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Premium Finance In 2010

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New York, Fishman and General US Grant

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Guiding Principals of Premium Finance

- A Lender has an insurable interest to amount of the loan
- However are the terms of the loan merely a disguised assignment?
  - Who gets the death benefit during the loan term
  - Is default required or effectively mandated
  - Is there a right to sell the policy and pay off the loan
  - What is the effect of non-recourse

Various Strategies and The Threat to Insurable Interest

- Upfront Cash
- High Interest Rate
- A Put Option
- Required Use of Broker
- Interest in Settlement Value

Do Aggressive Lending Strategies Violate Insurable Interest?

- Yes according to the New York Insurance Department
- No according to the California Federal Court

NY OGC Opinion, December 2005

- Details of Proposed Transaction
  - Lender would give full recourse loan to high net worth individual, which individual would use to purchase a policy on his or her own life.
  - Loan principal is equal to amount of premiums due on the policy, through a specific date, which would be after the expiration of the policy's contestability period (the "Exercise Date").
  - A separate party, usually a hedge fund, would agree to purchase the policy on the Exercise Date for a predetermined price covering repayment of the loan and accrued interest.
  - Hedge fund's participation would enable the borrower-insured to avoid any risk under the recourse loan.
  - The borrower-insured was not required to sell the policy on the Exercise Date, but could pay off the loan, with interest, and continue to retain ownership of the policy.

NY OGC Opinion, December 2005

- NY OGC's Opinion: Proposed Transaction Violates Insurable Interest Laws
  - OGC concluded that the insured would not be acting on his or her own initiative but would be persuaded to enter in the transaction because of perceived favorable terms -- However, no facts discussed in the opinion support such a conclusion.
  - OGC also concluded transaction would be in violation of New York's insurable interest law since it involved, "the procurement of insurance solely as a speculative investment for the ultimate benefit of a disinterested third party," constituting gaming in violation of New York law.
  - The opinion treated the put option as if it were a pre-agreed contract to sell the policy, despite the fact that: (i) the borrower had the right to retain the policy, and (ii) no transfer would occur for at least two years.
  - Since the OGC opinion was an opinion issued by an administrative opinion, it does not have binding effects on the courts. Thus, courts reviewing the opinion would likely consider it in conjunction with existing statutes and case law, as well as other similar opinions.

OGC Opinion Not Supported by New York Law

- In 2005 New York law Dictated that a Prior Agreement Was the Key Factor in Determining Validity of Procurement and Assignment
  - *St. John v. American Mutual Life Ins. Co.,* 13 N.Y. 31, 41 (1855)
  - *Olmsted v. Keyes,* 85 N.Y. 593, 600 (1881)
  - *Steinback v. Diepenbrock,* 158 N.Y. 24, 32 (1899)
  - *Finnie v. Walker,* 257 F. 698 (2d. Cir. N.Y. 1919)
  - *Travelers Ins. Co. v. Reiziz,* 13 F. Supp 819 (E.D.N.Y. 1935)

OGC Opinion Not Supported by New York Law

- **New York Courts Did Not Consider a Put Option to be a Prior Agreement**
  - New York Courts recognized that an option contract, such as a put option**,** is a unilateral agreement that provides rights to the holder of the option or put but no rights to the provider. *Kaplan v. Lippman*, 552 N.Y.S.2d 903 (1990).*Gluck v. Reuben Rose & Co.*, *Inc., et. al.,* 290 N.Y.S.2d 73 (N.Y. Civ. Ct. 1968).
  - As explained by the New York Court of Appeals: “The most striking feature of the contractual arrangement known as an ‘option’ is that while the optionor cannot act in derogation of the terms of the option agreement, the optionee is not bound until the option is actually exercised. **Thus, until the optionee gives notice of his intent to exercise the option, the optionee is free to accept or reject the terms of the option.**” (emphasis added) *Kaplan,* 552 N.Y.S.2d at 905.

Fishman – The MCC Program

- The Loan
  - "Premium Reserve" equal to 3% of face, a "fee for unused insurance capacity"
  - 2 year premium
  - Lender fees

The Interest

- 10%, plus
- Contingent interest no greater than 10% of face or the amount that the fair market value exceeds principal and interest, if the loan will be paid off
- Out of eighty Lincoln Policies financed, all were sold or forfeited

The Question

"As noted at the outset, resolution of this case comes down to the simple question of whether the policies issued by Lincoln were void at the inception because they were a stranger owned life insurance policy, which is prohibited under California law."

"Thus, read in conjunction with one another, California law provides that, for an insurance policy to be valid, it must, at its inception, have been held by someone with an insurable interest in the person so insured under the policy, that is to say, by someone who has an interest and advantage in "the continued life, health or bodily safety of" the insured and who would suffer a "consequent loss" where any of those situations to come to pass."

"Instead, Lincoln seeks for the Court to focus on MCC – the fact that it was almost immediately awarded a collateral assignment on the policy, the general practice and nature of MCC's program, and the allegation that the form in which the transaction went down with the Trust was nothing but a sham and that the Court therefore should basically pierce the contract/agreements' formalities and construe the transaction as actually conceived and intended by the parties."

"Notably absent form Lincoln's argument is any citation to authority from California (as opposed to citation to a federal district court opinion from Florida, New Jersey, and Minnesota, as well as bulletins issued by various state insurance regulators warning against the type of deal structured by MCC) allowing a court to basically look behind the terms and other formalities of an insurance agreement(s) and basically re-write it to reflect what was really going on between the various parties thereto insofar as determining the existence (or lack thereof) of an insurable interest to an insurance policy."

"The problem, as pointed out by defendants, is that when MCC took out a collateral assignment on the Policies said assignment was limited to that of a secured creditor, not an owner or absolute assignee. This is critical because California law recognizes that the fact an insurance policy is secured by assignment to a creditor does <u>not</u> change or otherwise impact the determination of whether an insurable interest exist (a proposition that may well change with legislative hearings in the California legislature)."

"So the fact remains that for two years this not only had the formal appearance of a legitimate life insurance policy on Dr. Fishman's life for the benefit of someone with an insurable interest in the same, but was in fact true as well."

"MCC's finance program skirts close to the letter, and certainly can be viewed as violating the spirit, of the law. Defendants may have found a loophole in the law barring a STOLI finding, but it is clear to the Court that this whole arrangement with the Fishmans was nothing but a more creative version of the same. Unfortunately for Lincoln, the law as it presently exists allows this kind of insurance arrangement to be valid. In such a circumstance, it is perhaps best to follow the wisdom expressed long ago by President Ulysses S. Grant, who said that "the best way to get rid of a bad law is to enforce it.'"

Have The Legislatures Changed a Bad Law?

- Overview of the laws
  - 2 year prohibition – does this eliminate the question of intent
  - Applicable to whom – a grantor in the state or a trust in the state
  - Is a loan a LSC?

California Answers the Challenge?

- Residence of the owner – or trust – controls, "regardless of whether or not issued for delivery in this state"
  - May a California Resident create a trust outside the state so that the trust may use premium finance to pay the premiums?

Insurable interest Section, 10110.1, amended to provide: “Trusts and special purpose entities that are used to apply for and initiate the issuance of policies of insurance for investors, where one or more beneficiaries of those trusts or SPEs do not have an insurable interest in the life of the insured, violate the insurable interest laws and the prohibition against wagering on life.”

and

"Any device, scheme or artifice designed to give an appearance of an insurable interest where there is no legitimate insurable interest violates the insurable interest laws"

- Fraudulent Life Settlement Act Includes: “Misrepresent the state of residence of an owner to be a state or jurisdiction that does not have a law substantially similar to this act for the purpose of evading or avoiding of this act.”
- To be contrasted with,
  - LSC is defined as, “a written agreement solicited, negotiated or entered into in this state between a provider and an owner.”

Restrictions on Premium Finance

- Definition of LSC includes a loan made on or before the date of issuance where:
  A. Loan proceeds are not used solely to pay premiums plus the costs and expenses of the financing.
  B. The owner receives on the date of the loan a guarantee of the future life settlement value
  C. The owner agrees on the date of the loan to sell the policy or any portion of the death benefit on any date following policy issuance, not including an agreement to sell the policy in the event of a default, "provided that the default is not pursuant to an agreement or understanding with any other person for the purpose of evading regulation under this act."

- Definition excludes:
  - A premium finance loan as defined in the act, or any loan made by a bank or other licensed financial institution, “provided that neither default on the loan nor the transfer of the policy in connection with the default is pursuant to an agreement or understanding with any other person for the purpose of evading regulation under this act.”
  - A loan by a lender that does not violate Article 5.8 of chapter of 1 of part 2, (Pre-Finance Section of Insurance Code) as long as the loan does not fit the LSC definition
- A premium finance loan is defined as one, “primarily for the purpose of making premium payments, which loan is secured by an interest in the policy.”

- "No person providing premium financing shall receive any proceeds, fees, or other considerations from the policy or owner of the policy that are in addition to the amounts required to pay principal, interest, and any reasonable costs or expenses incurred by the lender or borrower in connection with the premium finance agreement, except for the event of default unless…
- A violation of this section is a fraudulent life settlement act.
- Carrier may inquire on application about premium finance.

New York Act

- Applicability and choice of law is determined by residence within the state of an individual owner, but for a trust, by the state in which the grantor resides

Restrictions on Premium Finance

- Definition of LSC is different – need not be entered into in the state if the owner is in the state and does not include premium finance loans.
- LSC specifically excludes an assignment of a policy as collateral for a loan by a licensed financial institution, “provided that the default itself is not pursuant to an agreement or understanding with any other person for the purpose of evading regulation under this article,” or a loan made by a lender that does not violate Article 12b of the banking law.

Side Bar – Rhode Island Statute

- The Rhode Island Statute has an exception for “any loan made to an insured, a trust established by an insured, or an entity established by the insured by a bank, federally regulated entity or other licensed financial institution or any transfer, foreclosure, option to transfer, sale of any interest in collateral of such loans subsequent thereto not for the purpose of evading regulation under this statute

New York Changes to Banking Law

- Banking law currently has exemptions, into which many premium finance loans fall.
- Current law prevents any automatic default or acceleration, or power of attorney to confess judgment
- Settlement Act adds to Banking law: “No person may use a premium finance agreement in a manner designed to evade any requirement of the life settlement act

- Annual Filing for “Every person or premium finance agency that enters into a premium finance agreement.”
  - Must file with the insurance department an annual statement of financial condition
  - Details for the annual statement to be determined by the superintendant of insurance
  - The annual statement shall state the “aggregate face amount and life settlement proceeds of policies settled during the immediately preceding calendar year, together with a breakdown of the information by policy issue year.”

Other Restrictions

- New York has similar restrictions on the lender's ability to recover more than the loan amount
  - Lender is restricted from receiving any proceeds fees or other consideration from the policy or the owner, with an exception for "commissions earned by a licensed insurance producer."
  - New York also provides that any amounts that are in addition to the P&I and expenses "shall be remitted to the original owner or to the original owners estate."

    Also, if the policy is "sold, assigned, transferred, devised or bequeathed pursuant to the terms of a premium finance loan, any proceeds or other consideration received other than the amounts specified above shall be remitted to the original owner…"

Have the Acts corrected:

- Sale Mandated under the loan
- Upfront cash
- Interest Rate
- Put Option
- Brokerage fees on resale
- Non-recourse

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Insert Pro Closing Slide:

Insert Program Title/Date gram Title

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