

**About
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+ Cohen**
Client satisfaction
comes first

Because of our commitment to client satisfaction, we develop one-to-one relationships with all of our clients—from individuals to families and business owners. This helps guide our clients to the right financial solutions.

The trusted advisor

At Newman + Cohen, we distinguish ourselves as a business that operates on a foundation of integrity, quality service, lasting relationships, and sound performance.

We share insights and help develop customized strategies that ensure the continued growth and success of our clients. Our expertise, along with the wide array of insurance and financial products we offer, will help make your financial journey a success.



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**Investor-initiated
life insurance
(i.e., STOLI, SOLI, IOLI)
Nothing is for free—
there is always a cost**

In every profession, there are those who choose to use newly created strategies for the benefit of their clients, and there are those who push the envelope too far for their own personal financial gain without regard for their clients. The life insurance industry seems to be a haven for these individuals as each new strategy (gimmick) is engineered.

I have been in the life insurance industry since 1991. There was a time when VEBA's were the hot new strategy in which life insurance was sold on an income-tax-deductible basis in a welfare benefit plan. The plan was nothing more than a guised retirement plan which when attacked by the Service would be disallowed as a tax-deductible expense. The list is endless, and unfortunately these plans are all merely methods to sell life insurance by playing to the greed of the client.

By providing a little background, it will be easier to understand the risk of the transaction. Not too long ago, the life settlement industry moved from the viatical business, where terminally ill individuals (predominately AIDS victims) were selling their policies prior to their deaths. The benefit to the insured was to provide either a better way of life or provide funds to research treatment alternatives when there were no other sources of funds to pay for these treatment alternatives.

Fortunately for these individuals, treatment alternatives became more advanced and AIDS patients were able to enjoy a more typical life expectancy. Unfortunately for the investors, the returns promised never materialized, as the insureds did not die as expected.

Savvy investors realized the potential financial benefit of being able to predict mortality and searched for a segment of the population in which mortality can be easily predicted for large groups of individuals. That segment of our population is the elderly. I once heard Joe Jordan, an executive at MetLife, speak, and he indicated that older people have a tendency to die before younger people. Not exactly profound, but very true and very predictable!

A life settlement is the sale of a currently owned life insurance policy outside of the contestable period where life expectancy is greater than one year. It is my experience that buyers of life insurance policies are searching for individuals with life expectancies of between 10 and 15 years, or individuals of at least 70 years of age. Health impairments such as cancer or heart conditions will of course reduce life expectancy, and policies issued on younger individuals may qualify for life settlements.

The process by which life expectancy is determined is very similar to the analysis of health at the time of policy issuance, with the exception of a physical exam. Medical records are obtained with authorization and are assembled. The medical records are sent to companies that specialize in

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Investor-initiated life insurance...

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predicting life expectancy. Once life expectancy is determined, the policy is analyzed through the request of in-force illustrations outlining the projected cost to maintain the policy until the death of the insured.

Each life insurance buyer has determined what they are targeting as a projected rate of return. The offer to purchase the policy is made based upon the information outlined above. Not discussed is the bidding process and how commissions are generated by both wholesale brokers and the actual agent assisting in the transaction. Also not outlined is how the bidding process takes place. Needless to say, the combination of experience and the ethical nature of the agent involved will have a tremendous effect on the selling price ultimately received by the seller of the policy.

The use of life settlements, if used correctly and if properly planned as part of the long-term estate-planning process for high-net-worth families, may be a tool that will create wealth and significantly leverage the life insurance value to the family and/or charity. In other circumstances, where life insurance is no longer needed, prior to the creation of the life settlement industry, the carriers were able to establish the fair market value of a policy, also known as the policy surrender value. Now the marketplace will dictate the actual fair market value of a policy through the life settlement process, which is traditionally far greater than the surrender value at the ages outlined above.

Being patient is not historically the most favorable attribute of a life insurance salesperson. Furthermore, a disproportionate percentage of sales agents do not follow up consistently with their clients; they are on to the next first-year commission. Rather than wait and allow the marketplace to absorb this wonderful new concept of life settlements, sales agents wanted to find a process to create first-year commissions through new sales of policies that are expressly purchased to settle (sell). Accordingly, they appealed to the greed of people through the enticement of potential profit with no perceived risk, and the "nonrecourse" business was established providing a vehicle for agents to sell life insurance.

Programs were brought to agents whereby nonrecourse loans would be made to elderly individuals expressly for the purpose of purchasing life insurance to sell upon the passing of the incontestable period. These

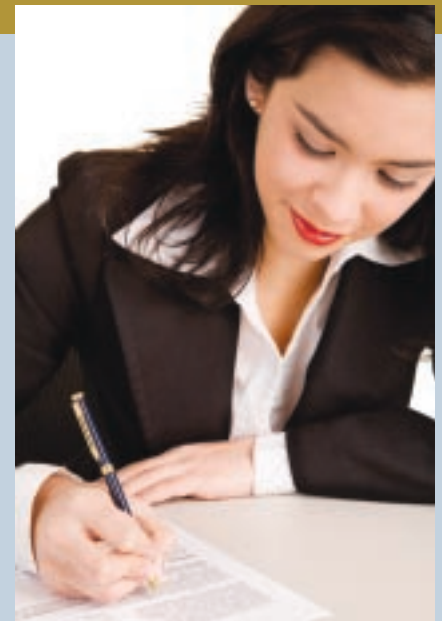
programs called for significant up-front costs that are capitalized in the nonrecourse note, interest to be accrued a few points above LIBOR, and nearly usurious back-end charges should the insured desire to maintain the policy and not sell it.

Furthermore, many of the initial programs required the lender to be the exclusive sales agent upon sale, to include minimum commissions prior to the insured being able to profit. The sale was not made with the allure of free life insurance, but with the anticipation of financial gain upon sale over and above the sum total of all costs outlined above. Other "deals," rather than waiting the two-year incontestable period, made up-front payments to individuals, merely buying the insured's ability to purchase life insurance.

I do not want to create the image that all agents are bad and that all premium finance programs do not have merit. Recently, a few "approved programs" have been created that legitimately utilize the projected fair market value of the death benefit as collateral. In each of these programs, the owner/insured will make a financial commitment for at least a portion of the loan, or at a minimum the insured/owner will pledge collateral for at least 25 percent of the loan even though the projected fair market value of the policy may be in excess of the loan.

Furthermore, the lender has no financial interest in the potential sale of the policy. The lender has the long-term intention of lending for more than the two-year incontestable period. Most importantly, the lending is completely disclosed to the carrier along with any supporting documentation. As a result, the policy will be issued with complete disclosure and approval by the carrier. Not all carriers have approved even these deals, including John Hancock.

Getting back to those "deals" where we believe risk to exist, what are the pitfalls even in these early programs? Due to the usurious nature of either the back-end program, where high-net-worth individuals could easily afford the premium, or "up-front deals," there is a lack of insurable interest by the "real" buyer of the policy. Why? The purchaser is merely a de facto purchaser for the financial benefit of an individual or entity that will not suffer a financial detriment upon the death of the insured. Accordingly, the de facto purchaser is prohibited from purchasing life insurance on said life, as there is



Any person who knowingly and with intent to injure, defraud, or deceive any insurer files a statement of claim or an application containing any false, incomplete, or misleading information is GUILTY OF A FELONY OF THE THIRD DEGREE.

no insurable interest.

Further exacerbating the issue is the desire of the agent to sell as much life insurance to increase commissions earned. The insureds who were lured into these programs with promises of significant financial gain without risk are asked to inflate their financial net worths and forget about other life insurance that may already exist on their lives.

You now may be asking yourself, "Why is the net worth of an insured relevant to the purchase of life insurance?" There are two levels of underwriting that take place prior to a carrier making an offer of insurance; they are as follows:

MEDICAL—Life expectancy is projected based upon an analysis of medical issues and certain types of avocations, such as skydiving, motorcycling, or scuba diving. Based upon these results, a life expectancy is created and converted to either preferred, standard additional charges and even possibly uninsurable.

FINANCIAL—Based upon the net worth of a family, each carrier, separately, will determine the total line of coverage available to the proposed insured. The overall line will be reduced by coverage existing at the time of application (including any that may have already been settled) and that which may be applied for with a different carrier.

If you are attempting to determine your overall insurance capacity, the calculation is made by multiplying your net worth by 50 percent. This amount is increased based upon your projected

life expectancy, which is determined by current age. Once life expectancy is determined, 50 percent of net worth is increased 6 percent per year up to life expectancy and is reduced by currently in-force coverage.

Accordingly, potential liability was created by certain advisers for their clients by coaching fraudulent answers on the application. Significantly overinflating the family net worth is one of the ways liability to the insured has been created by the adviser. These fraudulent answers increase total lines of coverage and the amount of coverage purchased by the unsuspecting proposed insured, thus increasing agent compensation. In other circumstances, currently in-force coverages have not been disclosed normally in concert with overstated financial information. The effect is the same: greater agent compensation!

Each of these situations is a fraudulent representation to the carrier, inducing the carrier to issue coverage in amounts far greater than the carrier would have issued had they been provided with correct answers.

Litigation has already been commenced by insurance carriers in their attempt to rescind fraudulently issued policies. On October 11, 2007, Lincoln National filed suit against Gordon R.A. Fishman Irrevocable Life Trust, Gordon R.A. Fishman, MD, Hannareta Fishman and MCC (promoter) in U.S. District Court, Central District of California, Eastern Division—Riverside, Case No. CV-07-1338 to rescind certain policies issued. There are numerous other cases that have been filed by carriers in their attempt to unwind these transactions.

As the carriers began to understand what was happening, they began to ask specific questions

concerning the use of premium finance or nonrecourse loans. Assuming these questions were answered correctly, very few, if any, carriers would issue coverage, regardless of medical and financial underwriting.

The next generation of “deals” began to arise whereby the intent of the transaction is hidden from the carrier. All questions pertaining to premium financing or nonrecourse financing are answered no, thus avoiding further inquiry by the carrier to determine the real intent of the coverage.

An irrevocable trust is created to own the coverage, and the life insurance is purchased in the name of the irrevocable trust. The irrevocable trust is disclosed to the carrier and indicates that the beneficiaries are those chosen by the insured, which are traditionally family members or trusts for their benefit.

Depending upon the “deal,” monies are paid up front to the insured, and the trust is redacted and the beneficiaries change to those who have in reality purchased the policy. Other “deals” wait two years and a sale takes place of the trust interest. Accordingly, the beneficiary is not and was never intended to be the family, but was a separate and disinterested party with no insurable interest in the policy.

To further hide the transaction from the carrier, false or misleading answers are provided during the inspection interview that each carrier conducts with a proposed insured prior to policy issuance. These questions pertain to avocations, doctor’s visits, intent (policy purpose), annual income, and net worth. Incorrectly answering these questions further lends credence to the overall fraudulent intent of the transaction.

Needless to say, there are numerous other

schemes used to disguise the real intent of the transaction from the carriers. The next logical question relates to what can take place if the carrier determines if there was a fraudulent inducement made to the carrier.

The most important one is that lying on a life insurance application in the state of Florida is a third-degree felony for which I cannot tell you what the sentence could be!

All other risk is financial. Every “deal” I have reviewed indicates that the intent of the transaction is that the policy will not be sold and that the policy will be owned for traditional uses (estate planning, etc.). The agreement supporting the transaction between the lender and the insured contains certain covenants, as do all agreements. The specific covenants I am most concerned about relate to representations made on the insurance application by the “proposed insured” (not the agent who merely is filling out the form).

- All agreements request that the proposed insured represent that if the insurance carrier was induced into issuing a policy based upon fraudulent information, the nonrecourse nature of the underlying loan is voided and the lender has every right to attack the proposed insured for all losses relating to the fraudulent statements.

- These representations further preclude the proposed insured from attempting to void the transaction by notifying the insurance carrier subsequent to policy issuance. The notification of a carrier of the specifics of the transaction would also cause unlimited personal liability to the proposed insured.

- Furthermore, all of the representations and warranties made in these agreements further indicate that the purpose of the transaction is everything but the express purpose of selling the policy.

Liability arises to the proposed insured during their life, both before and after the policy is sold. The carrier has the right to perform postissuance underwriting within the two-year contestable period. This may take place merely due to the luck of the draw (like an IRS audit) or because they have had numerous large cases come from one agent in one geographic area which is not normal for that agent, or they have found that the agent in question has written “SOLI” business and they are now investigating all the policies he/she has sold. I will discuss what can happen, both within or outside of the two-year contestable period.

WITHIN CONTESTABLE PERIOD

The carrier conducts their investigation, and it is determined that the questions asked on the

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John Hancock Financial Underwriting Supplement sample application questions



- ◆ Is there, or will there be, an understanding or agreement providing for a party, other than the Owner, to obtain any right, title, or other legal or beneficial interest in any policy issued on the life of the Proposed Life Insured(s) as a result of this application?

- ◆ What is the planned source of the funding for the policy(ies) currently applied for?

- ◆ Will the Owner, now or in the future, be paying premiums funded by an individual and/or an entity other than the Proposed Life Insured(s)?

- ◆ Will the premiums be financed through a loan?

If “Yes,” answer the following questions:

- ◆ What is the interest rate per annum?

- ◆ In addition to repayment of principal and interest, are there other fees, charges, or other consideration to be paid on maturity?

- ◆ What is the duration of the loan? Who is the lender? What amount and type of collateral is required to secure the loan?

- ◆ Will any policy issued on the life of the Proposed Life insured(s) as a result of this application replace a policy which has been vaticated or settled?

application were fraudulently answered. Specifically, those disclosures relating to "premium finance" were answered "no" by the "proposed insured."

Furthermore, during the inspection report, the "proposed insured" was further coached to answer specifically that "premium finance" was not utilized. Additionally, when asked about any inducement by the agent to enter into this transaction, the proposed insured further answered no.

To make matters worse, the application questions pertaining to net worth and then reconfirmed during the inspection report more than doubled the real net worth of the proposed insured.

WHO HAS LIABILITY?

The proposed insured clearly committed fraud on the application. The agent is merely a scribe, and the author is the proposed insured. The carrier has the right to reverse the policy issuance to offset the return of premium by their damages, including a reversal of commission.

On the other hand, the proposed insured has made representations that no fraud was committed during the inducement for the carrier to issue the policy. Accordingly, the documents were very self-serving by the lender, and these representations now create liability by the proposed insured to not only the carrier, but also to the lender, for their damages. This includes:

1. Commissions reversed by the carrier, as the lender is normally enjoying at least 33 to 50 percent of the first-year commissions generated from the issuance of the policy.
2. Lost earnings on the spread between their borrowing rate and lending rate.
3. Up-front costs to initiate the transaction to include legal documentation and additional inception fees included in the loan.
4. Commission on the sale of the policy at the back end of the deal.
5. Projected profit made by the lender upon the death of the proposed insured that would inure to the lender.
6. Legal costs to protect their interest in the transaction.

Not calculated would be the cost to hire criminal counsel to represent the proposed insured if the carrier felt so wronged by the proposed insured that they chose to bring this matter to the attention of the State Attorney.

OUTSIDE THE CONTESTABLE PERIOD AFTER SETTLEMENT OF POLICY

In discussing this exact issue with various attorneys and life insurance carrier officials, the

passing of the contestable period may not result in a free ride to those who have already entered into a "SOLI" deal. This potential liability is due to the fact that fraud in most states does not carry a statute of limitations. Many believe that if fraud is committed outside of the contestable period, there is no liability. From what we can tell, the jury is still out, and the carriers seem to believe that there is no statute of limitations for fraud.

Who is correct regarding the incontestable period and if the insurance carriers have the ability to contest a claim after the two-year incontestable period is still not decided. However, one still must decide if he/she wants to carry on a significant legal battle with an industry poised to hire the best legal minds, at your potential expense, to help determine who is correct.

From what I gather, the carriers are all taking the position that there is no statute and when determined even after the two-year contestable period, but before death, they will attempt to unwind the "deals" as they are found. If they are correct, please see above and attempt to determine what your or your clients' legal fees may be in attempting to unwind this transaction.

If the carriers are correct, there will never be any peace for individuals who entered into these types of transactions, and that liability will continue until the death benefit is paid by the purchaser after the proposed insured has died.

UPON DEATH OF THE PROPOSED INSURED AFTER SETTLEMENT OF POLICY

If the carriers are correct and fraud supersedes the contestable period, and a carrier determines that the policy was issued fraudulently, they would have the right to deny a claim. Assuming a \$25 million death benefit, don't you think the lender would be a bit angry and attempt to litigate to collect by virtue of enforcing their agreement as discussed above? While the proposed insured would be dead, their action would be made against the estate (surviving spouse or children) for financial injuries sustained by either the carrier and/or the lender.

Our experience indicates that many of these policies were on the lives of the husband. They entered into the transaction so they could "stay in the game" (they are looking for some action), which is often the case after retirement. They made \$500,000 and paid 35 percent in income taxes on the gain, which was further reduced by 50 percent of what was left in estate taxation, or the net to their family was \$162,500—a lot of money, or is it?



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Assuming this was a \$20 million family, did it really mean anything? Assuming the proposed insured truly understood the risk to themselves or their family, would they have consummated the transaction? I don't think so!

They really would not undertake the risk if the agent was not catering to the greed of the client, but truly looked at what was best for the proposed insureds and their families. If the sale of the ability to buy life insurance is so good for buyers to pay huge sums for these policies, perhaps it is something that should not be sold but kept for family enjoyment?

Once the life insurance profession intercepts these "schemes" and starts educating the professional public (CPAs and attorneys) about how truly transforming life insurance products are and how they can further increase the benefit of traditional estate-preservation techniques, only then will the buying public truly benefit by being exposed to planning opportunities only known to a select few professionals.

No proposed legislation affecting the life settlement industry discusses the abolishment of the industry except for that portion of the industry advocating "SOLI." As a matter of fact, life settlements correctly used are supported. What is not supported are specific techniques used to purchase life insurance without financial participation by the proposed insured for the specific intent to sell the policy to a disinterested third-party investor who has no insurable interest in the life insurance. The life insurance industry and the regulators do not want betting to take place from the inception of a policy issuance on the lives of individuals; that is left to places like Las Vegas and Atlantic City.