of money in a common enterprise involving an expectation of profits based solely on the instigation and efforts of a third party or parties.[24]

Potential securities law issues

Potential violations of federal or state securities law. In addition to insurance law issues, advisors must consider these programs as possible securities transactions. Insureds, their advisors, and insurance agents/brokers may face significant, long-term financial exposure if the non-recourse premium financing transaction is a security but not structured to be fully compliant with federal and state securities laws.

One of the more serious and often overlooked transaction risks is the possibility that the insured, the trustee, and the advisors are participating in the issuance, sale, or solicitation of unregistered securities in violation of sections 5(a) and 5(c) of the Securities Act of 1933. This risk should cause great pause because transactions falling under securities law may require very specific disclosure in the transaction and many additional statutory remedies.

In May 2005, the Eleventh Circuit affirmed a U.S. District Court finding in *SEC v. Mutual Benefits Corp.*[25] that "...these viatical settlement contracts qualify as 'investment contracts' under the Securities Acts of 1933 and 1934...." As a result, the directors and officers of the Mutual Benefits life settlement company were subject to both civil and criminal penalties for the illegal sale of unregistered securities and securities fraud.

The insured may think, "I haven't done anything wrong if I sell my policy two years from now and receive part of the proceeds." Similarly, most advisors and life insurance agents will argue that they are merely selling insurance. However, when the entire transaction is viewed from a broader perspective, it has all the elements of an investment under the classic *Howey*[26] test:

- An investment of money,
- With the expectation of profit,
- Based solely on the efforts of a third party or parties.

Indeed, prior to the *Mutual Benefits* case, the investment firm UBS carefully packaged several blocks of life insurance contracts as private placements under the acronym of "LILAC" ("life insurance leveraged annuity contracts"). Most promoters have not been so careful. Now, after the *Mutual Benefits* decision, the costs of being wrong on this particular issue are even higher. There is added risk of not only an unlimited right of rescission of the transaction for investors, but also the possibility of criminal prosecution. The securities classification risk is even higher if the "loan" comes from a securities-regulated entity, such as a hedge fund. In addition, the representations made to the hedge fund by the client, trustee, or promoters may give a cause of action to the hedge fund and its ultimate investors as in *Mutual Benefits*. Moreover, any misrepresentations can give rise to a claim of securities fraud by the insurance company, lender, or third-party investors.

Prior to the *Mutual Benefits* case, the settlement industry consistently cited a district court decision, *SEC v. Life Partners, Inc.*,[27] as the basis for insurance regulation of the settlement business. Despite the *Life Partners* decision, the SEC has persisted in its opinion that investments in settlements are securities. The precedent of the *Mutual Benefits* case creates a cavalcade of

21 Haderlie, TCM 1997-525 ; Wentz, 105 TC 1 (1995).

22 NAIC Viatical Settlements Model Regulation Rev. 3/16/04; 27 states have adopted the NAIC Viatical Settlements Model Act, and it is pending in eight others. Section 10 provides, "It is a violation of this Act for any person to enter into a viatical settlement contract with a two-year period commencing with the date of the issuance of the insurance policy or certificate...."

potential securities issues for everyone in the chain of the transaction.[28] Competent securities counsel should be part of the team assessing the risk of any non-recourse premium loan or life settlement transaction.

The risk of failure to comply with the Patriot Act. Some countries have more favorable tax laws regarding investor-owned life insurance that make U.S.-issued life insurance policies particularly attractive. Consequently, foreign investors have entered both the non-recourse premium financing market and the life settlement arena. For any transactions funded by entities outside the U.S., the insured's advisors may need to help the insured and the trustee stay fully compliant with anti-money laundering regulations and the Patriot Act.

Tax risks

Along with the insurance and securities law risks, clients and advisors must consider how the transaction will be taxed. There are many uncertainties here as well, as the following discussion illustrates.

The unknown tax cost of the unpaid loan. There does not appear to be any clear or certain guidance regarding the tax consequences related to non-payment of the loan. For example:

- If the insured decides to "walk away" from the policy at the end of the second year and transfer it to the lender in full satisfaction of the debt, is there reportable income and, if so, in what amount for the forgiveness of debt?[29]
- Is there taxable income or gifts to the trust or trust beneficiaries for the annual value of the insurance protection during the two years that the trust owns the coverage? If so, how is it measured and reported?[30]

An argument can be made that any "free" insurance benefit should be taxed as ordinary income and that income tax may be due on 100% of any forgiven loan balance, including all accrued interest and any waived fees or charges. The tax opinions will vary from advisor to advisor and from transaction to transaction.

On behalf of the insured, tax counsel might argue the position taken by some promoters in their marketing materials: that the loan obligation is real and the investors intend to enforce it by either (1) requiring full repayment or (2) transferring policy ownership in full satisfaction of the loan. In the opinion of the promoters' attorneys, any gain to the insured will be taxed, if at all, as a long-term capital gain transaction.[31]

Conversely, the IRS might argue that the insured paid nothing for the insurance and has received a taxable economic benefit. The IRS might also argue the insured also received an illegal rebate in the form of free insurance, cash or other compensation, and was an investor in the transaction. As the recipient of an illegal rebate, the insured may be liable for ordinary income tax on the value of all benefits received, including the value of any initial inducements, advances, and the total amount forgiven.

The *Sutter*[32] case bolsters that potential IRS position. In *Sutter*, the Tax Court held that Mr. and Mrs. Sutter must include, as income, the total premiums paid for the "free" insurance that was funded by an agent's commission leveraging scheme. In this case, the agent set up a financing company to loan the first year premium on a non-recourse basis. The agents received commissions in excess of the loans, and the insureds received free insurance. The insureds then allowed the policies to lapse at the beginning of year two. The Tax Court held that the taxable value of the "free" insurance was the premiums paid.[33]

In the past, an insured might ask his or her attorney for an opinion letter for protection against penalties in the event of an IRS challenge. With the publication of IRS Circular 230, however, an opinion letter may be either unavailable or prohibitively expensive. It may expose other parties in the transaction to IRS penalties as well.[34] The authors haven't seen any "more likely than not" opinion letters from insured clients' counsel affirming the tax and non-tax claims of promoters of "free" insurance.

Additional tax risks—charitable variations of investor-initiated life insurance ('IILI'). Investors are also involving charities in their efforts to acquire life insurance policies that would not otherwise be available because the investors lack an insurable interest in the insureds. One variation of non-recourse pre-

23 In its advisory opinion, New York State said, "...it appears that the arrangement is intended to facilitate the procurement of policies solely for re-sale. It is our view that a plan of this nature does not conform to the requirements of New York Insurance Law." Office of the General Counsel Opinion, *supra* note 13.

24 See, e.g., SEC v. W.J. Howey Co., 328 U.S. 293 (S.Ct., 1946), and SEC v. Edwards, 540 U.S. 389 (S.Ct., 2004), regarding whether a transaction involves a "security" or an "investment contract" covered by the Securities Act of 1933 and the Securities Exchange Act of 1934.

25 SEC v. Mutual Benefits Corp. et al., 408 F.3d 737 . (CA-11, 2005), *aff'g* 323 F. Supp. 2d 1337 (S.D. Fla., 2004). Technically, a viatical settlement is a life settlement transaction involving insureds with a life expectancy of less than 24 months. In the opinion of the authors, the finding in the Mutual Benefits case applies to all life settlement transactions, including the possibility that many—if not all—non-recourse premium financing transactions may be classified as disguised life settlements.

26 SEC v. W.J. Howey Co., 328 U.S. 293 (S.Ct., 1946).

mium financing transactions involves promising modest benefits to a charity or university in order to market to its list of wealthy older donors and alumni.[35] This allows the promoters to identify clusters of potential insureds through a single source. The promoters typically convince the donors to allow the investors to use their "excess insurability" by promising the charity an expected payment estimated at 2% to 5% of the eventual death benefit after payment of all expenses and a guaranteed profit to the investors. In essence, the charity is paid a modest finder's fee. Meanwhile, the charity may not be aware of its potential exposure under the securities laws, the potential 100% excise tax on money going into one of these schemes,[36] the potential harm to its reputation, or the risk to its tax-exempt status.

The risk of estate tax on the death benefit. Because the investors are looking for insureds with a projected life expectancy of 120 months (ten years) or less, advisors must evaluate the risk that the death benefit will be included in the insured's taxable estate if he or she dies during this period. For example, do the mechanics of the loan and any options or veto rights given to the insured or his trustee constitute retained powers under IRC Section 2042, or other Code sections, causing inclusion of the policy in his or her estate? If Section 2042 applies, is there a possibility that Section 2035 may also apply when the policy is transferred to the investors? This can add three years to the risk of estate inclusion.

Furthermore, if the insured must approve the transfer of the policy to trigger loan forgiveness or to repay the loan, will this possibility include the policy in the insured's taxable estate under IRC Section 2042 or 2036 until the transfer and thereby cause Section 2035 to apply? If the insured has a sincere desire to continue this life insurance as part of his or her estate plan (as opposed to selling the policy for a profit), the added tax risk of inclusion in the estate is a high price to pay for this flexibility.

Practical considerations

In addition to the tax, regulatory, and liability risks with these transactions, there are other potential drawbacks. Some are documented in the details of the transaction. In fact, most of the programs require the insured and the trust to formally acknowledge certain transaction costs, including the following.

Confidentiality and qualifying for the non-recourse loan. The investor group will require your authorization to obtain your client's medical records, evaluate your client's life expectancy and, assuming the loan is not repaid, have the right to continue to monitor your client's health until the death benefit is paid. While the insurance company wants your client to live a long time, the investors want your client to live only more than two years from the date the insurance becomes effective. Because many of these arrangements allow re-sale to a group chosen by the lender or investors, there is no way to guarantee that these buyers have adequate safeguards to protect the confidentiality of the client's health information and to prevent or veto the re-sale of the policy to undesirable individuals or groups.

Although the risk of an investor arranging for an insured's death may be very slim, it is greater when the owner-investors may sell or re-sell their policies to individuals or other parties without complying with the confidentiality safeguards required of reputable institutions. Also, there are "clearly litigated cases where one party has procured life insurance on the life of another, and then engaged in nefarious, life-altering actions to facilitate the death benefit payments under the policy."[37]

The cost of repaying the loan and keeping the policy. It is very unusual for an insured to participate in a "free insurance" premium financing program with the primary intent of repaying the loan after two years and keeping the insurance for the originally stated "insurable interest" purpose. In general, the purpose of the repayment option is to give apparent legitimacy to the insurance transaction and not to encourage repayment. In fact, the insured usually has lower-cost private or commercial recourse financing available as an alternative. The decision to use higher-cost non-recourse financing is yet another indication that the insured never intended to pay premiums after the second policy year.

Even the most compliant and professional non-recourse premium financing programs general-

[27] SEC v. Life Partners, Inc., 87 F.3d 536 (CA-D.C., 1996), *rehearing den.*, 102 F.3d 587 (CA-D.C., 1996).

[28] For an expanded discussion of these issues, see Rowland, "The Brewing Storm: Securities Regulation and Lifetime Settlements," J. Financial Service Professionals, pp. 76-84 (May 2003).

[29] See Gans and Soled, "A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference" (to be published), which notes that the IRS may take the position that "The Participant's basis in a life insurance policy must be reduced by the entire acquisition cost." Therefore, "the basis is likely to be very low at the two year point—indeed most of the premium is typically devoted to such costs during the policy's early years."

[30] Some analysts suggest that, at a minimum, these transactions will be governed by the split-dollar Regulations, with annual reportable income determined under either the economic benefit regime or the loan regime for each year that a death benefit is provided until the loan is repaid or cancelled.

ly expect to earn at least a compounded 15% return on equity for the investors. Many programs impose a much higher actual cost of repayment through a combination of exit fees and other charges to dramatically discourage repayment. While a violation of state usury laws does not create direct liability for the insured participating in the transaction, the high rate of interest charged should give pause for advisors to review the economics and give added weight to the concern that the transaction may actually be classified as an investment governed by the SEC.

The 'zero future insurability' risk. Does the insured clearly understand that the use of his/her "excess insurability" may do more than prevent him/her from obtaining additional insurance in the future? It may also prevent the insured from replacing his or her personal and estate planning insurance if updates are desired. In a tightening reinsurance market, the total of all insurance—both existing and applied for—is used to determine the amount of new or replacement insurance available. While this is almost universally disclosed in the documents for these transactions, the implications—especially with regard to replacement coverage—may not be fully understood.

The lack of errors and omissions coverage risk. The many regulatory issues identified above are heightened for an advisor with an insurance or securities license. All professional liability policies have prohibitions and coverage exclusions for transactions involving rebating, "wet ink" transactions, providing false information to insurance companies, and securities violations. In addition, most liability policies exclude coverage for any work involving settlements or viaticals. In the event of a problem, the insured and his or her trust are not likely to be able to look to the promoter's errors and omissions coverage for recourse because most of these issues fall outside the policy coverage as exclusions. Thus, the advisors and, ultimately, the insureds will bear these risks alone, and clearly, the insureds who qualify for and participate in these transactions have much to lose.

What options should advisors consider and what should they recommend to clients?

Reputable agents with clients whose primary objective is to acquire permanent life insurance as part of their estate plan will continue to ask with regard to premium funding, "Are there any 'good' non-recourse premium loan transactions that adequately address the risks and preserve my client's options?"

Even if clients and advisors can get comfortable with a particular transaction from a legal, tax, and regulatory point of view, and have reasonable certainty that the transaction does not pose significant liability, traditional planning techniques may offer lower costs to provide insurance coverage with far more certainty and less potential litigation liability. For example, assume that a 75-year-old man wants to purchase $10 million of life insurance for estate planning purposes. For comparison with non-recourse premium financing loans accruing at 15% per year, the advisor might consider the following options:

• *Alternative #1: A high early cash value policy.* The client could purchase a high cash value product instead of non-recourse premium financing. The annual premium on this policy is $675,373. After two years, the client will have paid a total of $1,350,746 in premiums. If, after two years, the client decides he no longer needs insurance coverage, he can surrender the policy for $1,114,063—the cash value at the end of policy year two. This enables him to walk away with a net balance sheet cost of only $236,683 for the two years of insurance plus the option of continuing it. By choosing a traditional alternative, the client has the additional option to keep the insurance after year two simply by paying the year three premium, because there is no loan to repay.

• *Alternative #2: A minimum premium guaranteed universal life ('GUL') policy with a 'catch-up' option.* With this alternative, the

31 Some transactions are structured to disguise the loan and treat the insured as an investor in a partnership or limited liability company. In those cases, the insured's investment interest terminates at the end of policy year two when the insured chooses not to purchase the other investors' interests.

32 TCM 1998-250.

33 The solution recommended with some non-recourse premium transactions is to draft a non-grantor irrevocable trust to isolate any tax liability within a trust whose only asset is the insurance policy. After two years, the trust signs over the policy in full payment for the loan, leaving the trust with no assets to pay any income tax or penalties. The promoters tell the insured this will insulate him from personal liability. However, this may give rise to a potential IRS tax shelter attack, particularly if anyone other than the client's attorney makes this recommendation. It may also be considered a conspiracy to evade income tax.

34 Circular 230 (Rev. 6-2005) (31 C.F.R. Subtitle A, Part 10 revised as of 6/20/05) basically allows the IRS to hold accountants and attorneys legally responsible not only for what they present in their tax and legal opinions, but also for any omissions of material information.

35 In North Carolina and Texas, for example, legislators changed the definition of "insurable interest" to allow charities and other tax-exempt entities to participate in IILI transactions. In other states, lobbying continues with key legislators to change the insurable interest law and allow IILI transactions for their favorite charity or university.

36 The Senate passed S 20-20 which would impose a 100% federal excise tax, retroactive to 5/4/05, on charitable death benefits associated with versions of investor-initiated life insurance. On 5/8/06, the Board of The American Council of Life Insurance ("ACLI") voted 26 to 4 in favor of a 100% excise tax on the resale of life insurance policies less than five years old.

client could pay the minimum premium required to purchase a GUL policy with a catch-up provision. The premium catch-up provision would allow the client to extend the policy's premium and death benefit guarantees either to a designated age or for life.

In this example, the minimum annual premium to maintain the policy for two years is $279,655. If, after two years, the client decides that he no longer wants the insurance, he can walk away, having paid total premiums of only $559,310. However, if the client decides to keep all the insurance, he can "catch up" to an age 100 guarantee by paying level annual premiums of $477,570 beginning with policy year three.[38] By comparison, if the client is allowed to repay the non-recourse premium financing loans, the cost to continue the policy will include not only the premiums and the loan repayment, but also the accrued interest and any other charges imposed by the lender-investor.

• *Alternative #3: Second-to-die convertible term insurance.* If the 75-year-old man is married and his wife is also age 75, they can apply for a survivorship life ("second-to-die") policy. Some carriers offer this type of policy on a term basis with an option to convert to permanent insurance later. In this scenario, the client would purchase a second-to-die convertible term policy with an annual premium of $77,100. If, after two years, the client decides he no longer needs the insurance, his total cost is only $154,200.

On the other hand, if the client decides to keep the insurance, he can convert the term policy to permanent insurance in year three without taking a new medical exam or providing any additional underwriting information because the conversion to a permanent policy is contractually guaranteed. The premium on the converted permanent insurance is $297,772 annually, making this the least expensive option. In addition, most estate plans defer the payment of estate tax until the second spouse's death, making second-to-die coverage the policy of choice to provide tax-free cash when it is needed.

• *Alternative #4: Non-recourse premium financing.* In a "clean," "fully disclosed" premium financing transaction, the client would take out a premium loan on a non-recourse basis. Using the numbers in the earlier example, when the premiums, loan interest, loan insurance, trust fees, and exit fees are factored into the loan, the client would be faced with a repayment obligation of $1,434,523 and out-of-pocket origination fees of $14,064.

If the client does not want the insurance after two years, his costs will include both the amount paid in origination fees and income tax on some or all of $1,434,523 when the loan is forgiven. Assuming a 35% tax bracket, the client could pay as much as $502,083 plus $14,064 in fees—a total cost of $516,147. However, if the client decides to repay the loan after two years and keep the insurance, he or she must repay $1,434,523 plus the year three annual premium of $442,838. In this example, the client's three-year average outlay after repaying the loan is $630,475.

What is the driving force behind these 'free' insurance transactions?

Considering all the potential drawbacks and the attractive alternatives that offer the same flexibility without the risks, one might ask, "Why would anyone consider one of these transactions?" The first word that comes to mind is "greed." Promoters of these "something for nothing" insurance schemes expect to earn millions of dollars in commissions by selling and then re-selling large amounts of insurance. Similarly, greed can induce clients to act on the promise of something for nothing without an adequate understanding of the risks. It is natural to seek out the "best deal," but advisors must also ask, "Is the best deal the right deal for my client and what are my potential exposures?"

A checklist for non-recourse premium financing transactions

The following list of questions, although not comprehensive, can help clients and advisors analyze most non-recourse premium financing transactions:

1. Is there any direct, indirect, or potential violation of the applicable state's insurable interest rules?[39] (Consider who might have and who has standing to bring this issue up.)

2. What is the risk of the policy being contested due to a material or fraudulent misrepresentation or omission by any party in the transaction?

3. Will the two-year incontestability provision be unenforceable due to either lack of an insurable interest or compelling circumstances, such as fraud or adverse impact on the public interest?

4. What indemnification provisions have the client or the trustee signed that might make the insured, the insured's trust or the estate liable for the investors' losses if the death benefit is not paid?

5. What is the potential for, and estimated cost of, litigation with the insurance company, the SEC,

[37] See Harrison, "Casey Jones, Who's Driving That Insurance Train," a very thorough paper presented at the 2005 ACTEC Summer Meeting. See also DiMassa and Winton, "Two Arrested in Homeless Life Insurance Scam. Pair are accused of obtaining policies on two men who later died in hit and run accidents," LA Times (5/19/06).

the state attorney's office, the IRS, the investors, or disinherited beneficiaries?

6. Are there any cash payments or other inducements that may be treated as (1) illegal payments to an unlicensed insurance agent, (2) illegal rebates, (3) benefits making the insured an "investor" subject to civil or criminal penalties under securities law, or (4) payments making the insured liable for improperly participating in a private securities transaction?

7. Have all parties—insured, trustee, advisors, and insurance agent/broker—made full disclosure of all requested and relevant details to the insurance company and its representatives?

8. Is the insured both aware of, and comfortable with, the loss of confidentiality regarding his or her health status and medical records until the death benefit is paid to the investors?

9. Does the program violate the state's prohibition on viatical settlements as an illegal "intent to settle" or as a two-year "step transaction"?

10. Do the marketing materials—including faxes, correspondence, and e-mails—increase the risk that the transaction may be challenged by the state insurance department, state or federal attorneys, the SEC, unhappy future owner-investors, or others?

11. Is the loan truly non-recourse or do transaction circumstances or details create a recourse loan situation? Does the fact that the arrangement is structured as a recourse loan make a meaningtul difference in the outcomes?

12. What are the tax costs for any benefits received, insurance provided, and loans forgiven?

13. What is the full repayment cost if the insured decides to keep the insurance? Does the transaction make ecomonic sense? Will the client, after all costs and tax exposures, and lacking a guaranteed market at a set price, make or lose money? How do you know?

14. Does the transaction (including any subsequent re-sale) constitute the illegal sale of an unregistered security with potential liability against everyone who assists or participates in the transaction?

15. Will a 100% federal excise tax be imposed in the case of a charity?

16. Is a participating charity risking its reputation or tax-exempt status in the transaction?

17. Will the death benefit be included in the insured's estate?

18. Is the insured comfortable with giving up the right to purchase new insurance and to replace existing insurance for his or her own personal planning?

19. Does the transaction comply with the Patriot Act?

20. What risks to the advisor's reputation and liability are associated with the transaction?

21. Will the transaction be covered under the errors and omissions insurance policy of the advisor, insurance agent, or broker?

22. Is the advisor comfortable legally and ethically with the transaction?

23. Is it the right thing to do?

By being fully informed of what lies beneath the iceberg of nonrecourse premium financing, advisors and their clients can arrive at the best solution—personally, legally, and ethically—for all concerned. ■

[38] If the insured's advisors can accurately estimate life expectancy, they may recommend paying a lower premium in order to maintain the death benefit for a reduced number of years instead of age 100 (or longer).

[39] Some states are revising their laws to prohibit investor-initiated life insurance as a violation of the insurable interest, viatical settlement, and life settlement rules.

Moneylaundering.com News

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Life settlement plans remain a money laundering risk

By Brian Orsak

It sounds like the makings of the macabre thriller: drug traffickers, seeking to hide illicitly obtained funds, buy up the life insurance policies of the ailing and elderly. The sooner those former policy holders die, the greater the return on the criminals' investment.

In a bizarre plot reminiscent of a B movie script, in 2001 and 2002 five men tied to a Colombian cartel were indicted for investing $100,000 in drug proceeds with Jackson National Life Insurance, a company that buys policies from holders wishing to cash in and resell to investors who collect when the original holder dies.

One of the men was also later indicted for laundering money through a similar investment through the now defunct Florida company Mutual Benefits Corp., according to court documents and an April 2007 story in the Life Settlements Report.

But while financial regulators have cracked down in recent years on the wire transfer of illegally obtained funds—the Colombian cartel sent nearly $3 million in wires to U.S. institutions, according to court documents—the growing secondary market for life insurance policies remains a largely overlooked means for money launderers to place money in U.S. banks.

"The life settlements business is a black hole," said Kenneth Rijock, a financial crime consultant with London-based consultancy World Check.

Born as a secondary market for terminally ill patients seeking to tap into the value of their policies while still alive, the viatical and life settlements markets have grown into a multi-billion dollar industry that have seen a "steep growth curve" in recent years, according to Brian Casey, an attorney who follows life settlements for Chicago-based law firm Lord, Bissell & Brook, LLP.

But because the institutions that provide/set up/arrange life settlement deals are not legally considered insurance companies, no anti-money laundering checks are required of them. That lacuna translates into opportunity for launderers and liability for banks, said Rijock.

"It became a major target for money launderers because who's going to ever suspect a check from a Fortune 500 life insurance company?" said Rijock. "You always think that when someone cashes in a life insurance policy, someone else has named them as a beneficiary, but you never suspect it might have been a business deal."

Launderers might invest illicit funds in life settlements both as a means to increase their assets and to hide the origin of the money before placing it in a bank, said Greg Baldwin, a partner at the law firm Holland & Knight in Miami who advises on anti-money laundering.

While life and viatical settlements might be managed by either companies or escrow agents, whatever checks issued will appear to come from insurance policies, he said.

In and out

Launderers might also "park" their funds in life settlements by placing their money with a company for a potential investment but then retracting the sum, feigning that they are no longer interested in the deal. Refunds will be issued as checks, giving the appearance of a normal transaction.

"One way or the other, you're going to get a check, and if anybody looks into it, it's going to look perfectly legitimate," said Baldwin.

Although many life settlement companies, such as Australia-based Life Settlements Fund, have voluntarily set up AML programs, organized crime groups are using clever means to obviate them, said Rijock.

In one case where laundering was uncovered, an organized crime figure tied to controversial, Russian tycoon Boris Berezovsky used both Netherlands Antilles and Gibraltar-based companies to hide a $15 million investment in life settlement policies, a deal that initially passed the inspection of a large U.S. law firm, said Rijock.

Another large viatical company with agents throughout Latin America discovered that a reputed narcotics drug trafficker had placed numerous investments through the company under the names of friends and family, and with the complicity of one of the company's agents, said Baldwin.

"The smart viatical company will have an anti-money laundering program to prevent that, but the ones that want to play at the deep end of the pool, without a life preserver, will take the money and not ask any questions," said Baldwin.

But smaller life settlement companies, interested in early growth, are not likely to spend many resources on finding out who is buying and selling their policies, said Casey.

"Compliance isn't where they throw their money first," he said.

The industry remains unaddressed, in part, because the U.S. Treasury Department decided that investments that aren't redeemable within two years are less likely to be used to launder money, said Baldwin. Life settlement investors base their investments on the life expectancy, usually six months to a few years, of the original policy holders. But because policy holders can outlive expectations, a single investment may last much longer than originally estimated.

The Treasury's view that launderers won't put their money in long-term investments is mistaken, said Baldwin, because "the underlying premise is that money launderers are not investors."

"There are situations where people will invest dirty money and viaticals are one of them," he said.

Casey said he and others recommended to the Treasury Department while the agency was drafting its Patriot Act regulations that it implement AML rules for life settlement companies, but the agency considered the issue a low priority. And future regulations are unlikely to come as long as there are few instances of laundering through life settlements, he said.

The U.S. Treasury did not return queries on regulating viatical and life settlements by press time.

Even if life settlements are defined as insurance companies, and are thus subject to Patriot Act and Bank Secrecy Act regulations, the learning curve will be slow.

"I don't think insurance companies have really full compliance programs yet," said Ellen Zimiles, chief executive of New York-based compliance company, Daylight Forensic & Advisory. "It's all very green territory for the insurance industry, and the banks had the BSA for a long time."

Until regulation comes, financial institutions will have to monitor closely the brokers and companies that deal with life settlements, she said.

"You have to know your broker, as well," she said.

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF FLORIDA

Reliance Financial Group, et al Debtor	**02-33249-PGH Chapter 7**

TRUSTEE'S NOTICE OF SALE

Trustee is selling his right title and interest in 604 Life Insurance Policies with a face value of $88,500,000 with $4,200,000 net cash value. Auction Sale to be conducted on November 8, 2006 in West Palm Beach, FL. Contact John Barbee Trustee via e-mail at jpb@jpbtrustee.com for details and qualifications to participate and acquire these valuable self liquidating assets.

2006 SOUTH FLORIDA SEMINAR ATTENDED BY MORE THAN 200 SENIOR ABOVE AGE 70.

THE GROUP

"The Pride of Choice"

PRESENTS

"A LIFE INSURANCE CAPACITY TRANSACTION"

(The asset you never knew you had)

<u>The Facts</u>

- Life Insurance capacity is defined as the amount of life insurance you could buy…but don't need, want or plan to ever purchase.

- Your mere ability to acquire life insurance could be a valuable asset, worth substantial dollars to you, your family and/or your favorite charities.

- Life Insurance capacity is limited in duration, subject to health and financial constraints and, once passed by, is gone forever.

- There are no obligations or out of pocket expenses to you, when engaging in "a life insurance capacity transaction".

NOTE: This is not an offer to sell life insurance, securities or financing. This information is for educational purposes only. Consult your attorney, CPA and/or professional advisors to determine if any of the information contained herein is applicable for you. Life insurance may only be offered by a licensed insurance agent. Legal advise can only be given by a licensed attorney. There are no guarantees which life insurance capacity transaction you will be offered, if any.

The Opportunity

To create dollars today by using a paper asset, (a life insurance policy not yet issued from a major insurance carrier insuring your life) in a joint venture type of arrangement with one or more of the major financial institutions that want to engage in these transactions.

The Transaction

You allow one or more of these financial institutions to enjoy the benefits of a life insurance policy in exchange for (1) them paying all premiums and expenses associated with it, and (2) sharing a part of these benefits with you.

The Possible Benefits To You

- Income tax free death benefits (***hundreds of thousands to millions of dollars***)
- Up front program acceptance fees (***hundreds of thousands to millions of dollars***)
- Annual cash payments for a number of years (***hundreds of thousands to millions of dollars***)
- Policy sale values at the end of a specified period of time (***hundreds of thousands to millions of dollars***)
- Any combination of the above

The Participation Requirements

- The client is between the ages of 73 – 85+
- Has no terminal or life threatening illness
- Is a non-smoker and relatively healthy for their age
- Is interested in maximizing their financial position or charitable intentions
- Has excess, (unwanted, not needed) life insurance capacity ($2 million or more) and wants to realize its value

The Process-Short and Simple

Step One

You complete our short, introductory application which only allows us to retrieve your medical records, forward them to the insurance company, funding institutions and life expectancy companies for pricing and transaction offers (about 2-3 months).

Step Two

You review transaction offers from the various funding institutions and accept or reject them.

Step Three

If you accept, you take an insurance medical exam and you complete transaction documents.

NOT FULLY DISCLOSED AS OF 02/2007.

Life Insurance Capacity Transaction

Goals)

- Maximize the amount of insurance possible
- Obtain it from the right insurance company(ies)
- Get it at the right price
- Pair it with the right financial institution(s)

The Group

The organization that has the sales volume, underwriting experience, deal exposure, and marketing clout to get you the benefits others can not.

Footnotes

- Life insurance policies are paper assets with 3 distinct values; death benefit values, cash values and capacity transaction values.

- This piece is all about "capacity transaction values".

- Capacity transaction values, if any, are determined by age, health, insurance underwriting, premium schedules, net worth and the current market place.

- Any capacity transaction contract offered from any financial institution is equivalent to winning a "mini lottery" and is considered extremely valuable and beneficial to the recipient. Only one out of every two individuals who apply will qualify.

- You the client do not pick ahead of time which capacity transaction you like best. This is determined by which financial institution/institutions offer you a capacity transaction for consideration.

- The Group represents all the financial institutions that engage in these transactions.

THE GROUP

"The Pride of Choice"

CONTACT US:

PROMOTER REIMBURSES ALL EXPENSES.

TRUST COMPANY TRICKED BY PROMOTER

THE GROUP

"The Pride of Choice"

, 2006

Dear

Please find enclosed:
2 trust documents
W-9 form
These 2 trusts are the ones that will be used to hold the life insurance policy and to facilitate your transaction. The W-9 form is needed for accounting purposes. Please Sign where indicated.

Additionally

Life insurance application, signature pages only.

2 copies of the Financial Statement, please fill out 1 copy and leave the other one blank. Please sign these where indicated.

Make a clear LARGE copy of your driver's license and Medicare card. We will follow that up with a 5 minute telephone interview to complete the life insurance application process.

Please sign where indicated, and return it to us in the overnight DHL envelope provided.

Also, please enclose two checks, each in the amount of $100. One check should be payable to *Insurance Trust* and one check should be payable to *Family Trust*. These checks **must be your personal checks** and **your signature must appear on the check**. We have already sent our Company check to you in the amount of $200 as reimbursement for these trust document charges.

As always, if you have any questions at all concerning the attached documents, please don't hesitate to let us know.

Thank you

Director of Operations

• Reimbursement for "gifts" to create trusts so the promoter-agent can deceive the insurance co.

• Check issued on or about time insurance was proposed and before application/medicals were done.

FOR SECURITY PURPOSES, THE FACE OF THIS DOCUMENT CONTAINS A COLORED BACKGROUND AND MICROPRINTING IN THE BORDER

LIFE PLANS, LLC

citibank®
CITIBANK FEDERAL SAVINGS BANK

63-8655/2860

06

PAY TO THE ORDER OF [PROPOSED INSURED — AGE 73] $ **200.00

Two Hundred and 00/100** DOLLARS

MEMO

AUTHORIZED SIGNATURE

SECURITY FEATURES INCLUDED. DETAILS ON BACK.

9

FLORIDA RESIDENT – AGE 73

THE GROUP

"The Pride of Choice"

- LEGAL COSTS TO PREPARE TRUST PAID BY PROMOTER – AGENT.
- TRUST PREPARED BY INVESTOR'S ATTORNE
- INSURANCE COMPANY DECEIVED
- INSURANCE COMPAY WILL NOT BE NOTIFIED WHEN THE BENEFICIAL INTEREST (THE POLICY) IS SOLD TO THE INVESTORS.

2006

FL

As per our phone conversation, enclosed please find the Trust documents which are in need of your signatures. This Trust document is the one that will be used to hold the life insurance policy and to facilitate your transaction.

Please sign where indicated, and return it to us in the overnight DHL envelope provided.

Also, please enclose a check in the amount of $3,100. This check should be payable to [YOUR] *2007 Insurance Trust.* This check **must be your personal check** and **your signature must appear on the check**. (A joint account is acceptable as long as you sign the check.) We have attached our Company check to you in the amount of $3,100 as reimbursement for these Trust document charges.

Finally, if you haven't already, I will need a copy of any utility bill as proof of your Florida residence.

As always, if you have any questions at all concerning the attached documents, please don't hesitate to let us know.

All Paper Back & Signed

Thank you and regards.

AB Famly trst
AB tax trst
Original only

Senior Account Executive

FRONT OF CHECK

INDUCEMENT TO FUND TRUST WITH
$3,100 Personal check, per letter from ins. broker.

LIFE EQUITY

FIDELITY FEDERAL BANK & TRUST

12/ /2006

PAY TO THE ORDER OF PROPOSED INSURED - AGE 73 $ ***3,100.00

Three Thousand One Hundred and 00/100 DOLLARS

MEMO

AUTHORIZED SIGNATURE

Details on Back. Security Features Included.

291

[BACK OF $3,100.00 CHECK FROM PROMOTER.]
NOTE: THIS ELDERLY PERSON WAS ONE OF ONLY A FEW WHO DID NOT ACCEPT THE MONEY AND WALKED AWAY.

ENDORSE HERE:

X

DO NOT SIGN / WRITE / STAMP BELOW THIS LINE
FOR FINANCIAL INSTITUTION USAGE ONLY

Security Features	Results of document alteration:
Microprint Line	• Small type in signature line or border appears as broken line when copied
Security Screen	• Absence of "Original Document" verbiage on back of check.
Chemical Protection	• Stains or spots will appear with chemical alteration.
Background Pattern	• Absence or modification of the background pattern would be visible.

Padlock design is a certification mark of Check Payment Systems Association

THE GROUP

"The Pride of Choice"

OFFER TO PURCHASE $3,000,000
AXA policy AT TIME OF ISSUE
BY PURCHASING THE BENEFICIAL
INTEREST IN THE POLICY.

2006

[FLORIDA RESIDENT
AGE 73]

N.Y.

Dear .

Enclosed please find as promised:

1) The complete life insurance application minus the signature pages which you have that we need signed and returned.
2) Exhibits A & B

you should also let this letter serve as my written confirmation to you that once the transaction is completed you will be receiving a purchase price equal to 3% of the death benefit of the policy. Additionally, there will be no out of pocket cost to you or any member of your family.

I have enclosed a return DHL envelop for the return of all the documents.

Warm regards,

Chairman

**"FREE" INSURANCE:
SOME THINGS I'D TELL MY MOTHER**

Stephan R. Leimberg

The elderly (typically 70 or older) parents of some of my closest friends have been approached by insurance agents selling what some call investor-initiated life insurance, others call stranger-owned life insurance, and still others call speculator-initiated (SPIN) life.

These senior citizens and their families come to me because I've written two major text books on life insurance, lectured in the graduate divisions of two law schools and throughout the country on the topic for over 40 years, and provided advice and consultation to Forbes, Fortune, the Wall-Street Journal, and the New York Times, and BusinessWeek on insurance and estate planning.

They also come to me because they know I have a better than average sense of "smell" - and an exceptional track record predicting many "too good to be true" insurance schemes that ended up in trouble.

Although the scheme takes many forms and is constantly mutating, "free" insurance is pitched essentially this way:

We ask that you do two things for us:

The first is for you to make certain medical and other personal information available to us.

The second is that you do something which we can't legally do directly. We can't buy millions of dollars of new insurance on your life. That would be illegal. So we'd like you to take out the insurance for us by pretending to take it yourself out for your own needs. Just tell the insurer you are buying it for "estate planning purposes." (We may "puff up" your wealth and/or income so you can qualify for a multi-million dollar policy and make even more money).

In return, we'll provide you with millions of dollars of "free" coverage for two years. We'll do that through no-risk financing which we'll arrange.

Now we know you don't really want or think you need any new insurance and that's fine with us. Because we both know, that's not what this is all about. At the end of the two *years, you can sell this two year old insurance to us and make a heck of a profit! In many situations sellers have been getting more than enough to easily pay off the premium loans, interest, and - even after brokerage costs - make a very handsome return. That's in addition to your two years' free insurance.*

But wait - there's more! If all that's not enough, we will offer you an immediate "sign-up" bonus of – say 2% of the death benefit! So if you buy $1,000,000 of insurance, you get a check for $20,000! Buy $5,000,000 of insurance, we'll write you a check - today - for $100,000.

And if you don't get an offer you like, in a worst case scenario, we've arranged for the lender to agree to take the policy in total payment of your debt. You'll owe nothing - no matter how large your debt or how little the policy is then worth. And of course, you can always keep the policy. You just have to pay back the loan, the interest, and other charges and pay premiums from that point on.

One more time: You have no real outlay, no risk, and you may pocket hundreds of thousands, maybe millions of dollars - merely by allowing us to take advantage of your "unused insurance capacity."

My friends want me to tell them this free lunch will taste as good as it looks.

So what do I tell them? I'd say:

Investor-initiated life insurance is **FRAUD.** It's **theft by deception** of the insurer - AND it's a **VIOLATION OF THE INSURABLE INTEREST LAWS** of every state in this country. It starts with a purchase the investors can't legally make on their own. Ask them - they'll tell you! It's unlawful for strangers to buy insurance on your life. **So your participation makes YOU complicit in helping them do something illegal - something the law clearly prohibits!**

Want some proof?

Section 13. Prohibited Practices - of the National Conference of Insurance Legislators (NCOIL) Model Act specifically provides that **it is unlawful for any person to enter into a life settlement contract if such person knows or reasonably should have known that the life insurance policy was obtained by means of a false, deceptive or misleading application for such policy. So if the Act is effective in your state and you omit mentioning the true reason for purchasing "free" insurance (to turn around and sell it), you may be barred from selling the policy to the very group of investors who encouraged you to buy it!** Worse yet, Section 14 B-1(a) - Fraud Prevention and Control - of the NCOIL Model Act provides: **"Any person who knowingly presents false information in an application for insurance or life settlement contract or a life settlement purchase**

agreement is guilty of a crime and may be subject to fines and confinement in prison."

A recent Texas alert is a reminder that **filing an application for insurance containing materially false information may be prosecuted as insurance fraud and subject the actor to civil and criminal penalties.**

In fact, in every state, insurance fraud is a serious misdemeanor or felony and in many cases will be punishable by jail time!

So Mom, fudge the facts on your application and I'll bring you a file in your next birthday cake!

If that's not enough, here are **more things I'd tell my mother**:

1. You are selling away your "life." Once investors get the policy on your life, no matter how much your family or business needs new coverage (and the insurance company wouldn't issue the policy if they *didn't* think your family or business really *did* need it), you may never be able to get more or replace what is gone. **The amount of insurance that can be issued on a person's life is limited.** If a new policy is issued on through an investor initiated life insurance arrangement, and later sold on the secondary market, **you might not be able to get additional life insurance in the future if the need arises.**

2. **If this is such a great deal for investors, why isn't it an even better deal for your family?** If insurance is *really* needed, why not buy and keep it for your family - rather than have it go to strangers? Have you checked to see if you *really need* the coverage? Life insurance may be far more valuable to your family than as a scheme for making what looks like a quick buck.

3. **Any incentive** (car, cash, trip, or other "gift" to get you to buy the policy) will be **taxable to you immediately as ordinary income.**

4. **The "free" insurance isn't free at all! You may have to pay tax each year on the economic value of the coverage that's provided for you.** There are several theories upon which the IRS

could base the tax - and reporting that income can be very expensive.

5. If you decide to turn over the policy to the lender and "walk away from the loan," its highly likely that the IRS will treat discharge of indebtedness as ordinary income. In other words, **you may incur significant income tax - and will have nothing to show for it.**

6. **If you sell the policy to a settlement company, your gain will be all or mostly all taxable at ordinary income rates.**

7. **Your family may never get any insurance - even if you die within the first two years.** Why not? Because if the insurance company discovers that the intent from inception was for you to sell the policy to investors, the insurer may rescind (take back) the policy. Most major insurers have stated publicly that they don't want to be involved in these schemes. So if you shade the truth or misdirect or omit essential information, your failure of candor may amount to what lawyers call a "material misrepresentation." **The insurance company potentially could void the policy after it is issued, based on a theory of fraud or lack of insurable interest.** Now you are (at best) involved in expensive and aggravating litigation.

   Worse yet, **if you are found to be deliberately less than completely honest in answering the questions you are asked** - for instance if you say or imply your intention in taking out the insurance is to protect your family or your business, but the insurer later proves (based on marketing materials and your own sworn testimony of what was said to you) that the intent all along was to re-sell the policy to investors, **you may have engaged in insurance fraud; in many states, as I noted before, that's a felony (criminal) offense.**

8. **Your estate is potentially liable to investors for millions of dollars!** These arrangements are document intensive. You are going to be asked to sign many many documents. Those highly complex legal papers are designed to protect the investors' and lender's interests (That's a polite way of saying that the provisions you agree to are stacked in favor of *them* – the investors and the lenders - and not you!). You may be asked - perhaps in words that are not very clear - even to a savvy attorney - to make certain guarantees to the lenders

and investors. If *after* the investors have purchased the insurance on your life, for some reason *they* can't collect, those investors may sue your estate for he insurance they expected to receive - but didn't.)

9. **No matter what you think you've been told, typically, the investors are not bound to purchase the policy from you at the end of the two years! You may not get anywhere near the amount of the money you expect. After taxes, you may even suffer a sizeable overall loss!**

   You bear almost all of the risk! The investors will not guarantee that they will buy the policy from you at the end of two years. Even if they *do* offer to buy it, they may offer much less than you anticipated. Why? One reason is that the sooner *you* die, the more profit *they* make. If your longevity - has for *any* reason improved at the end of two years, the policy on your life is not as valuable to them as they originally predicted. The problem is that what they decide at that time to offer you may not be enough for you to pay off your debt (a bank has been lending you hundreds of thousands of dollars to pay premiums for two years!).You'll still have to pay huge interest charges, brokerage fees, and income taxes - *if* you have any gain. And of course, if you turn the policy over to the lender, you'll end up paying significant income tax because of the discharge of your indebtedness.

   In one case reported in the April 23rd, 2007 edition of *BusinessWeek*, an 82 year old sold his $4.4 million policy for $1.1 million. But once the loan that financed the premiums was paid, he was left with only $361,256 - and after he paid a fee of $200,000 to the lender and promoter, he netted only about $162, 000! For a $1,000,000 policy for someone with a 7 year life expectancy, attorney Adam Balinsky, a partner at Baker & McKenzie, estimated that a purchaser might pay $250,000, But after paying various fees to middlemen that broker policies, the seller would be likely to take home only about $150,000. From those proceeds, the seller would have to repay the loan plus various lender fees and interest of 12% to 18%. In the end, the insured might only net about $42,000." And that, of course, is *before* state and federal income taxes!

10. **After you sell the policy to the investors (or let the bank take it and sell it to investors), you are the *only* party to the contract that hopes you live a long time.** Make no mistake; **this scheme is nothing less than financial speculation on your life.** Someone you don't know and have never met can profit by your early death. You may receive calls as often as once a month – and the person at the other end will be disappointed – if you answer the phone! You will be told (and will want to believe) that the odds are small of some investor taking steps to profit by your early death. But no one in this deal will - or *can* assure you that it *can't* happen.

    You should also know that **the original investors have the legal right (and often the intent) to sell the policy on your life - immediately - to other investors. There's no legal limit to how many times the policy on your life can be sold - or to whom.** So the policy on your life can end up in the hands of almost anyone (even just one investor) and **you will neither know or have any control over who will be your beneficiary.**

11. The purchaser of the policy will have permanent access to your medical records. **If you sell your life insurance policy on a secondary market, you will have to agree that the purchaser (including any subsequent purchaser if the policy is resold) has power of attorney to access your medical records for the rest of your lifetime.**

What would I tell my mom to do about SOLI?

One word will do.

It's "**DON'T!**"

Stephan R. Leimberg, Esq. is CEO of Leimberg Information Services, Inc., an e-mail and database service providing information and commentary on tax cases, rulings, and legislation for financial services professionals. The 1998 Edward N. Polisher Lecturer of Dickinson School of Law and 2004 recipient of the National Association of Estate Planners and Councils Distinguished Accredited Estate Planner award, Leimberg was also awarded the Excellence in Writing Award of the American Bar Association's Probate and Property Section. He is Editor, Keeping Current, a quarterly publication of the Society of Financial Service Professionals, has served as Adjunct Professor in the Masters of Taxation Programs of both Villanova and Temple University Schools of Law, and is on the Editorial Board of The Estate Planning Journal.

RMJ
R. MARSHALL JONES, INC.
Estate Planning & Insurance Consulting

470 Columbia Dr., Suite 100-E
West Palm Beach, FL 33409
Tel: 561 712.9799
Toll Free: 877.600.0029
Fax: 561.712.9899
Planning@RMJplan.com

MEMO

TO: [redacted]

FROM: Marshall Jones

DATE: Wednesday, September 26, 2007

RE: **Stranger Owned Life Insurance—Potential Questions and Background information.***

The enclosed information is confidential and intended solely for the person(s) identified on this cover sheet. If you have received this Memo in error, please contact our office. Thank you.

Definition of Stranger Owned Life Insurance: The creation of new life insurance with the intent of assigning directly or indirectly the policy benefits to investors who do not have an insurable interest, as defined by state law, in the life of the insured.

Insurable Interest. Under the Florida Constitution, the intended owner of a life insurance policy must have an insurable interest in the policy at the time it is issued. When the state's insurable interest requirement is not satisfied, the contract does not qualify as life insurance and the policy is void or voidable under both state and federal law.

Factors to consider when determining whether the insurable interest law has been broken:

1. Sales and marketing materials.
2. The entity that guides and directs the transaction.
3. The terms of all written and related documents.
4. The time that lapses between inception of the policy and the assignment of the ownership or beneficial interest to an unrelated party.
5. All incentives related to the transaction including future promises or expectations.
6. The individual or entity that ultimately pays the premiums.

Questions your client may be asked during an investigation, deposition, or in court:

1. Did the solicitation materials, or offers of financial rewards to purchase life insurance, lead the insured to believe this was a no risk, no outlay, or low outlay profit making venture?

2. Did the insured have a plan to acquire new coverage, sell it later and use the proceeds to fund other new coverage or old coverage?

3. Was the marketing initiated by or guided by investors, promoters, marketing people or their associates?

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* I wish to thank Steve Leimberg, Esq., Editor of Leimberg Information Services, Inc. (LISI®), for sharing his research in the preparation of this Memo.

4. Does an examination of all the documents indicate intent for investors to own the policy for its beneficial interest via a life settlement or other means?

5. How much time elapsed between the policy's inception and the assignment or transfer of ownership or beneficial interest to the investors?

6. Were the insured, other family members, or other family entity provided with any financial inducement, incentive, or rebates to engage in the plan?

7. Did the investors arrange for a premium loan or directly or indirectly pay the premiums?

8. Did the investors provide the trust document or other document(s) for the entity that would initially own the policy?

9. Was the insured directly or indirectly reimbursed for any expenses associated with acquiring the insurance?

10. Was a life expectancy evaluation completed for the benefit of investors or lenders or their representatives prior to or in conjunction with the formal application for life insurance?

11. What in depth discussions occurred with family members and advisors to determine the need for, amount, type, and cost of life insurance?

12. What in depth analysis took place to identify the best policy and company to accomplish the client's insurance goals?

13. Do the circumstances of the transaction (loan or otherwise) make it highly unlikely the insured would have the desire or ability to maintain the policy for the life of the insured?

<u>The Two Year Incontestability Provision.</u> Material misrepresentations regarding insurable interest will allow the insurance company to rescind the insurance policy within two years of issue. The incontestability provision was intended to provide the general public with assurance that the death benefits would be paid to their intended beneficiaries. However, the incontestability provision was not intended to allow intentional fraud to be rewarded. Fraudulent misrepresentations can allow the insurance company to rescind the contract whenever the fraud is discovered.

In looking at stranger owned life insurance cases, courts have a history of looking at the totality of the circumstances and facts to make its rulings based on substance over form and the economic reality of the situation.

<u>Are these life insurance transactions governed by securities law?</u> To provide the investing public with the greatest amount of protection, the definition of "securities" and the scope of authority are intentionally broad. This applies to both federal and state securities law and regulations.

In our opinion, federal and state securities laws can apply to all stranger owned life insurance transactions. In particular, the Securities Act of 1933 prohibits the offer or sale of non-registered, non-exempt securities. With regard to non recourse premium financing, we discussed this securitization concept in our July 2006 Estate Planning magazine article (Vol 33, No. 7) by using the classic test stated in SEC v. W.J. Howey Co., 328 U.S. 293 (S. Ct. 1946). In regard to other transactions where the insured provides a portion of the premium in cash or loan collateral, it is easier to see how the life insurance transaction becomes a security under the three part Howey test:

1. There is an investment of money by each of the parties involved. (With non recourse transactions, the insured invests the value of his unused insurance capacity.)
2. There is an expectation of profit by all parties.
3. The desired profit is expected to come solely from the efforts of a third party or parties.

If the Howey test is satisfied, it is very likely that there was never an insurable interest in the issued life insurance policy. It is my understanding that the SEC and the Commonwealth of Massachusetts both have taken the position in the Lydia Capital case that the hedge fund was engaged in the fraudulent sale of unregistered securities.

<u>2007 Hybrid Premium Financing Transactions</u>. After most major life insurance companies refused to issue life insurance in conjunction with non recourse premium financing transactions, various investor groups have developed alternative strategies to disguise the transaction. Recently, several life insurance companies have approved transactions where the insured has "skin in the game".

Example. The insurance company is told that the insured will be at risk for at least 25% of the loan using his own collateral and that the policy will be purchased for estate planning and not with the original intent to sell. However, the insured is told that he/she will have no cost or obligation at any time and that the insurance company has approved the transaction. As you would expect, the insurance company is not provided with two secret documents. The first is a secret loan to the insured, usually by the agent on a non recourse basis to cover his 25% collateral requirement. The second document is a secret agreement to sell the policy after two years, repay all loans, and provide the insured with a profit estimated at 7-8% of the death benefit.

<u>Stranger Owned Life Insurance is not new</u>. As Steve Leimberg reported in the June 2007 edition of Keeping Current, the first SOLI lawsuit occurred more than 125 years ago! It is the case of Warnock v. Davis (United States Supreme Court, 1881). It has never been overturned. It and subsequent cases reflect the consistent attitude of the courts against life insurance policies procured as a form of policy wager. The courts have been particularly opposed to schemes to disguise the intent of the purchase and facts that indicate a lack of good faith. [Note: the spelling of names has not been verified.]

1. <u>Facts.</u> Henry Crocer, age 27, purchased a large amount of insurance from Protective Life Insurance Company of Chicago. On the same day he purchased the insurance, Mr. Crocer entered into an agreement with Scioto Trust Association of Portsmouth, Ohio. Scioto was a group of investors who agreed to pay all the premiums and costs on a non recourse basis to Mr. Crocer. In return, Henry gave up all rights to 90% of the policy and named his wife, Kate, the beneficiary of the remaining 10% of the proceeds. At Henry's death, Scioto fulfilled its part of the bargain after receiving the

death benefit by paying 10% to Henry's widow, Kate.

2. The litigation. The estate administrator sued Scioto for the remaining 90% of the insurance proceeds. Scioto's defense was that it had a valid agreement and it had fulfilled all the terms of the agreement. The court acknowledged that all the terms of the agreement were valid. The court further held that the life insurance policy was valid and, as the insured's property, was assignable. However, the court also held that Scioto had no insurable interest in the policy. Consequently, it became a wagering policy that gave the investors a "direct interest in the early termination in the insured's life".

3. Insurable Interest. Because there was no insurable interest, the policy with respect to Scioto was deemed a mere wager in violation of public policy. The character of the transaction was not changed by the fact that a portion of the proceeds were payable to the spouse, who had an insurable interest.

4. Public Policy. There was no fraud or deception with this transaction; however, as noted, the transaction violated public policy. The Court said:

   a. Although a policy can be validly assigned, "if the arrangement was a cover for a speculating risk contravening the general policy of the law, it would not be sustained."
   b. And although it is appropriate to assign life insurance policy as collateral for a loan, it is wrong for an investor to receive back more than repayment of the loan and interest due.

RMJ