WRNewswire
An AALU Washington Report

Tuesday, 10 March 2015 **WRN# 15.03.10**

The *WRNewswire* is created exclusively for AALU Members by insurance experts led by Steve Leimberg, Lawrence Brody and Linas Sudzius. *WRNewswire* #15.03.10 was written by Steve Leimberg, co-author with Howard Zaritsky of Tax Planning With Life Insurance, Publisher of Leimberg Information Services, Inc. (LISI) and CEO of Leimberg & LeClair, Inc.

TOPIC: MORE FALL-OUT FROM STOLI TYPE SCHEME

CITATION: *Sciarretta v. Lincoln National Life Insurance Company*, 2015 WL 795593 No. 13-12559 (C.A. 11 Fla.); Fla. Office of Ins. Regulation, *Stranger–Originated Life Insurance ("STOLI") and the Use of Fraudulent Activity to Circumvent the Intent of Florida's Insurable Interest Law 2* (Jan.2009).

SUMMARY: Imperial Premium Finance LLC used a STOLI-like scheme which led to a criminal investigation of the company. It also led to the company being subpoenaed in a civil case arising from the scheme.

In response to that subpoena Imperial designated a corporate witness to be deposed and that witness also testified at trial. After the trial was completed, the district court imposed a monetary sanction against Imperial based on the court's finding that the company had *in bad faith* prepared the witness selectively in order to further its interest. Imperial's appeal of that sanctions order was denied. This court upheld the district court's imposition of a fine of $850,000.

RELEVANCE: The tangled web we weave when first we practice to deceive is a broad one and with STOLI schemes the web has ensnared thousands of insureds, agents, attorneys, CPAs, trust companies, and insurers. I first wrote of this in 2007 and warned of the trouble it would cause in "*Stranger-Initiated Life Insurance: Scorpion or Frog?"* a paper and talk for the University of Miami Law School's Heckerling Institute (Drop me a note at steve@leimbergservices.com and I'll send you a comp copy).

The hundreds of cases STOLI or SOLI has generated and continues to spawn should be constant reminders to all in the financial services profession of the consequences of greed and its progeny. I strongly urge planners to read the pithy and repeatable quotes of the court below—lessons that will be learned the hard way by those that cannot, or *will not*, learn from *others'* mistakes. The court here provides one of the best reviews of, and reasons for, insurable interest and anti-STOLI legislation.

FACTS: The reporting of this case starts out with this evolution of a quote from T.S. Eliot, "The Love Song of J. Alfred Prufrock," ll. 84–85 (1920):

> J. Alfred Prufrock saw the moment of his greatness flicker and the eternal footman hold his coat and snicker. If there had been an insurance policy on his life like the one that gave rise to this case, Prufrock might have seen -beside the footman - a grinning speculator rubbing his hands in gleeful anticipation.

As this court noted:

> We are all, in the long view, born astride the grave. But allowing parties to use life insurance policies to bet on when an unrelated person will drop off into the grave raises public policy concerns, which have led to restrictions on the practice.

One of the principal state law restrictions referred to by this court is the requirement that the purchaser of a policy have an insurable interest in the insured's life. Sadly, as often happens with regulatory restrictions aimed at thwarting the operation of a market, evasive schemes are soon concocted to circumvent the insurable interest requirement.

According to this court Imperial Premium Finance LLC used one of those schemes. It led to a *criminal* investigation of the company and also to being subpoenaed in a civil case. In response to that subpoena, Imperial designated a corporate witness to be deposed, and that witness also testified at trial. The court noted the one-sided and heavily loaded approach of this expert. Immediately after the trial was completed, the district court imposed a monetary sanction against Imperial based on the court's finding that the company had in bad faith prepared the witness *selectively* in order to further its interest.

This case is Imperial's appeal of that sanctions order.

The court's record states that "Imperial's primary business involved stranger-originated life insurance (STOLI)." STOLI is, by definition, a speculative investment. Simply put, it is gambling. It is a bet on the lives of the elderly. Although there are many varieties of STOLI, in essence a speculator finds an elderly person who, neither wants nor needs life insurance, allows the speculator to (directly or indirectly) buy insurance on that person's life in return for "free insurance for two years" and, in some cases, "a piece of the pie." Typically, the speculators have the insured apply on their behalf for the largest possible face amount insurance. The speculator (often through an intermediary to hide the real source of funds) pays the premiums. These investors hope to profit in one of two ways. One way is if the insured dies relatively soon—before the premiums investors have paid plus the interest they would have earned on the money invested exceeds the death benefit. Of course, the *sooner* the insured dies after the contestable period expires and the proceeds are payable to the speculators, the fewer the premium payments that are necessary to obtain the payout, and the greater their ROR (return on investment). The second way speculators can profit is by selling the policy to another speculator for more than the premiums paid and the cost of money up to the point of that sale. There appear to be no state or federal or contractual limits on how many times the "bet" can be resold or restrictions on to whom it can be sold.

Instead of buying a policy on a person's life outright, Imperial provided financing for life insurance premiums in the form of a loan. The terms of that loan were such that it was highly probable that Imperial would foreclose on the policy and become its owner when the borrower defaulted. The typical loan had a term of two years, a relatively high floating interest rate, and “substantial” origination fees, all of which—coupled with the fact that almost all these borrowers never wanted or needed the coverage and most could not afford the premiums—made the borrower almost certain to default. For example, the $335,000 loan Imperial made in this case had an interest rate that floated between 11 and 16 percent, and it had origination fees of nearly $112,000—more than a third of the loan principal.

Most states try to prevent STOLI transactions by requiring purchasers of insurance policies to have an insurable interest in the insured's life. Seeking to evade those insurable interest requirements, Imperial drafted its loan agreements to require that, during the term of the loan the policy be held in irrevocable trust (with a trustee chosen by Imperial) for the benefit of the insured's relatives. The court record found that “(t)he structure of Imperial's loans made them a sure bet with nothing but upside.” If the borrower somehow managed to pay off the loan when it came due, Imperial got its fees and interest, walking away with as much as a two-thirds return on its investment in two years. If the insured died before the loan matured, the arrangement ensured that Imperial could collect out of the policy proceeds the loan principal, the fees, and the interest it was owed. That was usually a substantial sum.

However, it almost always was not as much as the value of the policies themselves, under which the speculator beneficiary stood to collect hundreds of thousands or even millions of dollars upon the death of the insured. The court record noted that “(t)he ticket to that jackpot for Imperial was the clause in the loan agreements allowing it to foreclose (and therefore become owner and beneficiary) on the policies in the event of default.” In part because of the loans' oppressive terms, *most* of Imperial's loan customers did default. As a result, Imperial knew from the outset that it stood a better than even chance of not just collecting the higher than market interest and significant fees, but obtaining by foreclosure ownership of the policy and the full amount of the policy upon death of the insured. The court record noted that this would occur, Imperial thought, without violating the *letter* of the laws designed to prevent STOLI transactions.

However, the court stated that “Imperial's carefully designed scheme” to get around the insurable interest laws “did not keep it out of trouble” and that “(p)art of its practice was to ‘assist’ prospective insureds in filling out the insurance applications”. The court noted that as part of their efforts to avoid issuing policies that in a STOLI”, insurers typically require applicants to disclose any intent to seek premium financing. Knowing this, perpetrators of STOLI schemes often make what the Florida Department of Insurance describes as “misrepresentations, falsifications, or omissions of material facts in the life insurance application.” And Imperial was no exception. It eventually admitted that when its employees thought that *truthfully* disclosing the financing arrangements would harm the chances of having a policy issued, they “facilitated and/or made misrepresentations on applications that stated or led the insurer to believe the prospective insured was not seeking premium financing.”

The court noted, “That fraudulent behavior came to the attention of the United States Attorney for the District of New Hampshire, who in 2011 launched an investigation into

Imperial's business."That investigation resulted in an April 2012 non-prosecution agreement with Imperial. In return for not being prosecuted, the company agreed to give up its premium financing business, fire or accept the resignations of the employees responsible for that business, and pay an $8 million fine.

According to the court, the above is the background that, coupled with the following additional facts, led to Imperial being sanctioned.

Late in 2007, Florida resident Barton Cotton met with insurance agent Dennis Felcher. Felcher referred Cotton to Larry Bryan, whom Felcher knew was setting up STOLI arrangements. Bryan contacted Imperial about financing the premium payments for Cotton. In April 2008, Cotton granted Bryan's company WealthModes the exclusive right to procure, finance, and sell insurance policies on his life.

The next month, Cotton and an irrevocable trust in his name applied to Lincoln National Life Insurance Company for an $8 million life insurance policy. Consistent with Imperial's standard practice and in order to evade Florida's insurable-interest law, Cotton's wife and children were temporarily named as the beneficiaries of the trust. Cotton falsely stated on the insurance application that (1) he was not buying the policy for resale and (2) that he would not be using a third party to finance the premium payments.

Lincoln issued Cotton a $5 million policy which became an asset of the Cotton trust. Bryan advanced the premium payments to the trust until Imperial lent the trust $335,000. The trust used that money from Imperial to repay Bryan's advance and to continue making the premium payments. Imperial's premium financing loan required a floating interest rate between 11.5% and 16%. The loan agreement authorized it to foreclose on Cotton's policy and become its owner if the trust didn't repay the loan by its maturity date. Together, the combination of the high interest rate and the "origination fee" of nearly $112,000 caused Imperial's $335,000 loan to the Cotton trust to balloon to more than $557,000 in less than two years!

In May 2010, Cotton was diagnosed with esophageal cancer. The court noted that "Cotton's bad news was good news for Imperial because the value of a STOLI policy varies inversely with the life expectancy of the insured". A quick death of the insured shortly after the contestable period is a quick and often sizeable profit for the investors.

Imperial began marketing Cotton's policy for sale. The loan used to finance the policy reached maturity and became due on August 6, 2010. Cotton died two months later. At the time of his death, the trust had yet not paid back Imperial for the loan. Imperial, however, had not yet foreclosed on it. That left the Cotton Family trust as the record owner of the policy.

After learning of Cotton's death, Lincoln launched an investigation which turned up the fact that Imperial had financed the purchase of the policy on Cotton's life in order to market it to speculators under a STOLI scheme. Concluding that was enough to amount to fraud in the procurement of the policy, Lincoln refused to pay the death benefit to the Cotton trust.

In April 2011, the Cotton trustee sued Lincoln for the death benefit. Lincoln counterclaimed, alleging fraud, negligent misrepresentation, and civil conspiracy. Imperial made a second loan to the trust to cover its litigation costs but it was not a party to the case between the trust and Lincoln. Nevertheless, Imperial asked its outside counsel to represent the trust.

During discovery in the case against the Cotton Trust, Lincoln sought to depose Imperial. By that time, Imperial was aware that it was under criminal investigation. Because the topics included in Lincoln's subpoena touched on subjects related to the criminal investigation, Imperial's managers and employees exercised their individual Fifth Amendment rights. They all refused to testify in the Lincoln v. Cotton case. As a result, Imperial sought from the court either a stay of its deposition or permission to prepare and use an outside witness to testify as its designated corporate representative in the deposition and at trial. The court granted Imperial the right to use an outside witness for that purpose.

Imperial hired John Norris, an independent economist with a history of testifying as an expert witness, to serve as its designated corporate representative. Imperial provided Norris with some 20,000 pages of documents. Imperial's counsel met with Norris to brief him on the corporation's knowledge about the topics listed in the subpoena. However, Imperial's managers and employees were as reticent with Norris as they were with Lincoln. None of them would talk with him. Therefore, Imperial communicated with Norris through a single lawyer in its general counsel's office. Along with that official preparation, Norris told the court he did some "slight Googling of Imperial" and "found some general background information" about the company.

Imperial said that its outside counsel billed 72 hours of attorney time and 56 hours of paralegal time just on preparing Norris to testify at the deposition. Norris himself billed 50 hours of his time preparing for and testifying at the deposition. According to him, he used that time to review the subpoena and pleadings and to go "through the documents in the context of" the topics in the notice of deposition.

Lincoln deposed Norris for six hours on January 4, 2012. During the deposition, Norris was often unable to answer questions (apparently because Imperial had not briefed him on the answers).

Lincoln later subpoenaed Imperial to testify at trial. The topics in the trial subpoena were identical to those in the deposition subpoena. Imperial told Lincoln that it would again use Norris to testify. To prepare, Norris reviewed the deposition transcript and the attached exhibits. However, he did not seek any additional information about topics on which he had lacked information during the deposition. Imperial's outside counsel, who was responsible for educating Norris, did not ask him to obtain any additional knowledge in order to testify at trial.

Near the end of the trial, Lincoln called Norris as a witness. During the course of his direct testimony, which spans 31 transcript pages, he was unable to answer about 20 questions due to his lack of knowledge. Norris volunteered four times that he had done nothing "to further his understanding" or to "seek any further clarification" about materially identical questions that he had been unable to answer in his deposition. As he put it, "the thought never crossed my mind in the course of preparation."

On cross-examination, the attorney for the trust elicited testimony that Imperial had financed the premiums for 183 Lincoln policies. After cross-examination ended, the court asked Norris about the mushrooming loan balance, about the interest calculations, and about the reasons for commission payments to insurance agent Felcher. Norris knew next to nothing about those matters or the loan. He tried to arrive at some answers by performing calculations on the stand. However, he could not get it right. He arrived at the wrong amount of interest by incorrectly characterizing more than $78,000 in fees as interest. He also had no answer for the question about the payments to insurance agent Felcher, explaining that he had simply not asked Imperial about that.

The jury returned a verdict in favor of the trust. It found that Cotton and others had conspired to commit an unlawful act and that Cotton had made material misrepresentations on the application for insurance. However, it also found that Lincoln had not relied on or been damaged by the misrepresentations and similarly had not been injured by the conspiracy. The jury also specifically found that Cotton had not intended to “assign or transfer the policy to someone with no insurable interest in his life.” The court entered judgment for the Cotton trust for the $5 million death benefit and $850,000 in attorney's fees, plus costs and interest. Of that $5.85 million, the trust paid approximately $2.24 million to Imperial for the principal, interest, and fees it owed on Imperial's two loans. The remainder of the judgment went to Cotton's wife and children as beneficiaries of the Cotton trust.

The verdict form suggested that the unlawful act might have been an act “such as procuring a policy that lacked an insurable interest at inception, or misrepresenting material facts to Lincoln in the application for the Cotton Policy.” However, the form did not specify which of those acts (or what other act) the jury found Cotton and others had conspired to do.

The morning after Norris testified at trial, the court expressed concern about his and Imperial's conduct. The court characterized Norris as having been “blatant in his failure to follow the rules” for a designated witness. Imperial, it said, “hid behind” Norris, meaning that it hid facts harmful to it by not briefing Norris on them. The court notified the parties that it was considering sanctions against Imperial and Norris, and it invited briefing and argument on that issue.

After Lincoln and Imperial filed briefs on the issue, the court held a two-hour hearing. During the hearing, the court offered Imperial the chance to present evidence and argue against sanctions. It observed that Norris had given “one of the worst performances by a witness that the court had ever seen,” that he “didn't do his job as a witness,” that he “was basically trying to help Imperial to the detriment of everyone else,” and that he had prepared only “to help his client's side of the litigation.”

After the hearing, the district court issued an order assessing sanctions in the amount of $850,000 against Imperial. The district court explained that Imperial was the driving force behind the litigation and its selective preparation of Norris constituted bad faith. It said that the company's “promise of an educated and independent witness was simply a ploy to allow it to escape scrutiny, yet still benefit.” The court found that Norris had “exhibited deliberate ignorance to any inquiry harmful to Imperial's interests while at the same time trying to affirmatively help the Trust and Imperial's counsel at every opportunity." It reasoned that because Imperial had created the issues that led to litigation, Imperial and not Lincoln should bear the costs of the plaintiff's attorney's fees. The $850,000 sanction left the main damages award to the Cotton trust undisturbed but inverted the award of fees under Florida Statute § 627.428, in order to "prevent Imperial from obtaining attorney's fees and costs from the party harmed by its inequitable conduct."

The district court found that Imperial selectively educated Norris and acted in bad faith in doing so. The court pointed out that Norris was prepared to answer questions in ways that were helpful to Imperial, but that he lacked knowledge when the questions turned to areas that might cast Imperial in a bad light or otherwise harm it. According to the court, "Preparing a designated corporate witness with only the self-serving half of the story that is the subject of his testimony is not an act of good faith."

In the court's words, "A contrary result would allow Imperial to convert the investigation into its admitted criminal behavior into a stroke of good luck." Imperial's own employees who were knowledgeable about the transaction that gave rise to the litigation could not take the stand and offer non-answers like Norris did, at least not without perjuring themselves. Therefore, the court noted that the company seized on the existence of the criminal investigation as an opportunity to craft a perfect witness for its interests: one who was knowledgeable about helpful facts and dumb about harmful ones. As the district court pointed out, that all-too-clever behavior is not far from the long-disallowed use of the Fifth Amendment as both a sword and a shield. The appellate court found that, "The district court did not err, much less clearly err, when it found bad faith in Imperial's calculated preparations that produced the one-way witness that Imperial designated to testify for it."

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