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TOPIC: Premium Financing – Fraud Charge Against Insurer and Broker Dismissed

CITES: *Cilente v Phoenix Life Ins. Co.*, 2015 WL 8688142, 2015 NY Slip Op. 09203 (Dec. 15, 2015); *Orlando v. Kukielka*, 40 AD3d 829, 831–832 (N.Y. App. Div. 2007).

SUMMARY: In this suit, the plaintiff alleged fraud and fraudulent inducement against the insurer. The plaintiff claimed the terms of the policy and financing agreement (including the potential need for additional collateral to support the financing program) were not disclosed to him. But the court dismissed the complaint in its entirety.

RELEVANCE: Institutional premium financing loans to ILITs—requiring collateral from the grantor to protect any shortfall between the amounts loaned and the policy cash value—are very complicated propositions. *Generally*, this kind of premium financing should be considered *only* when:

- The client is a high net worth (typically $5,000,000 in assets or greater) older (70 to 85 or with new designs over age 50) individual and/or a client with a significantly reduced life expectancy who needs a large amount (generally *at least* $1,000,000 and preferably more) of insurance;

- the client doesn't currently *have* sufficient cash flow (e.g. lacking because of lower stock dividends or the relatively non-existent interest paid on bonds) or *wants* to use personal or business cash but does not want to liquidate valuable growing, illiquid, or rapidly appreciating assets, or has all or most of his/her wealth tied up in a business – or can easily afford to pay premiums but is obtaining high returns on current wealth):

- the client would be paying gift taxes on gifts of premiums for a trust owned policy because he/she has fully used his credit and annual exclusions; AND

- the client and the client's advisors are willing to learn and live with the potential downsides.

There are good reasons for a client meeting the above criteria to at least consider premium financing. Among these are that premium financing from a third party institutional lender (1) can enable the purchase of needed insurance with no immediate out of pocket outlay; (2) can provide the ability to borrow at short-term rates while keeping personal and hard-working business assets intact; (3) may avoid the need to liquidate appreciated or special assets such as closely-held stock; (4) avoids the need to make large gifts to a trust which in turn might result in gift taxes; (5) may compare favorably to the various costs and downsides of split dollar; (6) works very well with rated insureds in their 80's (short premium duration and earlier repayment) and (7) can work well with both single life and joint life contracts.

But this case illustrates that there are numerous potential downsides to institutional premium financing, among which are:

1. Increasing interest rates make borrowing relatively more expensive (cue in announcement of the recent Fed increase);
2. Even a small increase in interest rates may (significantly, rapidly, unexpectedly, and potentially at the worst possible time for the client) reduce or even eliminate the return that's anticipated when the projected numbers show a policy crediting rate that exceeds the loan interest rate;
3. Each payment of interest by the client is a gift (potentially taxable) to the life insurance owning trust;
4. Interest paid on premium financing is not deductible;
5. A premium financing arrangement is *always* highly complex and therefore always requires well informed and competent tax, financial, and accounting advice (and the consequent fees to obtain that advice);
6. The policy generally must have an increasing death benefit to meet the balance on the loan;

7. The policy performance anticipated may not equal the actual cost(s) of the loan
8. A slip in policy performance may require additional premiums or an increase in the loan or both (either of which can have an adverse spiraling effect);
9. Leverage can work both ways – so if the investment return falls (THINK TWICE BEFORE GOING INTO LIBOR!) or interest rates rise (making borrowing rates higher than the investment return) there may be a financial disaster;
10. The insured may "live too long" and make it necessary to surrender the policy to repay the loan;
11. The longer the loan continues, the more expensive it gets;
12. The policy could "self-destruct" before the insured reaches policy maturity (typically age 100) with a net death benefit lower than the accrued loan;
13. Eventually, the loan must be repaid, either out of pocket or out of the death proceeds;
14. The lender almost always retains (read the fine print) the ability to increase rates – substantially(!);
15. There is typically no guarantee the lender will renew the loan;
16. If the loan is due and the lender does not renew, the borrower must repay the loan from the policy itself or come up with the necessary cash from some other source (inevitably at the worst possible time);
17. If the lender refuses to make future loans (a decision that the lender typically reserves the right to make year to year) or extend credit, the policy might lapse
18. The borrower must prove credit-worthiness – each year;
19. If the client's wealth or income drops, the lender could refuse to extend the loan or demand more collateral;
20. If the policy doesn't perform as projected (as this case illustrates), the borrower may be forced to provide the lender with more collateral;
21. The policy owner can't borrow or withdraw money from the policy;
22. Most lenders will require the borrower to furnish all collateral from cash, brokerage accounts (stocks are often assigned a 50% valuation factor), or real estate;
23. A lender could foreclose on the debt if there is a default and thereby force a surrendering of the policies;
24. If the trust defaults, the client may be making a gift to the trust's beneficiaries in the amount of the debt the trust is relieved of.

The bottom line is:

> WHEN YOU PLAY WITH OTHER PEOPLE'S MONEY,
> YOU MUST PLAY BY OTHER PEOPLE'S RULES!

This case shows that both insurers and agents/brokers who are involved in third-party premium financing are subject to litigation risks. To protect yourself, put your assumptions in writing and once *you've* determined they are legal, ethical, financially sound, and appropriate for the particular client, share them *with* the client *and* the client's other advisors (who may spot issues or opportunities you may not have considered). Be sure you've listed the downsides as well as the advantages. Run illustrations that consider both up and down markets and various rates of return in the policy itself.

Do your diligence on the lender's soundness and track record. Don't let your client "go in" before you have planned – in writing – how to get your client "out." There must be an exit strategy – *other* than death! Examine a "worst case" scenario, and most importantly consider the up- and down-sides of viable alternatives.

FACTS: Alfonso N. Figliolia, as part of his estate planning, purchased and contributed to his family trust a $15,000,000 life insurance policy to pay his estate taxes. Because of the high amount of the annual premium, Figliolia sought to create a premium financing program, which he ultimately did through A.I. Credit Corp.

The cash value of this policy, however, did not accrue at a sufficient enough pace to keep the policy afloat. One of the consequences was that A.I. Credit began to seek additional pledges of collateral to support the premium financing program. After making additional pledges of collateral, Figliolia approached his broker and the insurer, Phoenix, in an effort to restructure the policies so he would not have to pledge additional collateral. These discussions resulted in a reduction in the face amount of the policy and the purchase of a second policy, also financed by A.I. Credit.

While this restructuring worked - briefly - the cash value of the second policy again did not accumulate at a sufficient rate to keep the financing plan afloat. The essential problem with both policies was that the interest *earned* on the cash value did not offset the interest being *charged* as part of the financing program. Faced with additional collateral calls, Figliolia decided to default. Then, he sued.

This court confirmed that the summary judgment of a lower court dismissing the fraud-based claims was properly granted. The alleged fraud was based on representations made in documents that were provided to Figliolia after he purchased the initial policy with Phoenix and executed the financing agreement. There is no evidence in the record indicating that the terms of the policy and financing agreement were not disclosed to him - including the potential need for additional collateral to support the financing program.

Likewise, certain claims made by the plaintiff under state insurance law claims were also dismissed. Figliolia had claimed that, in preparation of the second policy, his agent and Phoenix failed to comply with New York Law to provide the proper disclosure statements pertaining to the partial replacement of the first policy with the second, a requirement mandated by statute and regulations. Although the statutes in question do provide a private right of action for an aggrieved person in instances where an insurer or broker knowingly violates any provision of the section or regulations, Phoenix and the agent established that their failure to provide this disclosure was "inadvertent and not knowing", and the court concluded the plaintiffs did not raise a tryable issue concerning their knowledge of the noncompliance with the insurance statutes.
