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Understanding and Avoiding the Risks of Life Insurance Premium Loan Financing

Ed Zusman and Amir Tadjedin
Partners, Markun Zusman Freniere & Compton, LLP

Premium financing provides an avenue for high net worth individuals with substantial assets to obtain life insurance for estate planning purposes, collateralized by the insurance policy itself or other assets. It, therefore, allows individuals to maximize the face value of insurance while minimizing the current expense of paying premiums. Although there are several benefits of premium financing, including obtaining insurance without having to liquidate other assets, and certain estate planning / tax benefits, premium financing for estate planning purposes can pose significant risks that could have devastating effects on insureds. This article aims to raise awareness of such risks and provide strategies to avoid some of them.

Risks and Premium Financing Schemes

First, there is a significant and real risk of the insured defaulting on the premium financing loan. Defaulting on the loan puts the underlying insurance policy at risk of loss due to lapse or forfeiture. It also potentially subjects the insured to further financial ramifications, including possible loss of other collateral, which may be foreclosed upon due to default.

Second, there are risks related to the premium financing loans themselves. In particular, a loan's interest rate may exceed the rate at which the insurance policy accrues value, leaving no benefits for the beneficiaries of the policy once the policy has matured. In some cases, where the death benefit is less than the outstanding loan balance, it is possible that beneficiaries would receive no benefits under the policy <u>and</u> would owe the remaining balance on the unpaid loan.

Additionally, because the term of a loan will likely be shorter than the policy period, insureds may also be forced to either renegotiate the terms of their loan agreement or find other sources of financing the premium payment. Either way, this would likely increase the cost of the loan and the cost of maintaining the insurance. Moreover, many premium loans have variable interest rates, making the long-term costs unpredictable. If interest rates increase more than projected assumptions, insureds could be required to pay additional funds just to keep pace with their interest payments or risk losing the policy or their other collateral.

Another risk relates to the premium financier's payments of the premiums. Where the issuing life insurance company experiences a large drop in financial rating, it is possible that premium financiers may choose to stop paying the premiums to the insurer. In such instances, insureds run the risk of having their policies lapse, or being forced to find other sources of funding.

There are also a number of dishonest financiers who impose one-sided transaction terms, disregarding the insured's interests. With such predatory providers, the benefits are primarily to the insurance broker or agent (who receives a commission on the sale of the insurance product) and the premium financiers (who collect interest and other fees on loans, and potentially foreclose on the policies or other collateral). As set forth below, premium finance loans are ripe for predatory lending schemes, where lenders deceive customers into agreeing to loans that are unsustainable for them.

Examples of Predatory Schemes

In one common scheme, a trust purchases a life insurance policy on the life of a high net worth individual for estate planning purposes. As a means of paying for the premiums of the life insurance policy, the trust enters into a premium financing loan to preserve the assets of the trust, which are already tied up in other investments. This is a common reason for using premium financing—namely, to avoid liquidating assets or spending cash to pay for premiums. The loan financiers provide a two year loan, after which the full value of the loan, plus interest and fees, is due. The loan finance company secures the loan using the policy itself as collateral. After the loan becomes due, the finance company charges the trust exorbitant interest and fees, which forces the insured to relinquish the policy to the financier.[1] The financier then sells the policy on a secondary market, profiting both by the payment of interest on the policy and by the sale of the policy.

Another scheme involves financing companies providing "free loans" to customers in exchange for their life insurance applications. These loans are offered free of charge for a set period, after which the customer's payment obligation begins. However, like the scheme described above, after the "free loan" period ends, the finance company charges the customer exorbitant fees, forcing the customer to default on her obligation. Consequently, the financing company takes control of the policy.

Finally, other individuals have used premium financing as investment vehicles, pooling funds to provide loans to finance premium financing enterprises. Some of these investment companies provide non-predatory loans, while others have the goal of obtaining the policies as assets for their investors, and structure loans designed to increase the likelihood of default. Whether the loan company is raising money itself from investors to fund the premium financing business is a question to consider in evaluating contemplated premium financing transactions.

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Possible Illegality of Premium Financing Schemes

Although there are legitimate uses for premium financing, some arrangements may be illegal. Several states, such as California, New York and Georgia (among others), have laws against schemes designed to give the appearance of an insurable interest where no legitimate insurable interest exists. *See* California Insurance Code §10110.1(e); New York Insurance Code § 3205(b)(2); and Georgia Insurance Code Title 33, Section 33-24-3(e). Schemes such as those described above arguably violate such statutes, where the ultimate beneficiary of the insurance policy is the finance company, which does not have an "insurable interest" when the policy is issued.

Insurance companies that sell policies pursuant to premium financing arrangements run the risk of being involved in litigation regardless of whether they were actively involved in the financing transactions. If an insurance company is intending to do business with insureds who finance premiums, although not currently required by law, it would be prudent to perform some level of review on the premium financing company and the terms of the financing arrangement to decide whether the company is willing to undertake the additional risks associated with issuing a policy paid for through premium financing.

Risk Mitigation

To mitigate risks related to premium financing, it is important to recognize warning signs. First, premium loan financing should only be an option for individuals with high net worth and/or significant annual income that is likely to be sustained for the life of the loan. It would be unsuitable to offer loans to individuals who are unable to fund premiums based on their net worth or income. To mitigate exposure to liability, risks of premium loan financing should be explained, including the risk of losing the life insurance policy, the risk of losing collateral, and the risks related to significant fees and high/variable interest rates, among others. Customers need to understand the terms of any loan options, including the costs involved, any unspecified fees, and any variable components of the loan. Agents should consider recommending that the client's attorney and/or accountant also analyze the premium financing costs and potential benefits, as these proposals often are part of an estate plan for high net worth individuals. The carriers contemplating writing policies that have their premiums financed should understand this information as well.

Second, the financing companies themselves should be vetted for financial stability, reputation and complaints. It would be prudent to look for a pattern of loan foreclosures and asset forfeitures on loans issued by the firms. Relatedly, it is important to evaluate conflicts of interest between insurance salespersons and premium finance companies. Many times, insurance salespersons are also involved with companies offering premium financing, and may be compensated, in part, for the financing transaction. These relationships pose a significant conflict of interest and should be reviewed carefully. In particular, insurance brokers have fiduciary duties to their customers, including a duty of loyalty.[2] Insurance brokers acting as agents of their customers have special obligations to act in their customers' best interests. Consequently, when the broker is involved, and profits from both the sale of the insurance product and the financing transaction, there is a clear conflict of interest. These relationships should be clearly disclosed to customers so customers can make informed decisions about these transactions, and, in most instances, these conflict situations should be avoided.

Conclusion

The issues presented above are common potential problems arising from premium financing.

Although the basic structure of the transaction is legal, and there are many beneficial uses for premium financing, there is also the potential for a variety of abuses, ranging from undisclosed conflicts of interest to predatory lending to schemes designed to dispossess insureds of their policies and their collateral. The consequences of abuse are magnified because damages could include losses from the failure of an estate plan, the loss of an insurance policy, all the costs associated with that, as well as the loss of other property pledged as collateral.

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[1] *Security Life of Denver Ins. Co. v. Shah,* 2012 WL 4582763 (S.D. Ga. 2012) (premium financing arrangement running afoul of usury laws); *In re Derer* (Texas Department of Ins., Commissioner's Orders 08-0127 & 08-0698) (issuing cease and desist order to broker offering couple "no-cost" policy funded through premium financing); *Jones v. Mutual Credit Corporation*, 2008 WL 3972232 (Third Amended Complaint of January 9, 2008, alleging "fraudulent and predatory" premium financing loan scheme).

[2] Insurance agents' fiduciary duties extend to matters relating to premium financing arrangements (*see, e.g., Harris v. Illinois Vehicle Premium Financing Co.*, 2000 WL 1307513 (N.D. Ill. 2000), and those fiduciary duties can have implications extending even as far as dischargeability of a broker's premium financing-related debts in bankruptcy. *In re Nicholson*, 55 B.R. 645 (Bankr. N.D. Ga. 1985).

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Comments suggestions or inquiries are welcome and should be directed to: mary.pat.fischer@aon.com

Aon Risk Services Northeast, Inc.
199 Water Street New York, NY 10038 • (800) 243-5117

Ed Zusman and Amir Tadjedin are partners with Markun Zusman Freniere & Compton, LLP. They practice in the areas of financial services litigation, regulatory and enforcement defense, and professional liability.

Markun Zusman Freniere & Compton, LLP
www.mzclaw.com

Ed Zusman can be reached at (415) 438-4449.
Amir Tadjedin can be reached at (503) 224-9294.

X-10283-0513