Stranger-Owned Life Insurance: A Point/Counterpoint Discussion

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Our area of law, once so calm, seems to be giving rise to more and more controversy. The fate of the transfer tax system has been bouncing around for the last 10 years or so. Enterprising (or scheming, depending upon your perspective) practitioners are taking what everyone thought were standard planning techniques, adding little twists, and trying to obtain patents for them. And, in the insurance area, what began as a fairly innocuous innovation, viatical settlements, has bloomed into a new and very controversial cottage industry: the acquisition of insurance by an insured for the purpose of selling that policy to a third party.

This new technique, which differs from viatical or life settlements in that those older techniques involved acquiring a preexisting policy from an insured who no longer needed it, goes by many different names. This article will adopt both the somewhat pejorative term stranger-owned life insurance (or "SOLI") and the more friendly term "disposable policies." Each term refers not to a type of insurance product, but rather a technique for purchasing insurance in which an unrelated third party offers to loan to an insured the premium amounts for a policy on the insured's life at a fairly high interest rate and the insured has the option to sell that policy back to the third party at the end of two years. However, as the discussion that follows will show, even this brief summary of the technique is subject to interpretation.

This article will present both sides of the debate. Alan Jensen will present the arguments in favor of SOLI and Stephan Leimberg will present the opposing arguments. Each will also be permitted space to present a rebuttal of the other's position. Let the fun begin!

POINT: ALAN JENSEN

If you, as a senior citizen, were offered the prospect of significant cash within two years from the sale of a newly issued insurance policy on your life, for which you pay nothing, why should you not take it? This question frames the growing controversy on the sale of insurance policies on a non-recourse basis to the elderly. It has been dubbed pejoratively as "stranger-owned life insurance" or "SOLI," which conjures up evil intensions on the basis of life insurance agents.

SOLI is in great disfavor by the life insurance industry itself. It has attracted attention from Elliot Spitzer who, while as New York Attorney General, filed suit against Coventry First for alleged bid rigging on the sale of life insurance contracts on the elderly. The National Association of Insurance Commissioners recently adopted a revised Viatical Settlement Act that encompasses SOLI and institutes disclosure and reporting requirements in addition to establishing fiduciary standards for agents representing the elderly insureds.[1]

1. What Are We Talking About?

Definitions are important. Stranger-owned life insurance conjures up an unsettling, if not un-American, image of profiteers bilking unwitting elderly insurance prospects. The term "disposable policies" is more apt and devoid of some of the negative connotation in SOLI. It also accurately reflects the chief characteristic of this structure, which is the anticipated sale (hence disposable) of the policy after the two-year contestability period has lapsed.

Disposable policies are part of the life settlement market. In its most general terms, life settlement refers to the sale of an insurance contract to a buyer other than the issuing insurer before the death of the insured. The insured is usually an older individual with a life expectancy of 12 years or less. The buyers are investors who believe that the continued premiums required keeping the policy in force, plus the purchase price paid to the insured or owner, will be less than the ultimate death benefit, thereby providing an acceptable return on the investment. The sale of an insurance policy by an owner to a third party buyer is not illegal, but is subject to some significant qualifications discussed below.

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[1] *Ass'n. for Advanced Life Underwriting, AALU and Broader Industry Strongly Support Amendments to NAIC Viatical Settlements Model Act*, AALU Washington Report No. 07-06, Jan. 12, 2007, at 1, 2.

The secondary market, which is essential to the sale of disposable policies, began with the sale to investors of unneeded permanent policies originally purchased to address typical life insurance concerns. Without a secondary market consisting of willing buyers, the life settlement market would not exist. At the inception of the life settlement market, the owners of existing policies (the insureds, trusts established by them or their businesses) were motivated to sell because they no longer needed or could no longer afford the policies. Investors were at the time looking for higher rates of return in a period of historically low interest rates starting in the late 1990s. It was a marriage of convenience at that time between buyers and sellers and so begot the secondary market.

Anecdotal evidence on the explosion of this market is impressive. From $200 million in transferred death benefits in 1998, the secondary market engorged to $12 billion transferred in 2005.[2] The inventory of qualifying policies could not keep pace with the demand, so resourceful agents started marketing disposable policies to elderly insureds who had no particular need or desire for additional insurance. The transaction, they were told, would net them a considerable amount of cash with no out-of-pocket expense required. The development of these disposable policies and their sale in the secondary market incurred the wrath of the insurance industry.

2. Disposable Policies.

An insured would purchase a disposable policy with the clear intent to sell it after the two-year contestability period expired. The agent selling a disposable policy seeks an elderly, insurable candidate, usually 75 or older. The target will be told that he will not expend any of his own funds because the agent has procured nonrecourse financing for the purchase of the insurance. The insured nominally will act as grantor of a life insurance trust that will apply for and own the policy. The loan and accrued interest will be due in two years. At that time, the agent will tell the insured that, in all probability, the policy will be sold to investors for a price that will pay the loan and accrued interest, leaving a profit to split between the agent and the insured. If the insured dies within the two years preceding the anticipated sale, after the loan and interest are repaid, the insured's designated beneficiaries will split the net proceeds with the broker on some percentage basis, with often up to 50% going to the broker.

If the insured survives for two years, the owner (the life insurance trustee) typically has two options, in addition to sale of the policies to investors: (1) have the insured pay the outstanding debt with accrued interest and retain the policy; or (2) transfer the policy to the lender in lieu of foreclosure.

A sale in the secondary market is not guaranteed. Unless there is a clear decline in the health of the insured and consequently a shorter life expectancy than contemplated at the time of issuance of the policy, the trustee/owner may not find a profitable sale. If there is a market for the policy, the broker will arrange for the sale and, according to the agreement executed at the issuance of the policy, the trustee/owner and broker will split the net profits on an agreed percentage after paying off the lender.

Assuming the insured's health remains unchanged or in some cases improves, and therefore, the proposed sale attracts no buyers in the secondary market, the insured can direct the trustee to transfer the policy to the lender in lieu of foreclosure to extinguish the debt. Most disposable policies provide for nonrecourse debt. so the lender's recourse against the owner is limited to the policy itself.

The insured also can direct the trustee to pay the debt and accrued interest with funds provided by the insured. With improved or constant health, this is a less attractive alternative. If the insured is still insurable, he or she probably can obtain a comparable policy at the same or lower cost.

The transfer of the policy to the lender in satisfaction of the debt will eliminate the current and future financial obligations of the insured. The policy is then the lender's problem, who may sell it in the secondary market. However, if the policy was not sold in the first place by the trustee, any sale by the lender would assumedly be at a price insufficient to pay the existing debt plus accrued interest.

Finally, if the insured's health has materially declined, the insured may commit personal assets to pay off the debt plus a broker's commission and retain the policy. The insured would gravitate to this option in order to eliminate splitting the proceeds with the broker upon sale on the secondary market or to keep the policy in trust and, as a result, enable the estate to retain a larger of portion of the death benefit.

3. Economics 101.

So given this brief description of the disposable policy in the life settlement market, what is the fuss? The preservation of the insurer's profit margins seems to be the core of the controversy. Had the insurers profited in typical fashion from the sale of billions of dollars of new coverage, we would not be dis-

[2] LifeSource, Pub. No. LSRC-WH.010.1, Life Settlements 1 (Dec. 2004) (on file with author).

cussing the issue. The technique would not have appeared as a front page article in *The New York Times* on December 17, 2006.[3]

Why are insurers fighting the development of the sale of the disposable policy, which has promoted sales to a group (the elderly) that had not purchased policies in such amounts before? A simple answer is that the disposable policy, whichever of the three alternatives discussed above is selected, probably will not lapse. This basic fact distinguishes them from other types of whole life insurance policies. A recent report attributed to Milliman U.S.A. determined that over 89% of universal life insurance policies did not pay death benefits.[4] The sudden issuance of disposable policies, nearly 100% of which will be held until the death of the insured, surely raised havoc within the pricing of policies and profitability to the insurers. Put simply, insurers have priced policies on the assumption that a large percentage will not be retained until the death of the insured.

4. Abuses and Concerns Surrounding the Disposable Policy.

It is easy to confuse issues in this area. There is the risk of overreaction, particularly by federal or state legislation, that is ill advised and that could be fashioned as a blunt instrument against perceived abuses.

The creation of the secondary market, which allows the sale of the disposable policy, should be regarded as a favorable economic development for the consumer. An insured who purchased a policy to satisfy traditional insurance needs, but now finds the policy is unneeded or cannot be afforded, should be allowed to sell in the secondary market. For example, assume Congress finally addresses estate and gift tax reform and expands the individual estate tax exemption to $5 million. There will be individuals who have the liquidity issues connected with their estates solved by Congressional action and thus have reduced or eliminated need for life insurance. Why should they be prevented from selling in the secondary market and be forced to rely on what cash value they can obtain from the insurer?

Conceding that the secondary market can benefit the consumer who has purchased a policy for a long-term hold, what abuses exist in the current market involving disposable policies? There is a lack of any set of best practices, suggested or imposed by the industry itself, or a consistent and coherent pattern of state regulation. The dearth of any such direction has encouraged hyperbole at times and invites misrepresentation by some agents or brokers who are either unscrupulous or simply do not fully understand the market themselves.

The disposable policy frequently is touted as free insurance with no financial commitment by the insured. The insured may be told that he is assured of a significant profit on the sale in the secondary market of the policy's death benefit with a gross realization of 6% to 30% of that death benefit. They will be shown illustrations that will compute the premium and accrued interest (often ranging between 12% and 15%) offset by a much greater realization on the sale in the secondary market. But there is no certainty that the disposable policy can be sold in the secondary market, particularly if the insured's health maintains in the same condition as at the issuance of the policy. However, if this possibility is explained to the insured, he cannot complain of loss of profits in the event of no sale.

Tax costs associated with the disposition of the policy are also real and may be significant. Often, written disclosure to the client by the agent, if any, will have a brief suggestion to consult a tax adviser about the tax effects of a disposable policy, but those potential effects are left unstated. If the policy is sold on the secondary market, gain realized by the insured/owner will be taxed in two tiers: first as ordinary income to the extent cash value exceeds the premiums paid and then as long-term gain. The insured should be able to offset gain realized by his basis in the policy. Basis is equal to the amount paid in premiums but not accrued interest, and less the amounts received under the contract that were not included in the owner's income, such as nontaxable dividends. An extended discussion is beyond the scope of this article, but the assumption that basis in the policy equals the amount of the premiums paid without an offset for annual term costs may be challenged by the IRS.

To explain briefly, the IRS, in a controversial private ruling involving a viatical settlement, determined that the owner's basis in the policy is the amount of premiums paid less dividends paid on the policy and less term charges associated with the holding period.[5] This reduction for term charges could be significant because the insureds are quite elderly. The assertion by the IRS in this setting may be dubious, but it nevertheless has been advanced and cannot be ignored in discussing the potential risks with the client.

Additionally, promoters of life settlements frequently ignore the taxation of a policy that is relinquished to the lender in lieu of foreclosure. A substantial number of policies will not be purchased on the secondary market. The transfer of a policy to the

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[3] Charles Duhigg, *Late in Life, Finding a Bonanza in Life Insurance*, N.Y. Times, Dec. 17, 2006, at A1.

[4] LifeSource, *supra* note 5.

[5] Priv. Ltr. Rul. 9443020.

lender in lieu of foreclosure is a taxable disposition and gain will be measured by the amount realized (premium borrowed plus accrued interest) less basis, which will be the amount paid in premium for the policy (potentially reduced by term costs as the IRS may assert). As a result, in the no-sale situation, at least the amount of accrued interest, which can be substantial at a 12% to 15% rate, will be exposed to federal and state tax to be paid by the insured/owner by virtue of transferring the policy to the lender to extinguish the debt.

5. The Need for Permanent Insurance.

The insured must evaluate his need for permanent insurance rather than a disposable policy. The disposable policy is not designed for a long-term hold and is quite expensive, with large commissions and intentionally low build-up in cash value. This results in higher premiums in the future if retained by the insured after two years.

The insured under the disposable policy uses up some of his insurability by the amount of the death benefit. Insurers will insure any individual only for so much coverage. Consequently, large disposable policies can dramatically reduce potential permanent coverage for the insured. The disposable policy in most instances never lapses. Therefore, it will reduce the ability of the insured to buy additional coverage throughout his life and the insured should be so advised.

6. Insurable Interest.

For a disposable plan to be enforceable, the original owner must have an insurable interest, which is then assigned to investors. Many disposable policy designs do not appear to have an insurable interest. If none is found to exist because of the design of the plan, the insurance contract itself may be void from inception.

An insurable interest requirement exists in virtually all states. Many states have had the insurable interest determined by case law, while other states have enacted sometimes very dissimilar legislation defining where an insurable interest exists. Some state statutes have avoided defining insurable interest, although they may define who may insure the insured.[6]

There is, however, a commonality of definition, whether judicial or statutory, that the original owner of the policy must have an interest for the continued longevity of the insured and not to profit merely because of his death. The insurance contract should not be a gaming contract where the owner profits exclusively by the death of the insured. That said, most states allow the assignment of an insurance policy once it has been established that the applicant/owner has an insurable interest at the time of issuance of the policy. Clearly, if the insured himself obtained the policy directly, there would be an insurable interest present at the issuance of the policy. A subsequent assignment by him should not impose an additional insurable interest requirement on the assignee if the insurable interest existed at the issuance of the policy.

Some of the existing disposable policy plans, in all likelihood, lack a design that establishes an insurable interest at the time of issue. For example, a plan that has the insured commit to transfer the policy to investors immediately after its issuance for a flat fee paid coincident with the issuance of the policy probably lacks an insurable interest. The transaction was complete at issuance and the insured walked away with a significant check and no possibility of ever retaining the policy or having his family realize any death benefit, even if the insured died immediately. The insured immediately had assigned all rights in the contract and, if death occurred immediately, the death benefit would go entirely to the investors. Thus, the investors should be viewed as receiving the policy directly from the insurer.

To have an insurable interest, the agreement with the broker should provide substantial rights to the insured/owner in the proceeds if death occurs within two years from issuance. Further, the insured should have the right to reacquire the policy, and, hence, the access to a substantial portion of the death benefit by paying off the loan, accrued interest, and a reasonable commission to the broker.

If the acquirer does not have an insurable interest, the issuance of the contract is void *ab initio*. The consequences are dramatic because the insurer may return the premiums paid and cancel the contract. The broker, who arranged for the issuance of the contract, would be obligated to return the premium and would be potentially liable for anticipated profits represented to the insured.

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[6] *E.g.,* Brett v. Warnick, 75 P. 1061 (1904) (defining insurable interest by case law). *See also, e.g.,* N.Y. Ins. Law § 3205(a) (McKinney Supp. 2006) (defining insurable interest through statute); Mich. Comp. Laws §§ 500.2207, 2209, 2210, 2212 (2006) (defining who may insure the insured).

7. The Entry of the National Association of Insurance Commissioners.

The National Association of Insurance Commissioners ("NAIC") is interested in the disposable policy market. The Life Insurance and Annuities Committee of NAIC adopted an amendment to the Viatical Settlements Model Act that defines disposable policies as viatical settlement contracts.[7] Each state individually must consider and elect to adopt the amendments as state law. The amendments were initially proposed by James Poolman, Insurance Commissioner of North Dakota, after NAIC's 2006 summer national meeting.[8]

The amendments are comprehensive and address concerns on the issuance of disposable policies as well as their ultimate sale in the secondary market. The amendments would in most instances impose a five-year wait for the sale of viatical settlement contracts, now defined to include disposable policies.[9] The amendments also restrict promotion of the disposable policy as free insurance and require filing of promotional material with the state insurance commissioner.[10]

When the policy is sold in a viatical settlement, the amendments require disclosures that the broker represent the viator (insured) exclusively in a fiduciary capacity,[11] advise the insured of the right to rescind for 60 days after sale,[12] whether funds will be escrowed during the transfer process,[13] and address receipt of other offers, counteroffers, acceptances or rejections relating to the contract.[14] This last disclosure would specifically address by statute the alleged infraction committed by Coventry First on bid rigging that Mr. Spitzer attempted to correct.

The required disclosures in the NAIC proposal should be examined and refined. The mandatory delay of five years before sale in the secondary market seems questionable. By itself, it merely defers the sale to the secondary market for another three years. However, the five-year freeze is subject to some major exceptions that allow a person to sell within five years, such as a change in financial circumstance or a terminal medical condition.[15]

A five-year waiting period before the sale of a viatical settlement contract will change the economics of the life settlement market, but should not eliminate it. It may increase the likelihood of sale in the secondary market, for the chances of a decline in an elderly insured's health are greater in five years than they are two. This may benefit the insured with a greater likelihood of a profitable sale. It will also delay the return for investors, which will require a correspondingly higher return for the delay.

The secondary market will experience change and probably greater state regulation, perhaps in the form of the NAIC proposals. The industry could refuse to insure the elderly. Many insurers now request the applicant to state whether he intends to sell the policy. It is not clear if the insurer will refuse the application if the applicant answers yes. One hopes that the secondary market, which benefits the consumer who has purchased permanent insurance, will be left intact and provide a valid option for the disposal of an asset that the insured has bought and paid for, owns and should be allowed to transfer freely.

COUNTERPOINT: STEPHAN LEIMBERG

It is a perpetual curiosity that—even now—after so very many recent scandalous scams have been uncovered in the tax, financial, and estate planning field in general and with respect to abusive uses of life insurance in particular—that the offer of a "free lunch"—that "something for nothing" still has the power to cloud not just ordinary men's (and women's) minds—but highly qualified professionals as well. Certainly, SOLI is great proof that ethics are quickly abandoned and rationalization soon adopted when large amounts of money are readily available. SOLI has promoted a willingness to quickly ignore or abandon the strong warnings and harsh lessons of hundreds of cases over more than a century.

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[7] Minutes from the Meeting of the Life Ins. and Annuities (A) Comm., Nat'l. Ass'n. of Ins. Comm'rs. 3 (Dec. 10, 2006) (on file with author); *id.* at Attachment Five § 2(N)(2).

[8] Minutes from the Meeting of the Life Ins. and Annuities (A) Comm., Nat'l. Ass'n. of Ins. Comm'rs., 1-2 (Sept. 10, 2006) (on file with author).

[9] Minutes from the Meeting of the Life Ins. and Annuities (A) Comm., Nat'l. Ass'n. of Ins. Comm'rs., Attachment Five § 11(A) (Dec. 10, 2006) (on file with author).

[10] *Id.* at § 12(D), (E).

[11] *Id.* at § 8(A)(2).

[12] *Id.* at § 8(A)(6).

[13] *Id.* at § 8(B)(6).

[14] *Id.* at § 8(C)(2).

Let me first state what I[16] find *wrong* with SOLI itself:[17]

1. Insurance Fraud.

SOLI almost invariably starts with theft by deception, a fraud on the insurer. Because almost every major insurer in the U.S. asks numerous questions on its policy applications specifically designed to uncover SOLI transactions—and will not knowingly issue a contract that meets the definition of a transaction that involves "the anticipated sale" of the policy after the two year-contestability period has lapsed"—prospective insureds have been coached to lie, deliberately omit key information, or otherwise misdirect so as to trick the insurer into issuing a contract it would not otherwise issue. When a person states or implies the policy is being purchased to provide protection for his or her family or business and in fact it was knowingly purchased with the clear intent to resell it for a profit, that act is false, deceptive, or misleading with respect to material facts. In most states insurance fraud is a misdemeanor, but in some states it is or even a felony crime.

2. Illegal.

Second, SOLI is a violation of the spirit if not the letter of the insurable interest law in every state in this country.[18] SOLI is in diametric opposition to the very principle underlying insurable interest: if an owner of life insurance benefits from or is dependent upon the insured's continued living, it is logical to assume that the owner is not likely to bring about the insured's death in order to secure insurance proceeds.

SOLI is just the opposite. It starts with a purchase the investors cannot legally make on their own. It is unlawful in every state for investor-strangers to buy insurance on the life of a person with no insurable interest. And a statement such as the one above made in support of SOLI, "Clearly, if the insured himself obtained the policy directly, there would be an insurable interest present at the issuance of the policy. A subsequent assignment by him should not impose an additional insurable interest requirement on the assignee if the insurable interest existed at the issuance of the policy," begs the question. The accuracy of those words depends on whether or not insurable interest in fact existed at the time the policy is issued. In every single case on point—without exception—the court has stated that if the purchase of the policy by the insured is a cover or cloak for what is really an attempt to do by indirection what parties who are unrelated to the insured by blood or economic nexus could not do directly—the policy will be void ab initio or in some states voidable. Some states hold such statements to be punishable as misdemeanors while in others they are crimes.[19]

3. Foolish.

Once investors obtain a policy, no matter how much the insured's family or business needs new coverage (and the insurance company wouldn't issue the

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[15] *Id.* at § 11(A)(2).

[16] I'm obviously not alone. LISA, the Life Insurance Settlement Association, which represents the bulk of life settlement providers in the United States, provides in its Standards (Revised March 9, 2006):

> The LISI is, and always has been opposed to investor initiated life insurance transactions that are intended to circumvent insurable interest law. ...The LISIA opposes loans that attempt to use the life settlement transaction to validate illegitimate premium financing transactions. And ... As part of general operating practice, LISA members will not knowingly contract, or engage in business for life insurance policies that have been obtained by presenting or concealing materially false factual information for the purpose of misleading another.

See also J. Magner, *NAIC Adopts Viatical Settlement Act Model Provisions,* Steve Leimberg's Estate Planning Newsletter #1136 (June 13, 2007); S. Leimberg, *N.Y. Insurance Dept Opinion on Non-Recourse Insurance Transactions,* Steve Leimberg's Estate Planning Newsletter # 914 (January 12, 2006).

[17] *See also* Hetherington, McDowell, and Ganer, *SPIN Life: Hedging Insurable Interest* (2007) (copy on file with the author); Leimberg, Gibbons, and Nelson, *TOLI, COLI, BOLI, and Insurable Interests,* 28 Estate Planning 333 (2001); S. Leimberg, *Stranger-Owned Life Insurance (SOLI): Killing the Goose that Lays Golden Eggs,* 32 Estate Planning 43 (2005); Leimberg, *Stranger-Owned Life Insurance 33 (SOLI): Killing the Goose that Lays Golden Eggs,* 28 The Insurance Tax Review 811 (May 2005); Jones, Leimberg, and Rybka, *"Free" Life Insurance: Risks and Costs of Non-Recourse Premium Financing,* 33 Estate Planning 3 (2006); S. Leimberg, *Investor Initiated "Free" Life Insurance: Really a "Free" Lunch or a Prelude to Acid Indigestion?,* 41 Est. Plan. Inst. ch. 4 (2007).

[18] Although the wording varies widely from state to state, the essence and spirit of all states' laws is this: Insurable interest is present where the parties are closely related by blood or by law and there is a substantial interest engendered by love and affection and in the case of persons other than those related by blood or law a lawful and substantial economic interest in the continued life, health, or bodily safety of the person insured, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the insured. The tendency of the courts is to find insurable interest where the parties are close relatives or have a demonstrable business or economic nexus at the time of the policy application and issuance such that the policy-owner-beneficiary would benefit upon the *continuation* of the insured's life or suffer a demonstrable economic loss upon the insured's death.

[19] 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

policy if they *didn't* think the insured's family or business really did need it), the insured may never be able to obtain more or replace what is gone. In almost all SOLI situations to date, there has been little or no objective analysis of the insured's actual personal or business life insurance needs. Why would there be when, by definition, the objective of all the parties to the transaction from inception is "for the insured to purchase a disposable policy with the clear intent to sell it after the two year contestability period expired." So the insured, the insured's family, his or her business, and charities are denied the important professional service that a proper estate liquidity and cash flow needs analysis would provide and potentially deprived of the policy proceeds such an investigation might uncover.[20]

Would you say that elderly people will be induced by SOLI to do things that are foolish when you learn about a person who purchases a $10 million policy on December 14, 2005 and then sells it (actually, he sold his beneficial interest in the trust that owned the policy) to a settlement company for $300,000 after he has "determined that the sale of the beneficial interest in the policy "is in his best interest and the best interest of his family? How would you react if you were a family member—when you learn upon his death—on January 10th, 2006—that the investors were paid $10,712,328.77?[21]

4. Taxing.

Any incentive, such as a car, cash, trip, or other "gift" to entice a person to purchase the policy, will be taxable to that person immediately as ordinary income. The "free" insurance is not free because the insured will probably be subjected to significant income tax each year on the economic value of the coverage that is provided. If the insured or the insured's trust decides to turn over the policy to the lender and "walk away from the non-recourse loan," it is highly likely that the IRS will treat that discharge of indebtedness as ordinary income. In other words, the insured, even if the trust owned the policy, may incur significant tax and will have no cash to pay the tax! If the trustee sells the policy to a settlement company, any gain will be all (or mostly) taxable at ordinary income rates. It's likely the IRS will claim and argue (1) that basis is reduced by the cost of insurance, (2) that the entire amount realized in the sale is ordinary income, and (3) the amount that is reportable is taxable to the insured rather than to the trust—even though he or she may have received no cash in the transaction.[22]

5. Disappointing.

The insured's family may never be paid any insurance proceeds even if the insured dies within the first two policy years. Why not? Because if the insurer discovers that the intent from inception was to sell the policy to investors and there is a material misrepresentation in the application, the insurer is likely to rescind the policy.[23] At best, the insured's family faces expensive, aggravating, and uncertain litigation. There is already a case where the insured died shortly after the policy was sold to the investors. The insured's disgruntled heirs sued threatened to sue the investors.[24]

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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 15 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."

[20] This may prove to be malpractice on the practitioner's part. Counsel who "greenlights" this transaction without assurance from an independent, qualified insurance professional that the client's family and business (or intended charitable beneficiaries) have no needs becomes liable if later it turns out they did and a reasonable effort was not made to ascertain the extent of the need or shortfall.

[21] These are the facts alleged in the complaint for a declaratory judgment in *Life Product Clearing LLC v. Anita Lobel, Personal Representative of the Estate of Leon Lobel,* Case No. 07-CV-0475 (S.D.N.Y.). which was filed on January 22, 2007 (the "Life Product Clearing Complaint"). I am unaware of the outcome of the case but my guess is that it was settled. From the dates involved, clearly the sale was within the wet- ink period that most states would prohibit such transactions and is representative of one of the many likely problems that SOLI will present.

[22] S. Leimberg, *Investor Initiated Life Insurance: Really a "Free Lunch" or Prelude to Acid Indigestion?,* 41 Est. Plan. Inst. ch. 4 (2007).

[23] S. Leimberg, *Insurer Acts to Rescind Free Life Insurance,* Steve Leimberg's Estate Planning Newsletter No. 1013 (August 30, 2006). *Indianapolis Life* is a case in which the life insurance agents named themselves as trustees. They signed all the forms and retained all the powers to act on the policies they brokered. Over 20 policies have been successfully rescinded.

[24] *See* Life Product Clearing Complaint, *supra* note 210.

6. Liability.

All too often the insured never obtains counsel that is both competent[25] and diligent. (Why pay a big tip on a "free lunch"?) But lack of such counsel may make the insured's estate liable to investors for millions of dollars! The insured will be asked to sign literally dozens of lengthy and complex legal documents designed to protect the investors' and lender's interests—provisions that favor them rather than the insured.[26] The insured may unintentionally and unwittingly make certain guarantees to the lenders and investors that provide that, if *after* the investors have purchased the insurance on the insured's life, for some reason they are barred from collecting the proceeds, those investors have recourse against the estate for the insurance they expected to receive—but didn't.[27]

7. Uncertainty.

No matter what the insured is led or allowed or would like to believe, typically the investors are not bound to purchase the policy at the end of the two years! Even if they do offer to buy it, they *may* offer much less than anticipated. Why? One reason is that the sooner the insured dies, the more profit investors make. If the insured's longevity has—for *any* reason—improved at the end of two years, the policy is not as valuable to investors as they originally predicted. Investors advance their money to make a profit—and the less they pay for a given policy, the more profit they make. He or she or the trust that sells the policy to those investors may not obtain anywhere near the amount of the money expected. After interest, fees, taxes, and brokerage costs, it is quite possible that the insured will suffer a sizeable overall loss![28]

8. Mortality Risk.

It is an incontrovertible fact that, after the insured or the insured's trust sells the policy to the investors or lets the bank or other lender take it and sell it to investors, the insured is the *only* party to the contract that hopes he or she lives a long time. The successful outcome of the investors' bet depends on someone's death. Of course, the insured will be told (and will want to believe) that the odds are very small of some investor discovering the identity of an insured and taking steps to profit by his or her early death. That may be true. But, no one will or *can* assure the insured that it cannot happen.[29] Moreover,

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[25] Consider that counsel must investigate the insurable interest, rebate, tax, viatical, lending, rebate, trust, and other aspects of what is a very sophisticated transaction probably involving millions of dollars.

[26] J. Magner, *Life Settlement Transactions—Important Tax & Legal Issues Advisers And Fiduciaries Must Consider,* Steve Leimberg's Estate Planning Newsletter No. 1062 (Dec. 12, 2006).

[27] Louis S. Harrison of Harrison & Held, LLP, Chicago, stated in a very well balanced and carefully researched, but unpublished, paper entitled "Casey Jones, Who's Driving That Insurance Train" that "[t]he risks, though not substantial as discrete concerns, become so when the dollars of these transactions are considered. Policies that have aggregate face amounts of $10,000,000 or $20,000,000 mean that these amounts are the possible damages if the transaction does not go as planned. The practitioner needs to consider who bears the financial risk if the transaction goes south, for any reason."

[28] In one case reported in the April 23rd, 2007 edition of Business Week, A. Tergesen, *The High Price of Free Insurance,* at 106, an 82-year old sold his $4.4 million policy for $1.1 million. But when the loan that financed the premiums was paid with interest and other charges, 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! Attorney Adam Balinsky, a partner at Baker & McKenzie, estimated that for a $1 million policy for someone with a seven-year life expectancy, 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 income taxes!

[29] *State v. Roth,* 881 P.2d 268, 277 (Wash. App. 1994), is a case where the defendant married, insured, and then murdered his second wife by pushing her from a cliff. The court stated that he had an overarching design to obtain insurance proceeds by means that included murder of insured spouses and his fourth wife's murder was just another part of that plan. *See* Annotation, *Killing of Insured by Beneficiary as Affecting Life Insurance or Its Proceeds,* 27 A.L.R.3d 794 (1969 & Supp. 2004). *Overstreet v. Ky. Cent. Life Ins.,* 747 F. Supp. 1195 (W.D. Va. 1990), *aff'd in part, rev'd in part,* 950 F.2d 931 (4th Cir. 1991), involved the murder of an insured on a hunting trip with a friend who had taken out a life insurance policy on him. His hunting "accident" later found to be murder. *Craig v. State,* 347 S.W.2d 255 (Tex. Crim. App. 1961) was a case in which the insured was shot and killed by a bullet discharged by her husband's shotgun while they were fishing in a boat along a river; the insured was the beneficiary of three insurance policies on her life taken out shortly before her death. *Sun Life Assurance Co. of Canada v. Allen,* 259 N.W. 281 (Mich. 1935) is a classic. According to the court, "The mortality among the partners of Charles Elson was rather high. Federowitz, a partner, died March 21, 1922, at the age of 33, of either lobar pneumonia or delirium tremens, with $27,500 of life insurance payable to Elson, Goodstein and Allen, for which application had been made on February 25, 1921. Stanislaus Bogacki, another partner, died at the age of 44 from a cause given in his death certificate as 'fall down stairs in home, fracture of skull, alcoholism,' with $15,000 of insurance payable to the firm, the policy having been issued only three months after the death of Federowitz. Bogacki lived less than three years after his policy was issued. The record is silent as to Allen and Goodstein; all we know is they did not appear as witnesses in the instant case." *Lopez v. Life Ins. Co. of America,* 406 So. 2d 1155 (Fla. App. 1981) involved a situation in which the "almost victim's" wife obtained numerous life insurance policies from an insurer on his life; his wife kidnapped and attempted to murder him, purportedly for the insurance proceeds. In *Ramey*

the original investors have the legal right (and often the intent) to sell the policy individually or in a block with other policies immediately to a different group of investors. There is no legal limit to how many times the policy on your life can be sold or to who. Therefore, the insured has no control or knowledge of who

v. S.C. Life Ins. Co., 135 S.E.2d 362 (S.C. 1964), without the insured's knowledge or consent, his wife purchased a life policy naming herself as beneficiary. She then gave her husband arsenic in an attempt to take his life and collect proceeds of the policy. In *Liberty Nat'l Life Ins. Co. v. Weldon,*100 So. 2d 696 (Ala. 1957), a niece was murdered by her aunt-in-law, who was convicted and electrocuted for the murder. The aunt-in-law had taken out three separate life insurance policies on the child. These were among many "murder for insurance" cases mentioned—with vivid descriptions—in R. Jerry, "May Harvey Rest in Peace: *Lakin v. Postal Life & Casualty Insurance Company,*" 2 Nevada Law Journal 292-311 (2002).

If that's not enough, consider C. DiMassa, *2 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, May 19, 2006: "Two women in their 70s were arrested Thursday after they allegedly befriended two homeless men, took out 19 life insurance policies on them and filed claims worth more than $2.2 million after the transients mysteriously died in hit-and-run pedestrian accidents in Los Angeles. One of the men was hit by a car and killed in an alley off La Brea and Melrose avenues in 1999, and the second victim was run down in a Westwood alley last June. Detectives said they connected the two cases several months ago during a chance meeting between two investigators in the LAPD's West Traffic Bureau squad room. A detective handling the death of Kenneth McDavid, 50, was talking about the peculiarity of the case when another detective interrupted him to say he had worked on a similar-sounding, unsolved hit-and-run six years ago. Comparing notes, they realized that in both cases the bodies had been claimed by Olga Rutterschmidt, 73, of Hollywood, and Helen Golay, 75, of Santa Monica. "'It was somewhat unusual that two elderly ladies unrelated to the victim were coming in making requests for police reports…attempting to gain custody of the body and claiming there was no one else in the world who cared about this poor soul,' said Det. Dennis Kilcoyne. Investigators said they looked into the matter further and found that the women held 19 policies on McDavid and Paul Vados, 73—even though neither appeared to be related to the victims. Investigators say the women befriended McDavid and Vados and provided them with apartments in exchange for signing a life insurance policy, with Rutterschmidt and Golay listed as the beneficiaries. They then allegedly duplicated both men's signatures on rubber stamps and used them to secure additional policies. 'After two years of payments, the policies became good,' Kilcoyne said. 'Then bad things would happen.' Rutterschmidt and Golay secured insurance policies with Monumental Life, Bankers Life, Mutual of Omaha and Guarantee Reserve Life, as well as MONY Life Insurance. Each application told a slightly different story, authorities said. 'Our first thought was…they would leave the actual dirty work to someone else,' Kilcoyne said. 'We're not so sure about this anymore…. This is pretty evil.'" *See also* C. Chang, *Two Elderly Women Suspected as Femmes Fatales in Insurance Fraud Scheme,* NY Times, June 12, 2006: "Dwight Emile says his neighbor Olga Rutterschmidt always had a thing for get-rich-quick schemes…. 'I always used to say to her that one day I'd see her on the 11 o'clock news,' Mr. Emile said. Now he has. Posing as aunts, fiancées or cousins, they took out numerous life insurance policies on the men, Paul Vados and Kenneth McDavid, with themselves as the beneficiaries, collecting over $2.2 million after the men died in separate hit-and-run traffic cases," the authorities said. 'It's one of the most sinister, evil types of schemes I've ever seen, if it does turn out to be the case,' said Lt. Paul Vernon, a spokesman for the Los Angeles Police Department. 'They had to form a relationship with these men, get to know them, show that they cared, then turn around and kill them….' Court papers suggest a web of relationships, financial dealings and untimely deaths…." *And see* M. Tittinger, *Widows Face Murder Rap,* Daily Press, Aug 1, 2006: "The Los Angeles District Attorney's office has filed capital murder charges against Helen Golay, 75, of Santa Monica, and Olga Rutterschmidt, 73, of Hollywood, accusing the alleged conspirators with concocting a deadly plot to set homeless men up in paid-for apartments and then collect on multiple insurance claims by posing as the deceased's relatives following their untimely deaths. All told, the pair collected more than $3 million in insurance pay-outs, according to a felony criminal complaint filed by the DA's office against the women, who allegedly made dozens of claims with a wide array of insurance companies after the deaths of Paul Vados and Kenneth McDavid."

Another one: M. Martindale, *Victim's Dad Confronts Unger*, The Detroit News, July 19, 2006: "'He's left society with the responsibility to pay for the clothing, housing and feeding of his worthless carcass,' said Stern as his wife, Claire, stifled sobs a few feet away. … 'He deserves to rot in prison for the rest of his life in this world and…in eternal hell in the next.' Unger, a 45-year-old former mortgage banker from Huntington Woods, appeared before Benzie Circuit Judge James M. Batzer on Tuesday for his mandatory life prison sentence for first-degree premeditated murder. In his impassioned statement Tuesday, Harold Stern called his son-in-law Mark Unger a cold-hearted, cruel 'psychopathic mope,' who schemed to murder Florence to keep the house and the children, collect on Florence's $750,000 life insurance 'blood money,' keep his own $10,000 a month 'scam disability' and eventually inherit more than $2 million from his mother's estate. It was Batzer who had the final word, assessing Unger's conviction and the effect it has had beyond his own life. 'The defendant not only took the life of his wife but deprived the parents, brother and friends of her company,' Batzer said. 'He's deprived his own children of their mother and by his actions, has deprived the children of their father. "Murder is something that's like Humpty Dumpty,' said Batzer, referring to the children's nursery rhyme. 'No one can put anything here back together again.' The Ungers were in the midst of a divorce in October 2003 when Unger suggested a weekend trip to the Inn of Watervale resort, on Lower Herring Lake about 10 miles south of Frankfort. Investigators said that the Ungers argued on a boathouse deck and Mark Unger forced his 37-year-old wife off the 12-foot-high platform. They said she struck a concrete slab, severely injuring her head, and he then dragged her immobile body into the lake, where she drowned. Her body was found the next morning."

will own it and be its beneficiary.[30]

Ask yourself what you *really* know about life settlement companies? How many are there? Who runs them? Who owns them? How large are they? How many employees do they have? What state or federal agency monitors their activities and personnel? Who can (do) they sell policies to? Who regulates to whom they can sell? Who monitors those sales and those people? Does that monitoring agency have a staff of sufficient size and expertise to do the job? Who checks into the next level of ownership when a further sale of policies is made? And the next? What safeguards are built into this process?

There is greater and more thorough monitoring of casinos which deal with money than of viatical settlements which deal with lives.

On April 5, 2007, the federal court for the Southern District of Florida released information on a case in which Colombian drug cartel members bought life settlements to launder drug money.[31] The headline to an article on the case read "Cartel Accused of Laundering Cash Through Life Settlement Policies"[32] One official was quoted as saying "Nothing good can come of this. The potential for tragedy is shocking." Another was quoted as saying "The policy on the life of the Florida man has been forfeited to the federal government. It is no longer owned by anyone who might seek to do him harm. But the next person insured in any similar scheme might not be so lucky."

9. Conflict of Interest.

SOLI presents an inevitable and direct conflict of interest. Few would sanction and most would find unconscionable a business arrangement in which an investor agreed to pay a property owner to purchase fire insurance on her office building—in a deal in which—for cash—that owner would assign the fire insurance coverage to that investor—who could profit *only* if the owner's building burns down. It defies common sense and logic to place total strangers in a position to speculate on how soon a person will die!

10. Ethically Wrong.

Insurable interest laws are meant to stop the slippery slope inevitable one can get into when interests begin to conflict. Current insurable interest laws reflect that viewpoint and the arguments for insurable interest rest on consequential outcomes. If we put temptation in people's way, some (and in my opinion, even one is too many) will give in to it. When a temptation can lead to murder, there ought to be strong public disincentives. Hence insurable interest laws.

From a principled perspective, the problem seems to be "commodification," the reduction of a human being into an economic commodity. "Economic reductivism" is the reduction of all transactions into market transactions. At that point, they lose the warp and woof and texture of their noneconomic nature.[33] One of the noneconomic characteristics of the act of taking out a life insurance policy on oneself is that it is an altruistic act. Investor-initiated insurance is problematic if one views life insurance in that way because, from that ethical perspective, it perverts and vitiates the original purpose of the product.[34] Consider IRS Circular 230,[35] which frowns on tax transactions that have no legitimate business purpose, whose motive is merely to avoid taxation. The purpose of the Internal Revenue Code is being violated. Analogously, the original purpose of life insurance is being violated when it is reduced to a "mere" investment vehicle and we create a "market in death."[36] Gambling and speculation are different than risk management. True, there are similarities, but to fail to pay attention to the differences is to engage in economic reductionism.

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[30] The prevention of *unnecessary* risk to human life is, of course, what insurable interest is all about, why it is so important, and why the implications of SOLI must be taken so seriously.

[31] *See* The Life Settlement Report 2 (2007).

[32] *Id.*

[33] Dr. Ronald F. Duska, *Whose Life Insurance Is It, Anyway?,* 60 Journal of Financial Service Professionals 33 (2006).

[34] When North Dakota's Insurance Commissioner Jim Poolman was asked by the New York Times for his reaction to the Spitzer allegations (C. Duhigg and J. Treaster, *Spitzer Suit Accuses Company of Abuses in Insurance for Elderly and Ill,* N.Y. Times, Oct. 27, 2006, at C3), he answered that question with his own. "The larger question," he said, was "Should someone profit from another person's death?" The answer to his question is one of public policy—and there are plenty of people out there that see nothing wrong with making a market in—and freely speculating on—other peoples' lives. There are those who are all for the commoditization and secondary marking of blocks of contracts on other peoples' lives (including certain life settlement companies who have always touted their own and the life settlement industry's high ethics, the trustworthiness, the assurance that personal information will be adequately secured and held confidential, and that "those things don't and can't happen under our corporate quality controls") and those professionals who have only one bottom line issue: "What does my client have to lose?"

[35] *See generally,* J. Blattmachr, M. Gans, D. Rios, The Circular 230 Deskbook (PLI 2006).

[36] M. Goldstein, *Death Bonds: Inside Wall Street's Most Macabre Investment Scheme Yet,* Business Week, July 30, 2007, at 44. (July 30, 2007): "With all the happy banter, you wouldn't know there were new and imaginative ways to profit from people dying." … "It's as macabre an investing concept as Wall Street has ever cooked up." … "For investors, it's a ghoulish actuarial gamble: The quicker the death, the more profit is reaped. The life settlements industry finds itself in the grip of dubious characters devising audacious and in some cases illegal schemes to make money."

Some authorities think that life insurance may increase the likelihood of "adverse events" through what is called "moral hazard." In short, "the opportunity to gain without paying the full price is thought to create a temptation to immoral behavior." Moral hazard is, in this paradigm, is the inescapable effect of insurance—that the requirement of insurable interest is designed to temper.[37]

These investor-initiated life insurance transactions, called "Death Bonds" by *Business Week*, which are a modern-day reincarnation of the age-old attempt to speculate upon the hazard of a pool of lives in which the intended ultimate owners have no other interest. The practice demands forces a study of the convergence of ethics, economics, law, and life insurance and an exploration of the distinction between what *might* "work" and "what's right.[38]

REBUTTAL OF THE ANTI-SOLI POSITION: ALAN JENSEN

In response to Mr. Leinberg's forceful argument decrying the very existence of SOLI, I would offer the following comments roughly in the order that he presents his arguments in his counterpoint above.

1. **Fraud.**

Some SOLI plans may be invalid because they do not establish a valid insurable interest at the issuance of the policy. However, if the insurable interest is valid at inception, the subsequent sale to an unrelated purchaser is not illegal. Whether a client should participate in a particular program is an independent issue. The June 20, 2007 adoption by the NAIC of a revised Viatical Settlement Act ("VSA") is a welcome step in the right direction to achieve transparency in such transactions and thus have the prospective insured fully apprised of the risks inherent in the transaction. In fact, the VSA treats the SOLI like a security and requires full disclosure to the insured on the relative risks of the transaction, including potential lawsuits and tax liabilities if there is no ultimate profitable sale as anticipated at the end of two years.[39]

The focus of attention in the purchase of a SOLI should be the protection of the consumer. Insurers are well able to take care of themselves and have done so increasingly. They have the power to refuse to issue the policy. They can choose not to insure the elderly, which is clearly the SOLI market. They can ask, as many have, whether the purchase of the policy is being made with the intention to sell the policy during the life of the insured. If the applicant falsifies that information, then the insurer can (and some have) challenged the issuance during the contestability period for falsely representing a material fact in the initial underwriting.[40] The insurer can cancel coverage and return the premiums paid if successful in proving material misrepresentation in the application.

The risk of listening to the frenetic hyperbole denigrating SOLI plans is that the reaction, either legislatively or administratively, curtailing SOLIs will adversely affect the life settlement market in general, which must be regarded as a benefit to the consumer. It provides an alternative market for insurance policies apart from surrendering the policy to the insurer. If one believes in free competition, this opportunity should be regarded as meritorious to the consumer.

How prevalent is SOLI relative to the sale of non-SOLI products in the life settlement arena? A major national SOLI settlement provider estimates based on its purchase of policies from the owners that less than 10% of its purchases in the secondary market are clearly SOLI designed and financed policies. This means that the vast majority of settlements involve non-SOLI sales wherein the owner of the policy determined that it was desirable to dispose of the policies and was able to do so profitably in the secondary market. Based on that estimate, we are dealing with a minority of sales in the secondary market when addressing the SOLI product. This should be kept distinctly in mind to prevent overreaction that deprives the consumer of a valid market for a policy.

2. **Illegal.**

SOLIs are not *per se* illegal. Although SOLIs might violate the spirit of the insurable interest law in every state in the country, the appropriate way to determine their validity is whether they fail to establish an insurable interest at the time of the issuance of the policy. All states, as Mr. Leimnberg notes, have insurable interest laws. Some are codified; some are not and exist by virtue of case law in the particular

[37] Other authorities look at life insurance as a form of mutual aid and collective responsibility. To participate in a risk-pooling scheme is to agree to tax yourself not only for your own benefit should you die, but also for the benefit of others who might die when you do not. Viewed this way, life insurance creates what might be called "moral opportunity," the opportunity to cooperate with and help others. D. Stone, *Beyond Moral Hazard: Insurance As Moral Opportunity,* 6 Conn. Ins. L.J. 11 (YEAR).

[38] *See* Cooper, *The Avoidance Dynamic: A Tale of Tax Planning, Tax Ethics, and Tax Reform,* 80 Colum. L. Rev. 1553 (1980).

[39] *See* NAIC Viatical Settlement Model Act.

[40] Chawla v. Transamerica Occidental Life Insurance Company, 2005 WL 405405 (E.D. Va. Feb. 3, 2005), *aff'd in part and vacated in part,* 440 F.3d 639 (4th Cir. 2006).

jurisdiction. They have in common a requirement that the policy is issued either to the insured or to a party who has an interest in the continuing life and well being of the insured. An unrelated investor does not fall within the permitted category of those that can obtain the direct issuance of the policy.

But all states allow the assignment of an insurance policy that is validly issued to a person or entity with an insurable interest. Once the insurer issues the policy to a person with an insurable interest, the insurable interest requirement is satisfied and is not applied again on the assignment of the policy to determine the validity of the assignment. Were that not the case, traditional financing of policies through third-party lenders would be suspect. In those cases, there is not an assignment of ownership, but an assignment of the security interest. Were the loan not performing and if any cash value was not adequate to pay the loan and interest, the bank might not be cheering for the continued good health and vitality of the insured.

For example, New York addresses the issue of a subsequent assignment of a policy by statute. The New York statute on insurable interest specifically allows the assignment of a policy by a person who had an insurable interest.[41] Consequently, the statute limits the application of the insurable interest requirement to the time of issuance of the policy and does not again apply the statute at its subsequent assignment.

Was the policy issued to the insured or the insured's legitimate delegate, such as an insurance trust? This should be an easy question to answer, but given the variations of SOLI plans, it is not. One must determine that the insured or the trust had true ownership and could exercise substantial rights over the policy.

For example, what happens to the proceeds when death occurs within two years prior to anticipated sale? Who gets the proceeds during the contestability period is critical. First, do proceeds (or at least a significant portion) return to beneficiaries, which would be family in the typical case of the insured, or are they paid directly to investors? If the latter, arguably there is not an insurable interest at issuance, for there is not dominion over the proceeds by the insured to allocate in the insured's discretion.

Second, a valid SOLI would allow the retention of the policy at the end of two years by the owner (typically a trust) by paying off the outstanding debt, which would typically be nonrecourse. Third, if the broker cannot find a profitable sale for the SOLI, the owner can assign the policy in satisfaction of the debt, plus accrued interest. If all three of these characteristics exist, a valid insurable interest should exist and the SOLI should be sustained.

Anecdotally, the retention of SOLI policies occurs frequently. According to some agents, approximately 25% of the insureds or trusts owning the SOLI elect to retain the policy. Why would the insured cause the trustee to retain the policy and continue to pay premiums? The insured may have become uninsurable and is looking at a much abbreviated life expectancy. In that case, the insured would want to retain the policy and allow the proceeds, after payment of the nonrecourse obligation to pay the initial premiums, to be held for the benefit of family.

The legal ability of the insured to exercise options over the policy during the contestability period and not to be paid immediately according to a prearranged plan determines the validity or invalidity of the SOLI. The insured's intent to sell the SOLI at a profit in the future is irrelevant if the three ownership rights exist at the time of policy issuance.

3. Foolish.

The purchase of SOLI policies may indeed by foolish when weighted for potential adverse tax costs, the uncertainty of a profitable sale, or the exhaustion of future insurability. But is it the business of the courts and legislature to protect the particular consumers buying SOLIs against their own foolishness? The sensible solution to such an argument is answered in many of the suggestions of the revised VSA. If the insured has been fully apprised of the risks and rewards for entering the transaction, he or she should be allowed to do so. It is extraordinarily paternalistic to call for the abolition of SOLI. Zealots who would ban SOLIs face a daunting definitional test.

Are we determined to investigate at the issuance of the policy whether the insured primarily intended to sell? What if the insured changed his or her mind? The effort would probably stanch many transactions that the life settlement market now encompasses that are not SOLI. With the existence of the secondary market, the possibility of sale aways exists. Policies that were previously acquired for traditional insurance purposes, but now are unnecessary, should have a market apart from surrender to the insurer.

Agents selling SOLI products are looking at a market composed of high net worth individuals that qualify for the purchase of larger policies. If they do not fall within the suitability guidelines for the issuance of a policy, the insurer, on those grounds alone, may deny large coverage for a person with limited or small net worth. One expects that the targeted SOLI insureds have access to competent counsel and can pay for that advice.

If the prospective insured enlists competent counsel, the prospective insured should be advised

[41] N.Y. Ins. Law § 3205(b)(i).

that adverse tax consequences will arise if there is not a profitable sale as promised or predicted. The surrender of the policy constitutes a sale and the basis in the policy might equal the premiums paid. The owner will recognize income equal to at least the accrued interest, which can be substantial.

With the adoption of state legislation similar to the revised VSA, the required disclosures to the prospective insured should allow the prospect to make an informed decision. Whether it is foolish or not should be the prospect's concern and she or he should not have a paternalistic legislature or court make the decision.

4. Disappointing.

If the insured falsifies material information in the application, the insurer should be able to cancel the contract and return the premium. It is hard to get exercised about this because fraud in the inducement of a contract should never be rewarded, and the insurer would be quite within its rights to void the contract. As suggested above, the insurer has the right not to insure the elderly and can inquire about intent to sell the policy if the insurer wishes. It is interesting to note that in *Life Product Clearing, LLC v. Anita Lobel, Personal Representative of the Estate of Leon Lobel,*[42] the application contained a question whether the insured intended to sell the policy. At the urging of the agent, the insured left that question blank. Notwithstanding the absence of a response, the insurer issued the policy for $10 million. That omission is hardly a basis to argue fraud in the inducement. The insurer, we presume, read the application and could have specifically asked the insured to respond to the question. When Mr. Lobel died shortly after the issuance of policy and its immediate assignment to investors for $300,000, the insurer, after significant hesitation, elected to pay the claim.

5. Liability.

An agent's hyperbole, or in extreme circumstances fraudulent representation, to the insured would be substantially curtailed by the provisions in the revised VSA, and those disclosure requirements are needed in the market. The revised VSA would require sufficient information to the insured to make an informed decision, which seems all that should be provided and allow adults with adequate information to contract freely.

6. Mortal risk.

This could perhaps be renamed, as ACTEC Fellow Louis Harrison calls it, the "sleaze factor." It is unsettling that the SOLI policy will not die or pay proceeds until the death of the insured. It will be kept in force until the expiration of the insured. It will not be surrendered.

As counsel to a prospective SOLI purchaser, one should insist on knowing the identity of the purchaser and insist that the policy not be further assigned by the purchaser. This is a contractual right that can be extracted from the investors, or the insured can exercise his or her right by refusing to buy. Not only should there be a prohibition against assignment, there should be an affirmative obligation for the use of a blind trust, the mechanics of which are revealed to the prospective insured. This would be replete with limited access to a database of the policies.

If there is packaging of the SOLI products and the sale of that spin off, which has been a recent development in the market, the policies themselves have not been assigned, but right to proceeds in them might be. That assignment can be permitted without revealing the names of the insureds and can be done in a manner to preserve the anonymity of the insured within the database held by the blind trust.

Portrayal of the sale of SOLI products as an economic assault on the poor and downtrodden is an exaggeration. As mentioned above, the targeted market consists of wealthy and accredited investors with sophisticated counsel. These people should have access to adequate counsel to evaluate the proposal.

The paternalism that is sought in an effort to abolish SOLI is fraught with definitional difficulty and will stanch many of the benefits to the consumer that the life settlement market, in a larger sense, provides. To allow only the sale back to the insurer continues the economic monopoly on a very valuable asset of the insured when the owner should be able to explore its alternatives for maximizing the value of the asset.

REBUTTAL OF THE PRO-SOLI POSITION: STEPHAN LEIMBERG

It's good to have the last word(s) since the rebuttal argument above in favor of SOLI has many fatal factual and conceptual flaws:

1. About Fraud.

First, the pro-SOLI rebuttal argument concerning fraud begins by stating that:

> Some SOLI plans may be invalid because they do not establish a valid insurable interest at the issuance of the policy. However, if the insurable interest is valid at inception, the subsequent sale to an unrelated purchaser is not illegal.

[42] *See supra* note 21.

But if the insured has lied or mislead the insurer in the application, such as saying, "I'm buying this to pay estate taxes," "I'm buying this to assure my family's standard of living," "I'm buying this for buy-sell purposes," but the intent from inception is to sell at the earliest possible moment to profit on the transaction, that deliberate material misstatement or omission or misdirection is no less insurance fraud than a person who buys fire insurance with the intent to turn around and sell it to a party who does not own the underlying insured property.

The arguments about the NAIC Model Act and its requirements of greater disclosure and transparency are misdirected. That Act's stated purpose is not to somehow legitimatize SOLI; in the words of its chief architect, North Dakota Insurance Commissioner Jim Poolman: "The action of the Committee stops the abusive practice of Stranger Originated Life Insurance and significantly beefs up consumer protections for those that choose to legitimately sell their life insurance policy to investors." It was not meant to distinguish between good SOLI and bad SOLI; it was meant to kill SOLI![43]

Second, the argument that "insurers are well able to take care of themselves..." and have the power "to refuse to issue—or not issue the policy"—is incorrect, naïve, and not reflective of the way SOLI is working in the real world.

First, SOLI is now done almost entirely through "stealth" transactions—such as the downright sneaky trick allegedly played in the *Loeb* case where the insured sold a $10 million policy for $300,000 and died shortly thereafter. In actuality, the policy was owned by and payable to a trust that ostensibly was for the insured's family. But within days of the issuance of the policy, according to plan, Loeb sold and the settlement company representing the investors purchased not the policy itself but a 100% percent interest in the trust which that owned the policy. Ironically, the fool was Mr. Loeb, who died days later. But the set up was to keep the insurer in the dark.[44] My point is that these are deliberate structures designed specifically to obfuscate what is really happening. For instance, there are shape-shifting recourse loans soon followed by hidden non-recourse loans. To hide the shift of beneficial ownership, trusts, or LLCs, or partnerships are set up and, rather than assigning the policy or its proceeds to investors, these trick vehicles assign interests in the trust (or other entity) itself rather than transfer the policy—so the insurer doesn't see or find out who really is intended to receive gets the policy proceeds—or how soon the transfer to investors occurs.[45] Insurers are forced unnecessarily to spend millions of dollars to monitor and filter these fraudulent transactions. Why should they be forced to endure what is by definition fraudulent dealing and a lack of good faith in the single most important document they have to make an underwriting decision? Why should they be required to assume the costs of expensive and time-consuming post-application investigations and litigation? And as for the statement that "the insurer can cancel coverage and return the premiums paid if successful in proving material misrepresentation in the application," why place the burden on the injured party?

The next statement, that "curtailing SOLIs will adversely affect the life settlement market in general" is the exact opposite of the reality. The life settlement community is staggering under poor publicity (one settlement company that is so large it handles more than 50% of the country's entire life settlement business—is under investigation by New York State, and Florida has issued orders requiring it the Company to prove why it should not be banned from business in that state) and is in great need of distinguishing itself from rogue actors and actions such as SOLI. SOLI, together with other rampant consumer abuses,[46] is the very lightning rod that attracted the massive changes in the NAIC model

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[43] Steve Leimberg's Estate Planning Newsletter # 1060 (December 11, 2006).

[44] This was the same technique used by Lydia Capital, the subject of allegations by the SEC (jointly filed by Massachusetts), that about half the insureds falsified their applications by stating they had no intention of selling their policies when records show the policies were obtained for the express purpose of selling them to investors and in most cases, the gap between policy issuance and the transfer of the trust's interest in the policy to investors was only a month or two. The insureds, soon after the policy was issued, assigned his interest in the trust to either the broker—who then assigned it to Lydia—or to Lydia itself.

[45] In the SEC complaint against Lydia Capital (jointly filed by Massachusetts), it is alleged that about half the insureds falsified their applications by stating they had no intention of selling their policies. Yet the records and the timing between the application and the sale show the policies were obtained for the express purpose of selling them to investors. In one case the policy was obtained in 2005 but sold in 2006. But in most cases, the gap was only a month or two. In the typical case, the stated owner of the policies is a trust and the insured is a beneficiary of the trust. The insured, soon after the policy is issued, assigns his interest in the trust to either the broker—who then assigned it to Lydia—or to Lydia itself. Because those lies—material misrepresentations—mean the policies were obtained through false statements and give life insurance companies the right to rescind the policies, the value of the fund was—according to the SEC—wiped out. Since the SOLI contracts were essentially the hedge fund's ONLY asset, rescission by the insurers would render the policies nearly worthless. So the value of the fund is essentially obliterated.

[46] On October 26th, 2006, New York State attorney general Eliot Spitzer sued Coventry First, a company that claims to have a

act. In fact the following statement in the pro-SOLI arguement, "It provides an alternative market for insurance policies apart from surrendering the policy to the insurer. If one believes in free competition, this opportunity should be regarded as meritorious to the consumer" falls into the same trap promoters of SOLI shamelessly tried selling—with little avail—to the NAIC regulators, i.e. that SOLI and legitimate life settlements are the same and to stop SOLI would be to stop legitimate life settlements. But the following statement from the Life Insurance Settlement Association (LISA), the largest representative of the life settlement industry, decries SOLI: "The LISA is, and always has been, opposed to investor initiated life insurance transactions that are intended to circumvent insurable interest law."[47] So the statement that the consumer could be deprived of a valid market for a policy —implying that SOLI legislation would stunt the growth of legitimate life settlements—is clearly a misguided (but commonly used by SOLI promoters) bit of fallacious propaganda.

2. About Illegality.

There is a statement in the pro-SOLI rebuttal that "SOLIs are not per se illegal" immediately followed by "...SOLIs might violate the spirit of the insurable interest law in every state in the country..." In tax law we have found that a violation of the spirit of the law can't be justified or cured by a hyper-technical reading and following of a carefully selected paragraph or sentence of that same law.[48] In fact, cases and IRS pronouncements such as *Winn-Dixie,*[49] *CM Holdings,*[50] *Dow Chemical,*[51] *American Electric Power,*[52] *Wal-Mart,*[53] *Addis,*[54] *Weiner,*[55] IRS Notice 2002-59,[56] the proposed Treasury Regulations on split-dollar life insurance,[57] *Neonatology,*[58] *Finderne,*[59] and Notice 2003-24[60] show that an evasion of the spirit of the law almost inevitably will result in disaster to those who attempt it. Recent *Wall Street Journal* headlines affirm that "when the words mean what the promoter says they mean, no less and certainly no more," serious trouble will result.[61]

Perhaps the most common statement repeated by SOLI promoters is one repeated above in defense

market share of more than half of all life settlement business and in 2005 purchased 1,318 life insurance policies representing more than $3 billion in death benefits. C. Duhigg and J. Treaster, *Spitzer Suit Accuses Company of Abuses in Insurance for Elderly and Ill,* N.Y. Times, Oct. 27, 2006, at C3. *See also* Press Release, Office of New York State Attorney General Eliot Spitzer, Oct. 26, 2006. *See also* A. Elstein, "Coventry First was charged with pretending to conduct auction-style bidding to get the highest price for people looking to sell their life insurance policies, while paying off rivals to ensure they (Coventry) received the business." Crain's N.Y., Oct. 26, 2006; R. Silverman, *Eliot Spitzer Sues Coventry First in Probe of 'Life Settlement Cases'*, Wall St. J., Oct. 27th, 2006, at C3. Spitzer was not alone. On May 15, 2007, the Florida Office of Insurance Regulation issued a Notice and Order to Show Cause to Coventry First LLC alleging violations of the Florida Insurance Code and for "engaging in fraudulent or dishonest practices." The 11-count order issued by the Florida OIR details Coventry's transactions with eight Florida viators involving insured individuals ranging in age from 73 to 84 years old. In one example, a person had two life insurance policies with a face value of $19.4 million. The Coventry transaction paid the viator only $968,832 in current value while the brokers allegedly involved in the transaction were paid over $1 million. Amazingly, Coventry collected a $247,707 bonus for keeping the total offer on the transaction, including compensation, under $2.5 million. The OIR demanded that Coventry explain its actions and why it should be allowed to continue to operate in Florida. Coventry's alleged practices included payments to brokers to not seek other competitive bids, payments to brokers not involved with specific transaction, and even a payment to a broker to encourage another broker not to seek a competitive bid for sale.

[47] Life Insurance Settlement Association Standards (Revised March 9, 2006) (copy on file with the author).

[48] *See* S. Pollack and J. Soled, *Tax Professionals Behaving Badly,* Tax Analysts, Oct. 13, 2004. The authors, having contemplated why tax professionals behave unethically and form highly suspect corporate tax shelters void of any economic substance, conclude the reasons are simple: money and opportunity. *See also* J. Eustice, *Abusive Corporate Tax Shelters: Old 'Brine' in New Bottles,* 55 Tax L. Rev. 135 (2002).

[49] Winn-Dixie Stones, Inc., et al. v. Commissioner, 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11th Cir. 2001).

[50] In re CM Holdings, Inc., 254 Bankr. 578 (D. Del. 2000), *aff'd* 301 F.3d 96 (3d Cir. 2002).

[51] Dow Chem. Co. v. United States, 250 F. Supp. 2d 748 (E.D. Mich. 2003); Dow Chem. Co. v. United States, 278 F. Supp. 2d 844 (E.D. Mich 2003), *rev'd* 435 F.3d 594 (6th Cir. 2006).

[52] American Electric Power Co. Inc., et al. v. United States, 136 F. Supp. 2d 762 (S.D. Ohio 2005).

[53] Wal-Mart Stores, Inc. v. AIG Life Insurance Company, 2004 WL 405913 (Del. CH 2004), *rev'd,* 860 A.2d 312 (Del. 2004), *on remand,* 872 A.2d 611 (Del. Ch. 2005), *aff'd in part and rev'd in part,* 901 A.2d 106, 2006 WL 1562069 (Del. 2006). The families of deceased insureds covered by Wal-Mart's COLI coverage sued Wal-Mart in a class action suit on the argument that mere employment doesn't qualify as the insurable interest that Texas law requires.

[54] Addis v. Commissioner, 118 T.C. 528 (2002).

[55] Weiner v. Commissioner, T.C. Memo. 2002-153 (2002).

[56] 2002-2 C.B. 481.

[57] Reg. 164754-01 (May 9, 2003).

[58] Neonatology Associates P.A., et al. v. Commissioner, 115 T.C. 43 (2000).

[59] Finderne Management Company, Inc. v. W. Barrett, 809 A.2d 842 (N.J. App. 2002), *certification denied,* 827 A.2d 287 (N.J. 2003).

[60] 2003-1 C.B. 853.

[61] Statement by Alvin D. Lurie, Former Assistant IRS Commissioner and first recipient of the Employee Benefits Committee of the ABA Tax Section's First Lifetime Employee Benefits Achievement Award for "dedicated service and contributions improving Employee Benefits Law" (copy on file with the author).

of SOLI: "But all states allow the assignment of an insurance policy that is validly issued to a person or entity with an insurable interest." True, but again, not the *whole* truth. Although most states allow assignment of a policy as a property right, in every single court case on point the court has added that assignment, even to one who has no insurable interest in the insured, is permissible—*assuming* that assignment is not a cover for a transfer intended to cloak the true substance of the transaction, i.e., an attempt to vest ownership of life insurance into the hands of a party who never had and never will have, insurable interest.[62] New York State is poised to enact an outright prohibition against these arrangements.[63]

Yet another misunderstanding deliberately encouraged by promoters and repeated in the arguments for SOLI above is that the insured or other owner's ability to "exercise substantial rights over the policy" is, *per se*, indicative that insurable interest laws are satisfied. Yet in my opinion the temporary dominion over the proceeds by the insured and his or her ability during some limited time to allocate policy proceeds in the insured's discretion will not, by itself, satisfy the purpose or meet the spirit of insurable interest laws. Rather, in the presence of an intent to sell to investors, serve merely as smoke to disguise the parties' true objectives. Flaunting the legal ability of the insured to exercise policy rights during the contestable period didn't fool the General Counsel of New York's insurance department—and will not in the presence of intentions to settle—fool a court. I strongly disagree, therefore, with the pro-SOLI statement that "the insured's intent to sell the SOLI policy at a profit in the future is irrelevant." If in fact there is a prearranged plan (whether or not in writing and regardless of whether or not it is legally enforceable), it will fail the spirit if not the letter of every state's insurable interest law.

3. About the Pro-SOLI Statements About Regarding SOLI being Foolish.

Promoters may agree that "It is extraordinarily paternalistic to call for the abolition of SOLI." I do not. First, many individuals who are approached with SOLI arrangements will not be able to find, afford, and be actually served properly by competent counsel. For instance, one strain of SOLI offered seniors $50,000 of free insurance.[64] But reading further, it becomes apparent that unnamed investors would pay all of their premiums and the proceeds would be split $15,000 (going to the insured's named beneficiary) and $35,000 going to the investors. Billed as "Cost, No Cost, No Premium, Zero Premium or Zero Payment insurance coverage" or "final expense" or "final arrangement" whole or universal life, it is targeted to low wealth level individuals 65 to 85 years of age. These programs are certainly not being pitched to highly sophisticated persons or to those with high-powered expert advisers.[65] Yet this is just one form SOLI takes—belying the statement that "one expects that the targeted SOLI insureds have access to competent counsel, and can pay for that advice." The truth is, left unchecked, SOLI will mutate as quickly and broadly as a kudzu and it is already obvious it will not

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[62] *See* S. Leimberg, *Investor-Initiated Life Insurance: Really a "Free Lunch" or Prelude to Acid Indigestion?,* 41 Inst. Est. Plan. ch. 4 (2007).

[63] New York State Senator Jim Seward submitted a letter on July 16, 2007 to NCOIL, a copy of which is on file with the author, stating that the law in New York "is wholly inadequate for the purpose of regulating the expanding life settlement market." He expressed concern that "New York senior citizens are being encouraged to enter into stranger-initiated life insurance transactions that sometimes benefit those who are negotiating the transaction, or the investor who is investing in it, more than the policyholder." He states that legislators are in the "final stages of enacting a law in New York that will be one of the preeminent in the nation to address this topic," revisions to New York law that is "somewhat consistent with the NAIC Viatical Settlement Model Act but also unique with additional consumer protections and disclosures." The New York bill draft contains an outright prohibition against SOLI arrangements (section 7811, subsections (c)(3), (g) & (i) rather than by extending the prohibition against viaticating to five years as is the case under the NAIC model Act. Senator Seward stated that there will be an annual reporting requirement and language removing the profit motive for entering into a SOLI-type transaction by a premium finance agency or other financing entity.

[64] Warnings by Texas, Vermont, Georgia, and North Carolina Insurance Departments on "Zero Premium" Life Insurance (copies on file with the author).

[65] P. Kiel, *Reed, Abramoff Discussed "Mortgaging Old Black People,"* GQ, July 13, 2006 describes "a plan hatched by Ralph Reed and Jack Abramoff which sounds suspiciously like 'mortgaging old black people,' as a former Reed associate told the magazine. In July of 2003, Abramoff and Reed considered launching something called the Black Churches Insurance Program. We know how this scheme would have gone, because Abramoff pitched something similar to a cash-strapped Texas tribe, the Tigua. Basically, since the tribe couldn't pay Abramoff, he offered to arrange 'a life-insurance policy for every Tigua 75 or older.' When those elders died, the death benefits would have gone to Abramoff through one of his non-profits. The Tigua didn't take Abramoff up on the offer, but it was too good of an idea to let go. So Abramoff apparently thought black churches were a good target. This would have been the same thing, according to GQ's Sean Flynn, except that it was African-Americans. Or as 'a former associate of Reed's' told GQ, 'Yeah…it sounds like Jack approached Reed about mortgaging old black people.'"

stop at the "rich and famous," and I have serious doubts that even many counsel of wealthy individuals will have the combined expertise in insurance, contract, viatical, security, and insurable interest law to properly advise elderly clients on these transactions without dozens of hours of research.

As for the objection that anti-SOLI legislation is "paternalistic," that may be true. Certainly insurable interest laws are paternalistic, they have been deemed necessary by courts for hundreds of years[66] in many countries. Not a single court in all that time—nor a single lawmaker for that matter—has ever expressed that such laws are anachronistic, unnecessary, nor overly paternalistic such that they never were or are no longer appropriate. We are, after all discussing nothing less than an act which creates—in most cases—a multi-million dollar incentive to accelerate an investor's interest. Seatbelt and airbag (and motorcycle helmet) laws, while all clearly paternalistic, all unquestionably save lives. So do guardrails—even though there are signs that warn of "sharp curves."

The pro-SOLI argument above implies that sufficient information to the insured to make an informed decision is all that should be provided and that adults with adequate information to should be allowed to contract freely, no matter what the risk (or who may lose). I strongly agree that insurable interest is a public policy decision and that the public, through its legislators, have both a right and a duty to explore and discuss their views on the issue of insurable interest. But unless and until the citizens of a given state act to revoke insurable interest laws, a few clever individuals should not be allowed to blatantly evade them.

4. About the Pro-SOLI Mortal Risk Rebuttal Discussion:

The first major statement made is, "As counsel to a prospective SOLI purchaser, one should insist on knowing the identity of the purchaser and that the policy not be further assigned by the purchaser. This is a contractual right that can be extracted from the investors, or the insured can exercise his or her right by refusing to buy." That argument sounds logical, but in reality a person entering into a SOLI contract *never* knows the identity of the purchaser(s). And even if he or she did, the initial purchaser would have a legal right to assign it—just as the insured or the insured's trust did.

And no real life investor group would ever agree to a "prohibition against assignment." What would happen to a trustee of an irrevocable trust who purchased an investment burdened with a prohibition against ever selling it? Remember which side has the high-powered, more experienced counsel, financial strength, and overall bargaining power and assess how realistic it is to assume any policy owner will ever be able to extract such guarantees.

There is no limit to the mischief that can occur when insurable interest laws are flaunted—as the following recent news reports illustrates:

> "A prominent pastor accused of falsifying life insurance documents to profit from deaths in his congregation was charged with theft and forgery," the attorney general said Tuesday. The criminal complaint against Acen Phillips echoes the allegations in a lawsuit filed this year by AIG Life Insurance Co. At issue are claims filed under a group life insurance policy taken out for American Church United, described as a group of Baptist churches that prosecutors say was headed by Phillips. Prosecutors allege Phillips, the founder of New Birth Temple of Praise Community Baptist Church, forged the documents to funnel money to church groups he controlled, sometimes showing up at funerals to make contact with family members about filing a claim…. AIG's lawsuit claims Phillips took out the policy to cover its full-time ministers but later allowed anyone, not just employees, to be covered if they paid a monthly $50 fee.

C. Slevin, Colo. *Minister Accused of Profiting From Congregation Life Insurance Policies,* Associated Press, Aug. 8, 2007 (available online at www.businessweek.com/ap/financialnews/DBQSSMV62.htm).

[66] "Betting on when the Pope (and other high profile church members who might succeed the Pope) would die was a popular form of speculation until 1591 when Pope Gregory XIV forbade this type of wagering. One writer of that era commented "persons who were engaged in that illicit and indecent wagering, to increase their chances of winning, did not blush to circulate calamities against worthy men who were thought likely to be raised to the purple." As far back as 1477, the English enacted An Act Against Unlawful Games (17 Edw.IV, c.3) to prevent trafficking in insurance. By 1664 that a wagering contract was made unenforceable in An Act Against Deceitful, Disorderly, and Excessive Gaming (16 Car. II). For some time, betting on how long a famous or infamous person would live became high sport. It was common practice to allow a third party or betting group to purchase a policy on a person's life and rarely did the insured give consent to such insurance or even know of its existence. All too often, "impatient insurance owners did what was necessary to accelerate their interests. This mischievous trafficking in human lives became so vicious that it shook and shocked a society that was not known for its squeamishness. Popular accounts of the period describe the practice of purchasing insurance on the lives of those being tried for capital crimes. These policies constituted naked wagers on whether the accused would ultimately be convicted and executed for the alleged offense. A related practice was the purchase of insurance on the lives of famous, elderly persons; the premium would be a function of what was known about the person's health, including any recent illnesses." *See* P. Swisher, *The Insurable Interest Requirement For Life Insurance: A Critical Reassessment,* 53 Drake L. Rev. 477 (2005).

The very last sentence in the rebuttal, "[t]o allow only the sale back to the insurer continues the economic monopoly on a very valuable asset of the insured when the owner should be able to explore its alternatives for maximizing the value of the asset," is again a continuation of the deliberately misleading confusion between legitimate life settlements (i.e., the sale of a policy originally purchased to provide security, to satisfy the insured's risk shifting and risk sharing objectives—but no longer needed or affordable) and the use of life insurance as a security. I have no problem with a the former, although I suspect many involved in the life settlement field are not competent to do—or have not actually done for every client—a full "needs analysis" and so how would they know for sure if the client really no longer needs the coverage? Likewise, there are many ways to make a policy "affordable" and anything less than an exhaustive effort to help a person who will be survived by a spouse or other family member or dependeant beneficiaries keep a needed policy is suspect) but see great and growing problems with the latter.

WHAT I DO AGREE WITH:
STEPHAN LEIMBERG

There is little I agree with in the key "pro-SOLI" statements above. But I do agree with these statements:

- SOLI involves "the anticipated sale" of the policy after the two year-contestability period has lapsed.
- An insured would purchase a disposable policy with the clear intent to sell it after the two year contestability period expired.
- Stranger-owned life insurance conjures up an unsettling, if not un-American, image of profiteers bilking unwitting elderly insurance prospects.
- A sale in the secondary market is not guaranteed.
- The insured/owner may not find a profitable sale.
- There is the risk of overreaction, particularly by federal or state legislation, that is ill-advised and which could be fashioned as a blunt instrument against perceived abuses.
- There is a lack of any set of best practices, suggested or imposed by the industry itself, or a consistent and coherent pattern of state regulation. The dearth of such direction has encouraged hyperbole at times and invites misrepresentation by some agents or brokers who are either unscrupulous or simply do not fully understand the market themselves.
- Tax costs associated with the disposition of the policy are also real and may be significant.
- The disposable policy is not designed for a long-term hold and is quite expensive, with large commissions and intentionally low build-up in cash value.

I also agree with the argument that a secondary market is a positive development for insurance consumers and that one who in fact purchased a policy to satisfy traditional needs and no longer needs or can afford the policy should be able to sell it.[67] But as I've stated numerous times above, that should not be confused, as promoters so often attempt to do in these discussions, with a policy "manufactured" for sale to the secondary market, i.e., one for which there never was a legitimate need or intent for the insured to shift or share risk.

We need to distinguish between ethically and demonstrably appropriate life settlements and life insurance initiated by and incubated and manufactured merely for investment purposes. While a person or party who has purchased life insurance to solve risk shifting or risk sharing problems has every right to do whatever he, she, or it wishes with the policy once it is issued, those same property rights do not apply to one who obtains coverage by deceit. In fact, no property rights accrue to such a party.[68]

Second, promoters often seek to place the blame for (or justify the fraud on) insurers. Specifically, they make the argument as stated in the pro-SOLI commentary above, that "The preservation of the insurer's profit margins seems to be the core of the controversy. Had

[67] Just as it is improper for an adviser not to mention the option of a life settlement to a person considering lapsing or cashing in life insurance, it is also unethical not to consider and illustrate to the policy owner the advantages of retaining coverage on extended term, reduced paid-up, or even borrowing if necessary to keep coverage in force.

[68] In fact, the courts make it clear that property rights must give way where there is the chance where (1) a human life may be endangered or (2) there is speculation on a life such that a risk to that life previously not existent comes into being.

the insurers profited in typical fashion from the sale of billions of dollars of new coverage, we would not be discussing the issue." The implication is that the lapse assumptions built into life insurance contracts are justification for what is occurring in the marketplace, i.e., fraud on insurers and violations of state insurable interest law. It is true that insurers, when pricing policies and for competitive purposes, have taken into consideration the mathematical probability that some policies would lapse. Those assumptions and the consequent "lower than otherwise" pricing may—or may not—have been good business judgment. But regardless of whether or not hindsight will prove such competitive tactics wise or foolish, they were based on the assumption of good faith and honesty in the insured's application for insurance and the price agreed upon and paid by the policy owner *was* lower than otherwise because of it. The insured received exactly what he paid for—and perhaps more! Where there is deceit in the application, there is an absence of the requisite good faith which is vital to a valid life insurance contract.[69]

Third, there is an implication in the pro-SOLI argument above that the parties from inception can intend to immediately settle the policy as soon as the two-year incontestable period expires[70] and, through artful dodging, still have insurable interest by providing substantial rights to the insured/owner in the proceeds if death occurs within two years from issuance and further give the insured the right to reacquire the policy at the end of two years by paying off the loan, accrued interest, and a reasonable commission to the broker. I disagree. Insurable interest laws and the courts that enforce them are not so feeble and toothless as to allow evasion by hyper-technical tactics designed to sidestep the purpose of the law.[71]

Fourth, there is a statement in the pro-SOLI argument above that "The mandatory delay of five years before sale in the secondary market seems questionable." Unfortunately, it's pretty clear (at least to me) that a five-year freeze (subject to the many and major reasonable exceptions NAIC's Model Act provides that allow a person to sell within—even two years—in the event the transaction falls outside of the NAIC's definition of a SOLI transaction—and after two and before five years—for events such as a change in financial circumstance or a terminal medical condition)—or some other language such as that proposed in New York State that removes the financial incentive to engage in SOLI—is needed.

Why is a very strong anti-SOLI law needed? First, existing law cannot stop SOLI. Insurance departments are understaffed; most states are working with "yesterday's laws!" These laws could not possibly anticipate the volume of insurable interest abuse, the organized highly financed, and packaged manner in which SOLI would be promoted. Nor could yesterday's lawmakers dream of the perversion of combining life settlements, premium financing, and life insurance to make a creature—like Frankenstein—none of the three were meant to be. Furthermore, the rebate and anti-inducement laws of most states are being ignored with impunity. State insurance departments do not have the people to monitor and enforce them—and all too often—if violated—they have no teeth. Promoters treat the light penalties as a cost of doing business.

That is why the problem must be attacked at the root. The financial incentive to violate insurable interest laws and commit a fraud on the insurer—for all of the parties—particularly the insured—must be killed. The NAIC did that in the recently passed amendment to its Model Act. If investors must wait for more than five years before they can get their hands on the policy, and the insured must wait more than five years to get his or her hands on the money, their investments are

[69] R. Kreitner, *Speculations of Contract, Or How The Law Stopped Worrying And Learned to Love Risk,* 100 Colum. L. Rev. 1096 (2000). In *Connecticut Insurance Company v. Schaefer,* 94 U.S. 457 (1876), the U.S. Supreme Court stated that the "essential" inquiry was "[t]hat the policy shall be obtained in good faith, and not for the purpose of speculating upon the hazard of the life in which the insured has no interest." In *Davis v. Gulf States Ins. Co.,* 151 So. 167, 169 (Miss. 1933), the court noted a policy will be invalid "where it was procured by the insured, on the inducement of the beneficiary, for the purpose of enabling the latter to effect insurance on the life of a person in which he had no insurable interest and thereby to evade the law against speculative or wagering insurance; but in such case it is not so much a question whether the beneficiary had an insurable interest in the life of the person who procured the policy as it is a question of the good faith and motives behind the procurement" (quoting 37 C.J. 389).

[70] Reliance on the incontestable clause is misplaced. There are cases in which courts have held that an insurer has waived or is estopped from raising a lack of insurable interest because the incontestable period has expired. *See* 43 Am. Jur. 2d, Insurance, §§ 761-784. But most cases find, as did the court in *Beard v. American Agency Life Ins. Co.,* 550 A.2d 677 (Md. 1988), that, under the common law, an incontestable clause in an insurance contract does not bar the defense of lack of insurable interest. *See also, e.g.,* Carter v. Continental Life Ins. Co., 115 F.2d 947, 948 (D.C. Cir 1940) ("It is well settled that the incontestable clause does not prevent the insurer from asserting this defense [lack of insurable interest]"); Commonwealth Life Ins. Co. v. George, 28 So. 2d 910, 914 (Ala. 1947) ("the decided weight of authority, and sound reasoning as well, support the view that the incontestable clause furnishes no answer to the defense that the plaintiff was without insurable interest").

[71] This is the thrust of the outline and presentation *Investor Initiated Life Insurance: Really a "Free" Lunch or a Prelude to Acid Indigestion?* that I presented at the 41st Annual Heckerling Institute on Estate Planning, on January 9, 2007. *See* 41 Inst. Est. Plan. ch. 4 (2007). The outline has extensive citations to cases, and I strongly recommend that any practitioner with an issue in this area study the outline in its entirety.

less predictable. And capital will go elsewhere.[72] In spite of what promoters would have the press, public, and legislators believe, the NAIC Model Act, although not perfect, provides numerous assurances that such strong medicine will not thwart legitimate life settlements where policies were purchased for needs that no longer exist or the policy is in fact no longer affordable—even with extended term or reduced paid up or third party financing options.

Furthermore, it is true that life insurance is property and that the owner of life insurance has significant rights protected by law to use that property to the fullest extent possible. But, it is also true that it is unique property since it is a contract on the life of a human being. An *enormous* risk of life is created each time a policy is issued. As such, legislatures and courts have—and hopefully will continue to—enact and enforce strong insurable interest laws that balance property rights with the need to thwart incentives to take a human life.

There is an implication in the pro-SOLI commentary above that SOLI is a "victimless crime." I suggest that there is no such thing and that an adviser is not safe from moral cupidity for sanctioning an action that might "work" for his client—even though it is a form of pollution that will eventually hurt others. In fact, insurers are already being forced to raise premiums significantly for elderly applicants.

Life insurance, premium financing, and life settlements are all socially useful tools and when used properly and appropriately, are ethically responsible solutions to important problems people face in their lives. But, like gasoline, dynamite, and matches, they were never intended to—and cannot without harm to each - be used together.

There are those who would, because of laziness, shortsightedness or unchecked greed, pervert the altruistic purpose of life insurance, the utility of premium financing, and the good of life settlements—and by doing so—do serious harm to all three institutions,[73] to the public—and inevitably—to themselves.

SOLI—by whatever name—is not about disposable policies; it is about commoditized disposable people!

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[72] Alone, even the five-year ban is not enough in my opinion. That is why states must mandate more agent/broker education in each state's settlement and insurable interest laws, require more transparency and disclosure to insureds, insurers, and to state insurance departments by settlement companies, eliminate the trick of re-domiciling, which is of moving abusive transactions to states with lax laws to avoid a more strict law in the insured's domiciliary state, provide penalties for violations of state law that are stringent enough so that paying a fine isn't viewed as a mere cost of doing business.

[73] *A Perspective on the Growing Controversy in Life Settlements,* Insurance NewsNet, Inc., April 18, 2007. Quantum Insurance Design national sales director Michelle Olmstead warned "abusive sales strategy employed in marketing STOLI threatens the legitimate life settlement industry and called for more regulation." As for its unsavory status, Robert Nelson, Grace/Mayer Insurance Agency, Inc.'s vice president of financial and estate planning said the first order of business is distinguishing life settlements from SOLIs and SPIN-LIFE. Nelson warned against the danger of over regulation if companies and practitioners started dabbling in SOLI schemes to cash in on the U.S. target market that research firm Conning & Company estimated to be worth $492 billion. While the temptation is there Nelson cautioned SOLI could eventually trigger the collapse of the industry."

APPENDIX

2007 Legislative and Regulatory Activity on SOLI

As the chart below indicates, professional insurance regulators, individuals who are professionally trained in and work on a daily basis with the overseeing of the public's interest in life insurance transactions, are taking steps to contain the spread of SOLI:

April	The Life Insurance and Annuities (A) Committee of the National Association of Insurance Commissioners (NAIC) votes unanimously to adopt changes to the Viatical Settlements Model Act intended to thwart SOLI—including a five-year ban on settlements within five years. North Dakota, under the leadership of Jim Poolman, enacted legislation based on the revised NAIC VSMA. The Idaho Department of Insurance issued a bulletin opining that SOLI (a/k/a STOLI) transactions may violate its insurable interest and rebating laws. Similar alerts were issued by New York, Utah and Louisiana in 2006.
May	Georgia's Department of Insurance issued a directive regarding "Zero Premium" life insurance solicitations; announced it was starting an investigation to determine of this marketing program violates Georgia laws or regulations; and cautioned producers not to participate in such marketing programs until its investigation is completed. Broker Joseph Bennaco was charged by the Massachusetts Secretary of State with fraudulently selling SOLI related investment schemes that targeted the elderly. In one of several alleged schemes, Gennaco sold "free" life insurance with a cash "kicker." He then made a nonrecourse loan secured only by the policy to the insured to finance the first two years' premiums. The interest on the loans was deliberately rigged so that, at the end of two years, the insured could not continue the policy and was forced to allow the lender (Gennaco) to take over the policy. Texas's Department of Insurance alerts agents, companies and consumers regarding SOLI market transactions called "zero premium life insurance," "no cost to insured plans," "high net worth settlements," "non-recourse premium finance transaction," and "new issue life settlements." A similar warning was issued by the Vermont and by the North Carolina Departments of Insurance, which opened an investigation of internet advertisers claiming to offer customers free life insurance in return for giving investors a beneficial interest in the policy. The release suggested agents should not enter into any agreement or arrangement to market or sell a "free" life insurance product.
June	NAIC's Executive Committee approved and a plenary vote of 46 – 0 approved [what]. The National Conference Of Insurance Legislators (NCOIL) met in Washington, DC. It discussed methods of preventing investors from manufacturing life insurance policies. Prior to the meeting, this group was urged by its leaders to pass a resolution urging state departments of insurance to promote enforcement of existing insurance laws that combat SOLI, update the insurable interest and life settlement laws with model language tailored to the existing laws which adds specific reference to premium finance schemes whereby an investor takes most of the death benefit at policy inception, makes an arrangement to purchase the policy, or pays an inducement to the consumer to take out the policy, and authorize life insurers to require an applicant for new life insurance to certify that she or he is not participating in a STOLI scheme. At a July 18, 2007 meeting, NCOIL continued its amendment of its Model Act but rejected the five-year ban that the NAIC adopted.