Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1233
Date: 28-Jan-08
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Life Products Clearing v. Lobel – Key Insurable Interest Case**

In over 60 newsletters, (**Search LISI Archives for SOLI or STOLI or Investor Initiated Life Insurance)** we've alerted LISI members to the potential mischief and trouble involved when life insurance is artificially manufactured to benefit investor groups.

This is such a case and is very important to and should be read by every member of the estate planning team.

It is also an excellent review of the concept of insurable interest and the distinction between an insured's right to sell or assign his/her rights (or to name as beneficiary) – even to one who has no insurable interest – and a scheme designed to act as a cover for a transfer to stranger-investors who never did and never will meet the spirit of the insurable interest law.

EXECUTIVE SUMMARY:

This is a decision involving $10,712,328.77 paid in death benefits on a policy issued to the insured's trust but almost immediately assigned by plan after issue to the plaintiff in return for a $300,000 payment to Lobel.

This important Stranger-Owned Life Insurance (SOLI or STOLI) case was decided by the US District Court for the Southern District of New York which concluded that the estate of the insured had sufficiently alleged a plausible claim that he purchased the policy with the prior intent to transfer it to a stranger possessing no insurable interest in his life. The District Court denied the plaintiff, to whom the insurer paid the policy death benefits, a judgment on the pleadings and sets the stage for a possible payment of the proceeds to the insured's estate.

FACTS:

Leon Lobel was a 77 year old retired butcher. He had lived in New York but retired to Florida.

Early 2005:

During 2005, Lobel was approached by Joel Miller and Stephen Lockwood, insurance agents for Lincoln Life & Annuity Company of New York. Miller made Lobel aware of a financial opportunity which promised an immediate, substantial cash payment by taking out a life insurance policy on himself for the benefit of an investor group which was a stranger to him. Because the investor would pay all the premiums, there was virtually no cost to him.

Several steps were required:

- Lobel would apply for a large life insurance policy for the benefit of a trust in his name.
- Simultaneously, he would establish an irrevocable trust to own the policy.
- Lobel would pay only a $1,000 fee to establish the trust.
- The trust would initially be for Lobel's benefit, but when the policy was issued to the trust, Lobel would immediately sell his beneficial interest in the trust to the investor in exchange for an immediate cash payment.
- The investor would pay all the policy premiums and maintain the policy, and receive all the proceeds when Lobel died.
- The proposal contemplated that neither Lobel nor his family would ever own the policy or have a beneficial interest in it, nor would Lobel have the realistic option to retain the policy for his own use.
- Lobel would never pay any premiums himself, nor would he receive financing from the investor to pay the premiums.
- Lobel had no personal desire to obtain a life insurance policy for the benefit of his family or as part of an estate planning decision, and he could not afford one even if he so desired. He was attracted to the plan solely because of the promise of quick cash.

November 15, 2005:

Leon created the Leon Lobel Insurance Trust naming himself as the "Initial Beneficiary." The Trust Agreement mentioned LPC, the investor, by name and

indicated a possible future transfer of the Policy to LPC. Lobel had no input into the terms of the Trust. Rather, the Trust Agreement was prepared by counsel for LPC. [Angel alleges that Lobel never met the Trustee and signed all the papers in Florida, despite the fact that the Trust was established under New York law and the Policy delivery was deemed to have occurred in New York.]

The same day, he applied for a $10 million life insurance policy naming the Trust as the sole beneficiary. The final page of the application indicated that the insurance agents for the Policy were Joel Miller and Steven Lockwood and the page was signed only by them. A space was provided on the page for the agents to indicate the answer to the following question:
"Does the client intend to use the policy for any type of viatical settlement, senior settlement life settlement or for any other secondary market?"

The question was left unanswered.

The Policy's "Policy Specifications" page stated that the minimum initial premium due on or before the date of issue of December 14, 2005 to commence coverage under the Policy was $31,872.16. There is no indication that Lobel ever paid this or any other premium.

The entire first year's premium was $572,000, an amount Lobel could not afford.

December 14, 2005:

The policy was issued to the trust. Lobel never received a copy of the policy.

December 16, 2005:

Lobel was told in a December 16th letter: *"As discussed, if you do not wish to retain this policy for your estate planning needs, an investment group . . . has indicated to me that they would purchase your beneficial interest in the Trust for $ 300,000."*

But in reality, from the outset, Lobel did not intend to retain the Policy, but rather always intended to sell the Policy to the investor for a large cash payout. The identity of the investor -- LPC -- was known to all parties well in advance of the letter.

The letter also enclosed two forms for Lobel to sign: one entitled "Beneficial Interest Transfer Agreement" and another entitled "Acknowledgments and Consents Relating to Sale of Beneficial Interest." These forms provided for the immediate single payment of $ 300,000 by LPC to Lobel.

They also allowed for Lobel to transfer the beneficial interest in the Policy and shifted the obligation to pay premiums from the Trust to LPC. The Transfer Agreement also provided that the beneficial interest in the Trust was "further assignable and saleable" by LPC.

Lobel was asked to sign an "Acknowledgments and Consents Relating to Sale of Beneficial Interest" provision that indicated that

"[a]fter reviewing several alternatives for maintaining the Policy and paying the premium, Leon has determined that the sale of the Beneficial Interest to the Purchaser for the Cash Consideration is in his best interest and in the best interest of his family."

It also stated that

"Leon acknowledges that he has had sufficient time to thoroughly analyze and discuss the strategy of selling his Beneficial Interest in the Trust to the Purchaser."

December 20, 2005:

Lobel signed both documents immediately upon receipt and returned them to Lockwood, resulting in the sale of his beneficial interest in the Trust to LPC. With that sale of his interest in the trust, he sold the right to any insurance proceeds paid at his death. The interest in the trust was sold to the Plaintiff, Life Product Clearing LLC (LPC) for $ 300,000. [So at most, there was a period of a few days when Lobel was the beneficiary of the Trust.]

January 5, 2006:

Lobel received the $300,000 (before tax) payment.

January 10, 2006:

Leon Lobel died.

In total, LPC had paid only one quarter of the first year's policy premiums (the sum of $ 149,000) which represented the minimum amount required by Lincoln Life to be paid for the policy to go into effect.

LPC filed a claim under the Policy. After a year-long investigation, the insurance company paid the face value of the $10,000,000 policy plus interest, a total of $10,712,328.77, to the trust which was then held by the Plaintiff.

Lincoln Life refused to provide copy of the Policy to Lobel's family after his death.

The Plaintiff, LPC, sued Lobel's estate's personal representative, his daughter, Linda Angel, for a declaration that LPC is the rightful beneficiary of the Trust.

Angel counterclaimed against LPC and the Trust and its Trustee, Jonathan S. Berck, contending that Lobel's transfer of his interest in the Trust to LPC was void as against public policy.

Angel argued that the transaction involved an impermissible "wager policy", i.e., that LPC, a stranger to her father, gambled on his life, wagering $300,000 that he would die *sooner* rather than later.

In the words of the court,

"In fact, the "wager" turned out to be extraordinarily successful because Lobel died within days, and LPC stands to earn more than $ 10.7 million from its $ 300,000 investment."

So this case is about a motion for judgment on the pleadings filed by LPC, the Trust, and Berck. They argued that the material facts are undisputed, and that they are entitled to judgment as a matter of law declaring that Lobel's procurement of the Policy and subsequent sale of his beneficial interest in the Trust to LPC were legally valid and binding transactions, and that LPC was entitled to enforce its beneficial interest in the Trust.

Angel counterclaimed and asked the court to declare the Trust void and hold that Lobel's estate is entitled to recover the death benefits paid under the Policy. Naturally, she did not seek to have the Policy voided -- rather, she asserted that the appropriate remedy is the disgorgement of the death benefits by the Trust to the Estate.

The court noted that

"The Policy is an example of a recent development in the life insurance industry that has "bloomed into a new and very controversial cottage industry": the acquisition of life insurance by an insured -- usually an elderly person -- for sale to a third party. J. Alan Jensen & Stephan R. Leimberg, Stranger-Owned Life Insurance: A Point/Counterpoint Discussion, 33 ACTEC J. 110, 110 (Fall 2007).

Often pejoratively termed "stranger-owned life insurance policies," these policies enable the insured to obtain ready cash by selling his policy to a stranger whose only interest in the insured is his early demise.

These policies are lawful only if the insured purchases the policy with a good-faith intent to obtain insurance for the benefit of his family, loved one, or business; they are not lawful if the insured purchases the policy with the intent to resell it to a stranger at the earliest possible moment."

The Judge concluded that Angel alleged sufficient facts to state a claim that is plausible on its face -- that Lobel obtained the Policy with the prior intent to transfer it to a stranger with no "insurable interest" in his life. He therefore denied the motion for judgment on the pleadings in LPC's favor and by doing so set the stage for a disgorgement of the $10,712,328.77 held by LPC.

COMMENT:

The substantive question here is,

"Was Lobel's transfer of his interest in the trust to LPC invalid because LPC lacked an insurable interest?

WAGERS LONG OUTLAWED:

As far back as 1881, the Supreme Court in Warnock v. Davis expressed its disdain for "wager" insurance policies, life insurance contracts that are

"a mere wager, by which the party taking the policy is directly interested in the early death of the assured."

Steinback v. Diepenbrock held in 1899 that the law – when making the determination of whether a policy is a mere wager - looks both at the form *and* the substance: "*The insured, instead of taking out a policy payable to a person having no insurable interest in his life, can take it out to himself and at once assign it to such person. 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.").*

WHY INSURABLE INTEREST REQUIRED:

In the 1911 case of Grigsby v. Russell, Justice Holmes explained the rationale for this concern:

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.

The "insurable interest rule" operates to prevent the issuance of "wager" life insurance policies.

New York statutory law provides:

No person shall procure or cause to be procured, directly or by assignment or otherwise any contract of insurance upon the person of another unless the benefits under such contract are payable to the person insured or his personal representatives, or to a person having, at the time when such contract is made, an insurable interest in the person insured.

Insurable interest is defined under New York law as:

(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.

There have been constant attempts to evade the insurable interest rule – and these have been uniformly criticized and struck down by both Federal and New York courts.

Warnock v. Davis: Here, the insured applied for a life insurance policy and simultaneously agreed to assign 90 percent of his interest to an association that had no insurable interest in him. The day the policy was issued, the insured assigned it to the association. The Court concluded, in dicta, that the insured's agreement to assign was invalid because the association lacked an insurable interest in his life.

Grigsby v. Russell: Here, the Supreme Court overruled the dicta in Warnock, concluding that an assignment is not *automatically* condemned when the assignee lacks an insurable interest, so long as there is no prior agreement to assign.

NOTE: The Grigsby Court drew the distinction that

"*cases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith."*

So while the lack of an insurable interest in the insured on the part of the assignee was not a bar to 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 one's family or business.**

The Grigsby Court reiterated that

"[t]he very meaning of an insurable interest is an interest in having the life continue."

Numerous cases such as Hota v. Camaj or Wells v. Squires make it clear that only one who obtains a life insurance policy on himself "*on his own initiative*" and *in good faith* -- that is, with a genuine intent to obtain insurance protection for a family member, loved one, or business partner, rather than an intent to disguise what would otherwise be a gambling transaction by a stranger on his life -- may freely assign the policy to one who does not have an insurable interest in him.

Travelers Insurance Co. v. Reiziz: in applying the Grigsby ruling concluded:

[A]n assignment of a life insurance policy, when not made by the insured in bad faith and with the intention that the assignment is to be used as a mere cover for a wager policy, is not against public policy and is sanctioned. . . . It is undoubtedly true that, if the policy was taken out by the parties with a view to its immediate assignment, the transaction would be nothing more than a mere subterfuge to avoid the well-settled rule that a party cannot procure insurance upon the life of one in whom he has no insurable interest. The authorities do not conflict upon this point. But obviously the question whether the insured lent himself to one without an insurable interest in his life as a cloak to a gambling transaction (Grigsby v. Russell, supra) is not a question of law, but rather is a question of fact.

THE ROLE OF INTENT – AND HOW IT'S DETERMINED:

Finnie v. Walker: Courts look at the insured's intent at the time the policy is procured. There, a non-contemporaneous assignment of policy was held invalid because "wagering intent" was established by fact assignee knew that insured was ill and potential payout was large);

Courts will read the policy and the assignment together, as forming part of one transaction and consider – among many other things – in determining when an arrangement is a genuine good-faith assignment and when it is simply a sham transaction designed to evade the insurable interest rule - the following factors:

- Did the insured (using his own money) pay the premiums?
- What was the length of time between the insured's purchase of the policy before assigning or selling it?

NEW YORK OGC OPINION:

New York State Insurance Department's Office of General Counsel issued a key opinion on December 19, 2005 with respect to the statutory prohibition against wager policies.

The opinion addressed one form of "free" insurance arrangement where:

- a third-party bank lends money to an older individual who uses the money to purchase a life insurance policy.

- the individual pays premiums under the agreement that gives the insured a put option to sell the policy to a third party on a pre-determined exercise date at least two years from the date of the loan.

This arrangement was declared impermissible because

"*it appears that the arrangement is intended to facilitate the procurement of policies solely for resale."*

NOTE: The OGC opinion also stated that the ability of the insured to immediately transfer a policy, "irrespective of the existence of an insurable interest in the assignee," does not permit procurement of a policy "solely as a speculative investment for the ultimate benefit of a disinterested third party. Such activity . . . is contrary to the long established public policy against 'gaming' through life insurance purchases."

While New York or other states' courts are not bound by this opinion, in New York State courts will uphold the interpretations of an agency charged with administration of a statute if the interpretations are not unreasonable or irrational – and New York's insurance department is highly respected and often followed throughout the country.

WHY THE LOBEL COURT DENIED THE PLAINTIFF'S MOTION:

LPC never had an insurable interest in Lobel and did not claim it ever did. Accordingly, the Court held that LPC's motion must be denied if Angel sufficiently pleads that Lobel did not procure the Policy "on his own initiative" and that instead the transactions were designed "as a cloak to what was, in its inception, a wager" by LPC on Lobel's life – which of course is exactly what Angel pleads.

The counterclaims allege, explicitly or implicitly, the following facts, which the Court states "must be assumed to be true at this stage of the litigation": [Ask yourself, in a "could be SOLI" situation where you represent one of the parties, if your facts are substantially similar. I have put a star * after the fatal facts I've seen in all too many cases. The few that I have not starred are clearly "smoking gun" facts *most* promoters are too clever to commit]

- Lobel had no prior interest in obtaining additional life insurance before he was approached by Miller with the plan to buy a policy for resale to

an investor*;

- the plan to resell the policy to an investor existed before Lobel applied for insurance*;

- from the outset Lobel intended for the investor to pay all premiums, maintain the Policy, and receive any benefits under the policy when he died*;

- Lobel was ostensibly obtaining $10 million in life insurance, at age seventy-seven, for virtually no cost to him*;

- Lobel could not afford to pay the extremely high premiums on the Policy and was attracted to the "quick cash" aspect of the plan*;

- Lobel executed the Trust Agreement the same day he applied for the Policy*;

- the Trust Agreement mentioned LPC by name as the possible future transferee;

- LPC was involved from the outset, as its counsel prepared the Trust Agreement*;

- Lobel provided no input into the drafting of the documents*;

- Lockwood's December 16, 2005 letter, dated just two days after the Policy was issued, noted Lobel's interest in assignment, and enclosed two forms that already named LPC as the transferee;

- Lobel signed the documents immediately upon receipt, and apparently did not take any time to consider other options or the details of LPC's offer;

- Lobel assigned his interest in the Trust just a few days after the Policy was issued; he was the beneficiary of the Policy for at most a few days; and he never paid any premiums on the Policy*;

- Lobel was not even given a copy of the Policy; and

- when Lobel applied for the Policy, the agents did not answer the question in the application form asking whether the client was purchasing the insurance for "any type of viatical settlement, senior settlement, life settlement or for any other secondary market.*

- LPC's claim that Lobel's statement to the insurance company that he had a net worth of $8-10 million proves his ability to pay the Policy premiums would be unavailing upon a showing that Lobel did not in fact have such net worth and lied on his application*.

According to the court, these factual allegations, taken together, surely make a plausible claim that Lobel intended to transfer the Policy to LPC prior to procuring it and that such a scheme surely could amount to an impermissible attempt to circumvent the prohibition on wager policies.

BUT YOUR HONOR, EVERYTHING WE DID LOOKS KOSHER:

LPC argues that the following facts, taken together, support judgment on the pleadings in its favor:

- Lobel signed the Policy application papers himself;

- he always had the ability to retain the Policy if he so chose;

- he alone established the Trust to hold the insurance; and

- he named himself as the sole beneficiary of the Trust at the outset and designated the Trust to be the sole beneficiary of the Policy.

So what?, said the court: "These facts, even *if* true, do not require a different result at this juncture, as they do not contradict Lobel's alleged intent to sell the Policy to LPC before the Policy was procured. Moreover, these facts are contradicted by Angel's allegation that her father could not afford the premiums: $ 572,000 the first year alone and $ 373,786 annually thereafter until he turned eighty-eight years old. If this allegation is true, Lobel did *not* have the ability to keep the Policy for himself. [If in fact Lobel was really worth $8-10 million, he probably could have paid the premiums – but as is so often the case in SOLI situations – the parties often lie or obfuscate to make it appear that their net worth is much greater than it actually is – to obtain a

greater amount of insurance and from that a greater profit on its sale]

What about the argument that there must have been insurable interest; otherwise the insurer never would have paid. The Court pointed out that,

"The fact that Lincoln Life paid the proceeds to the Trust after a lengthy investigation is not controlling."

BUT DON'T WE HAVE A RIGHT TO USE LIFE INSURANCE AS PROPERTY AND DO WITH IT WHAT WE WANT?

LPC argued that Lobel had an absolute right to transfer the Policy to LPC because he assigned it *after* the Policy was issued naming the Trust as the initial beneficiary (with Lobel himself as the Trust's beneficiary).

Angel didn't dispute the right to use a life insurance contact as property – and admitted that "as a general matter, a policy may benefit a trust and that the beneficial interest in that trust may be transferred to a third party with no insurable interest."

What she argued was that "LPC cannot overcome the fact, however, that only interests in *valid* policies may be transferred, and if there was a pre-assignment *agreement* to transfer to LPC the Policy is an invalid wager policy.

The disparate sections of a state's law must work in tandem and not in opposition: **even *immediate* surrender of a policy is permissible, but that assumes the *initial* acquisition of the policy was in good faith and there was no prior intent or agreement to transfer it to an otherwise disinterested investor.**

Similarly, LPC's argument that single contractual steps in a sequence must be considered as separate legal transactions and not as a single, sham transaction cannot prevail. **The law prohibits gaming the system to procure wager policies, regardless of the creativity of form.**

CASES OF INTENT ARE CASES OF FACT:

Cases that turn on the issue of a party's *intent* are generally not appropriate for summary disposition. Because Lobel's pre-assignment intent is central to LPC's claim, and Angel's claim -- that Lobel never intended to obtain life insurance but always intended, for what amounted to a $300,000 fee, to transfer his

beneficial interest in the Policy to an investor -- is more than plausible, the Court held that "*LPC cannot prevail as a matter of law at this stage in the litigation.*"

WHY THIS CASE IS SO IMPORTANT:

It's true that this case is rife with facts as blatant and egregious as could be wished for [assuming you are trying to prove a lack of insurable interest]. The room is filled with smoke from the gun.

Not every case will be as clear. In fact most will present much more difficulty and few insureds' estates will be anxious to prove a lack of insurable interest. (Many states' laws would not provide for a disgorgement and pay-over to the insured's estate – particularly if it is clear he or she aided and abetted the material misrepresentations that led to the issuance of a policy that would not have been issued had the insurer known all of the relevant facts.

Of course, few insurers would (or should) accept an application if one or more key questions is (are) left unanswered – and fewer still would (or should) pay proceeds to anyone where the facts so clearly indicate a high likelihood that insurable interest was lacking – and that the insured wasn't worth nearly as much as he claimed.

The judge in this case applied the facts and quickly saw through the subterfuge. Others will do the same!

The other reason this case is so important is that it serves as a warning to both investors and those potential insureds that would get involved in SOLI schemes: Since we don't know who will win this case, what DO we know?

First, we know that investors may not reap the rich rewards dangled in front of them. And if the Lobel family wins, investors may not want to risk their capital – which in turn might impact on the price settlement companies will offer on their behalf to policy sellers. So both investors and sellers will suffer.

Insureds may lose a legacy for a Lexus, i.e., they may engage in insurance fraud (a felony in most states) and end up with little or nothing to show for it (except perhaps unexpected legal fees and tax bills).

Stay tuned to LISI for more on this case – and other SOLI cases that will be coming to a theatre near you!

Hopefully, neither you nor your client will be on the wrong end of one!

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Steve Leimberg

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CITES:

Life Product Clearing LLC v. Linda Angel is __ F.Supp.2d ___, 2008 WL 170193 (S.D.N.Y.) (Jan. 22, 2008) (No. 07 Civ. 475 (DC); Steinback v. Diepenbrock, 158 N.Y. 24, 31 (N.Y. 1899); Warnock v. Davis, 104 U.S. 775, 779 (1881); Grigsby v. Russell 222 U.S. 149, 154-55 (1911); New York Insurance Law § 3205(b)(2); N.Y. Ins. Law § 3205(b)(2) (McKinney 2006); Hota v. Camaj, 750 N.Y.S.2d 119 (2d Dep't 2002); Wells v. Squires, 102 N.Y.S. 597 (1st Dep't 1907). Travelers Insurance Co. v. Reiziz, 13 F. Supp. 819, 820 (E.D.N.Y. 1935); Finnie v. Walker, 257 F. 698, 701 (2d Cir. 1919)

Extensive commentary on insurable interest and SOLI is available in Zaritsky and Leimberg, **Tax Planning With Life Insurance: Analysis and Forms: 2nd Edition:** **(RIA 800 – 950 1216);** N.Y. Ins. Law § 3205(a)(1), in Leimberg, "*Investor Initiated Life Insurance: Really a "Free Lunch" or Prelude to Acid Indigestion?*", Chapter 4, 41st Annual Heckerling Institute on Estate Planning, University of Miami School of Law (2007) and in J. Alan Jensen & Stephan R. Leimberg, *Stranger-Owned Life Insurance: A Point/Counterpoint Discussion,* 33 ACTEC J. 110, 110 (Fall 2007).