

## **Disposing of Excess Life Insurance**

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You were 22 and newly married. A friend from the high school days backed the hearse to the door and sells you your first \$5,000 life insurance policy. Over the years, you add to the list, winding up with a total life insurance portfolio of perhaps \$1 million.

Now, you are 70, and the premium notice for the largest policy is in your hand. Your home is in good shape and paid-for, you have \$100,00 in the bank and \$400,000 in securities, and you have an AT&T pension which with Social Security pays \$7,000 per month. No debt.

Your pension income is payable jointly and to the survivor for life, so except for a few hundred dollars downward adjustment in the Social Security retirement income for your wife, your death will not materially impact her financially.

The life insurance was bought to replace income lost to a premature death. But you didn't die. Then you thought of it as liquidity for an estate tax bill. But today your net assets must exceed \$2 million to incur an estate tax (or \$4 million with minimal defensive planning). You don't have that much.

If you no longer had to pay for the life insurance, you could afford four weeks in Tuscany . . . *every year*. So why hang onto it?

The answer may be to sell those policies to an institutional investor, perhaps for much more than the cash surrender value. Although such sales, called "life settlements," have grown in 10 years from \$1 billion in 2000 to \$15 billion in 2006, this form of sale is not without controversy. In this article, we will cover the arguments, pro and con, to see how much weight to assign and whether the sale of excess life insurance is really the great idea of the century.

**Plain Vanilla Life Settlements.** In the aftermath of 9-11, Newt Gingrich said, "This [Islamic jihad] war will be won by a busboy with a 22 and a silencer." In a life settlement, the prospective purchasers are always institutional because we don't want to do business with someone employing the busboy to improve the bottom line. The investor has medical experts evaluate your health history. The point is to gauge your probable longevity, thereby enabling the investor to discount the death benefit to date of purchase. The investor's aim is to purchase the policy so that the purchase price and policy premiums combine to yield a 15% net rate of return at the date of your death. The offers, however, vary all over the lot. This is partly due to differences in the underlying medical evaluation, and partly to heavy competition.

The payment is in cash. The taxation is less clear. Your tax basis in the policy is the total of premiums paid through the date of sale. IRS has issued two private letter rulings in which it contends that basis must be reduced by the mortality charge portion of the premiums. Remembering that revenue rulings and private letter rulings are merely the opinion of an IRS lawyer, not authority, the tax bar generally ignores these two statements. The second level is the difference between basis and cash surrender value; *e.g.*, you have paid \$5,000 per year for 30 years, a total of \$150,000, and the cash surrender value is \$210,000, a difference of \$60,000. This part is generally conceded to be ordinary income. The price received in excess of \$210,000 (in the illustration) is probably, but not certainly, capital gain.

The best prices go to the insured over the age of 70 who has some health problems affecting longevity; *e.g.*, high blood pressure versus arthritis.

**Investor-Originated and Stranger-Originated Life Insurance.** One long-time insurance industry gadfly, retired insurance professor Joseph Belth, calls Investor-Originated and Stranger-Originated Life Insurance "Speculator-Originated Life Insurance." Referring to these forms by their acronym (IOLI, STOLI, and SPIN

Life), these are transactions in which the applicant buys a policy for two years (to get it past the incontestable period) with the intention of selling it into the life settlement market at the end of that time, *for a profit*.

A finance company lends the insured enough money to pay the first two annual premiums, often using a non-recourse loan; *i.e.*, if the numbers do not hold up, the insured may walk away from the deal without liability for the loan. The process begins with (a) an applicant over the age of 70 years, (b) then a search for a company interested in selling a policy that will absolutely remain effect until it matures at death (depriving the carrier of the money to be made from lapses), then (c) issuance of the policy with various safeguards to assure the lender that it gets its loan repaid as a secured creditor. The method of securing the loan sometimes takes the form of a collateral assignment of the policy to the lender “as its interests may appear,” and more often through use of an irrevocable life insurance trust as owner-seller.

**The Opposition.** The public policy at work here is to discourage wagering on a life. It is not so much an issue when the insured is selling seasoned policies that are no longer needed, but clearly arises when the purchase and resale is instigated by others. The use of institutional investors is thought to temper an inclination to expedite policy maturity by felonious means, but it gives cause for pause.

At least 18 major life insurance companies refuse to issue IOLI and STOLI policies. The question is in the application, and the application is denied if the answer discloses an intent to resell the policy. Some agents have attempted to skirt the issue by completing the application incorrectly. When discovered, this may lead to policy rescission. One major carrier issued \$8 million to an applicant who did not disclose an intent to sell the policy. Two years later, the first sale took place. This led to an investigation and discovery that the insured had a modest net worth and had purchased \$100 million of life insurance through different companies, all for sale into the life settlement market. When put on notice, all the carriers rescinded their policies. Keep in mind that rescission is not available to the carrier after the two-year incontestible period. If rescinded, the carrier must return the premiums paid. When you consider interest on the premium financing, that refund may not be enough to make the lender whole. If the loan is recourse – that is, the applicant-borrower is liable for its repayment where the security proves inadequate – this could amount to serious borrower liability.

The major considerations are unlawful wagering on the life of another, and insurable interest. The purchase of life insurance without an insurable interest by the buyer in the insured makes it a wager.

The case law on the use of life insurance to wager on the life of another goes back to *Warnock vs Davis* in 1881. There, the court saw it as, “. . . a mere wager, by which the party taking the policy is directly interested in the early death of the assured.”

In 1889, the court in *Steinback vs Diepenbrock* held that the law must look to both form and substance. “The insured, instead of taking out a policy payable to a person having no insurable interest in his life, can take it out [payable to his estate or to one or more dependents, than at once assign it to someone with no insurable interest]. But such an attempt would not prove successful, for a policy issued and assigned under such circumstances, would be none the less a wagering policy because of the form of it.”

In 1911, the court in *Grigsby vs Russell* explained the rationale for an insurable interest: “A contract of insurance upon a life in which the [policy owner] has no interest is a pure wager that gives the [policy owner] a sinister counter interest in having the life come to an end. And although that counter interest always exists, . . . the chance that in some cases it may prove a sufficient motive for crime is greatly enhanced if the whole world of the unscrupulous are free to bet on what life they choose.”

Under New York law, life insurance without an insurable interest is prohibited. It defines insurable interest as follows:

“(A) in the case of persons closely related by blood or by law, a substantial interest engendered by love and affection; (B) in the case of other persons, 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 courts, especially the courts of New York, have regularly criticized attempts to evade the insurable interest rule. The lack of an insurable interest will not stop a subsequent assignment, there must be an insurable interest in the first instance, as well as a good-faith intent to obtain insurance for the benefit of the insured’s dependents or business. The *Grigsby* court put it this way: “[t]he very meaning of an insurable interest is an interest in having the life continue.”

**Intent.** A good-faith intent to obtain insurance for the benefit of the insured’s dependents or business, is divined at the date of policy purchase. The courts will read the policy and assignment together – as a single transaction if clearly related – in order to determine a “wagering intent.” (*Finnie vs. Walker*) The following factors are considered most relevant:

- Did the applicant pay for the policy from personal resources?
- How much time elapsed between the purchase and the assignment?

The Office of General Counsel for the New York State Insurance Department rendered an opinion published December 19, 2005 that IOLI, STOLI, and SPIN Life purchases are impermissible because “it appears that the arrangement is intended to facilitate the procurement of policies solely for resale.” The opinion goes on to say that a legal power to assign a policy to someone having no insurable interest does not, by itself, remove it from consideration as a wagering transaction.

**Facts and Circumstances.** In one \$10 million case, the insured contended in court that (a) he signed the policy application himself, (b) he was at all times able to retain the policies if he so chose, (c) he alone established the life insurance trust that owned the policies, and (d) he was the sole beneficiary of the trust, and the trust was the sole beneficiary of the policy.

The court said, “So what? Even if true, those facts alone do not contradict the inference of intent to sell the policy before it was even bought.”

- He had no apparent interest in buying life insurance before being approached by the agents.
- The plan to resell the policy existed prior to its purchase.
- He intended at all times for the lender to pay all the premiums for the first two years, and for the life settlement investor institution to maintain it until his death, receiving all benefits except the net proceeds of policy sale.
- He obtained \$10 million of life insurance at age 77 at no cost to himself.
- His income was such that he could not afford to pay the premiums for \$10 million of life insurance, and in fact, was attracted by the windfall sale profit anticipated.
- His life insurance trust was signed the same day he signed the life insurance application.
- The trust agreement mentioned the institutional investor as a possible purchaser.

- The insurance carrier was involved throughout the transaction, including having its legal department draft the trust.
- He (the insured) had no input into the preparation of the trust agreement.
- A letter from the agent to the insured, dated two days after the policy was issued, noted the interest of the insured in assigning the beneficial interest in the trust (thus the policy proceeds) to the institutional investor, enclosing two forms naming that investor as the assignee.
- He signed and returned the documents immediately on receipt, and without taking the time to consider either the details of the transaction or other options.
- He was the beneficiary of the trust that was applicant, owner, and beneficiary of the life insurance insuring his life, assigned his trust beneficiary interest within two days following policy issuance, and never paid any of the premiums.
- In applying for the policy, the agent never answered the question in the form asking whether the applicant (the trustee) was purchasing it for “. . . any type of viatical settlement, senior settlement, life settlement or for any other secondary market.”
- His claim to have a net worth of \$8 million to \$10 million was not persuasive upon a showing at trial that his true net worth did not approach those numbers, and that he therefore lied on the application.

**The Constitutional Right of Free Alienation.** Under the *Constitution of the United States*, Article I, Section 10, no state may pass any “. . . law impairing the obligation of contracts . . .” Based on that premise, one might argue that the insured has an absolute right to assign the policy or trust interest to anyone he or she pleases, whether or not an insurable interests exists. The response, however, is only interests in *valid* policies may be transferred. If there was either misrepresentation in the inducement (to cause the carrier to issue the policy), or a pre-issuance *agreement to assign* the policy (making it an invalid wager on the life of the insured), the policy is invalid, thus non-assignable.

**Conclusion.** In order to discern when the purchase and sale of a life insurance policy is both legal and consistent with established public policy, you must be aware of the arguments here presented. As with the abuse of *Goldsmith vs John Hancock Mutual Life* back around 1960, there is always someone who pushes the envelope too far, spoiling a good thing for everyone else. (In that case, it involved the loss of deductibility for policy loan interest on financed life insurance.) Approaching seventy-something prospects for inordinately large life insurance purchases for the sole purpose of reselling them into the life settlement market crosses the line of applicable public policy. That does not, however, eliminate the concept altogether.

The opening discussion of the sale of policies originally purchased for real needs, but after they no longer fill those needs, remains practical. They also run little “busboy” risk when sold to an institutional investor.

Similarly, if you are a regular supporter of a favorite church or charity, it has an insurable interest in your continued support, as well as a prospective loss on your death ending that support. Therefore, there should be no practical, ethical, or legal difficulty in obtaining life insurance on you where the entity is applicant, owner, and beneficiary, with you providing the insured life and two or more annual premiums. This should be relatively unaffected by an awareness that the policy may be sold to an institutional investor any time after the incontestible period expires. Arguably, it should also be unaffected by non-recourse financing of the premiums during those first two years where the option exists for your donations to be applied to payment of the ongoing premiums if the policy is *not* sold. Obviously this argument does not hold water if you are donating \$300 per year and the premiums are \$30,000.

Most institutional investors require a policy of at least \$500,000. Some now, however, will purchase then down to \$50,000. So, I would argue:

- that if you can afford to maintain a policy of \$50,000 or more, even a term policy;
- you are the applicant, and your dependents (or a trust for their benefit) are named as beneficiaries; and
- you pay the premiums for two years without borrowing;

you should face no problem with either industry opposition or the ethics of public policy in selling the policy should you decide to do so for any reason two or more years later.

If you have maintained a portfolio of policies over the years for family protection, and retire with all or most of them in excess of needs, their sale into the life settlement market can provide a welcome addition to retirement capital. If over 70 and healthy, you may expect 3% to 5% of the death benefit, and if over 70 and *not* so healthy, perhaps a great deal more. In all cases, the sale price should substantially exceed the surrender value. Just stay with institutional investors so you need not look over your shoulder for the busboy.