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

By Stephan R. Leimberg

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

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

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

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

> *We ask that you do two things for us:*
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> *The first is for you to make certain medical and other personal information available to us.*
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> *The second is that you do something which we can't legally do directly. We can't buy millions of dollars of new insurance on your life. That would be illegal. So we'd like you to take out the insurance for us by pretending to take it yourself out for your own needs. Just tell the insurer you are buying it for "estate planning purposes." (We may "puff up" your wealth and/or income so you can qualify for a multi-million dollar policy and make even more money.)*
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> *In return, we'll provide you with millions of dollars of "free" coverage for two years. We'll do that through no-risk financing which we'll arrange.*
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> *Now we know you don't really want or think you need any new insurance and that's fine with us. Because we both know that's not what this is all about. At the end of the two years, you can sell this two year old insurance to us and make a heck of a profit! In many situations, sellers have been getting more than enough to easily pay off the premium loans, interest, and – even after brokerage costs – make a very handsome return. That's in addition to your two years' free insurance.*
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> *But wait – there's more! If all that's not enough, we will offer you an immediate "sign-up" bonus of – say 2% of the death benefit! So if you buy $1,000,000 of insurance, you get a check for $20,000! Buy $5,000,000 of insurance, we'll write you a check – today – for $100,000.*

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

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

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

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

Want some proof?

> **Section 13. Prohibited Practices** – of the National Conference of Insurance Legislators (NCOIL) Model Act specifically provides that **it is unlawful for any person to enter into a life settlement contract if such person knows or reasonably should have known that the life insurance policy was obtained by means of a false, deceptive or misleading application for such policy**. So if the Act is effective in your state and you omit mentioning the true reason for purchasing "free" insurance (to turn around and sell it), you may be barred from selling the policy to the very group of investors who encouraged you to buy it! Worse yet, Section 14B-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."**
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> A recent Texas alert is a reminder that **filing an application for insurance containing materially false information may be prosecuted as insurance fraud and subject the actor to civil and criminal penalties.**
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> **In fact, in every state, insurance fraud is a serious misdemeanor or felony and in many cases will be punishable by jail time!**

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

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

1. You are selling away your "life." Once investors get the policy on your life, no matter how much your family or business needs new coverage (and the insurance company wouldn't issue the policy if they *didn't* think your family or business really *did* need it), you may never be able to get more or replace what is gone. **The amount of insurance that can be issued on a person's life is limited.** If a new policy is issued on through an investor-initiated life insurance arrangement, and later sold on the secondary market, **you might not be able to get additional life insurance in the future if the need arises**.
2. **If this is such a great deal for investors, why isn't it an even better deal for your family?** If insurance is *really* needed, why not buy and keep it for your family – rather than have it go to strangers? Have you checked to see if you *really need* the coverage? Life insurance may be far more valuable to your family than as a scheme for making what looks like a quick buck.
3. **Any incentive** (car, cash, trip or other "gift" to get you to buy the policy) will be **taxable to you immediately as ordinary income.**
4. **The "free" insurance isn't free at all! You may have to pay tax each year on the economic value of the coverage that's provided for you.** There are several theories upon which the IRS could base the tax – and reporting that income can be very expensive.
5. If you decide to turn over the policy to the lender and "walk away from the loan," it's highly likely that the IRS will treat discharge of indebtedness as ordinary income. In other words, **you may incur significant income tax – and will have nothing to show for it.**
6. **If you sell the policy to a settlement company, your gain will be all or mostly all taxable at ordinary income rates.**
7. **Your family may never get any insurance – even if you die within the first two years.** Why not? Because if the insurance company discovers that the intent from inception was for you to sell the policy to investors, the insurer may rescind (take back) the policy. Most major insurers have stated publicly that they don't want to be involved in these schemes. So if you shade the truth or misdirect or omit essential information, your failure or candor may amount to what lawyers call a "material misrepresentation." **The insurance company potentially could void the policy after it is issued, based on a theory of fraud or lack of insurable interest**. Now you are (at best) involved in expensive and aggravating litigation.

   Worse yet, **if you are found to be deliberately less than completely honest in answering the questions you are asked** – for instance, if you say or imply your intention in taking out the insurance is to protect your family or your business, but the insurer later proves (based on marketing materials and your own sworn testimony of what was said to you) that the intent all along was to re-sell the policy to investors, **you may have engaged in insurance fraud; in many states, as I noted before, that's a felony (criminal) offense.**
8. **Your estate is potentially liable to investors for millions of dollars!** These arrangements are document intensive. You are going to be asked to sign many many documents. Those highly complex legal papers are designed to protect the investors' and lender's interested. (That's a polite way of saying that the provisions you agree to are stacked in favor of *them* – the investors and the lenders – and not you!). You may be asked – perhaps in words that are not very clear – even to a savvy attorney – to make certain guarantees to the lenders and investors. If *after* the investors have

purchased the insurance on your life, for some reason *they* can't collect, those investors may sue your estate for the insurance they expected to receive, but didn't.

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

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

10. In one case reported in the April 23rd 2007 edition of *Business Week*, an 82 year old man sold his \$4.4 million policy for \$1.1 million. But once the loan that financed the premiums was paid, he was left with only \$361,256 – and after he paid a fee of \$200,000 to the lender and promoter, he netted only about \$162,000! For a \$1,000,000 policy for someone with a 7-year life expectancy, attorney Adam Balinsky, a partner at Baker & McKenzie, estimated that a purchaser might pay \$250,000. But after paying various fees to middlemen that broker policies, the seller would be likely to take home only about \$150,000. From those proceeds, the seller would have to repay the loan plus various lender fees and interest of 12% to 18%. In the end, the insured might only net about \$42,000." And that, of course, is *before* state and federal income taxes!
11. **After you sell the policy to the investors (or let the bank take it and sell it to investors), you are the *only* party to the contract that hopes you live a long time. Make no mistake, this scheme is nothing less than financial speculation on your life**. Someone you don't know and have never met can profit by your early death. You may receive calls as often as once a month – and the person at the other end will be disappointed – if you answer the phone! You will be told (and still want to believe) that the odds are small of some investor taking steps to profit by your early death. But no one in this deal will or *can* assure you that it *can't* happen.
12. You should also know that **the original investors have the legal right (and often the intent) to sell the policy on your life – immediately – to other investors. There's no legal limit to how many times the policy on your life can be sold – or to whom.** So the policy on your life can end up in the hands of almost anyone (even just one investor) and **you will neither know nor have control over who will be your beneficiary.**
13. The purchaser of the policy will have permanent access to your medical records. **If you sell your life insurance policy on a secondary market, you will have to agree that the purchaser (including any subsequent purchaser if the policy is re-sold) has power of attorney to access your medical records for the rest of your lifetime.**

What would I tell my mom to do about SOLI?

One word will do.
It's **"DON'T!"**

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