STRANGER ORIGINATED LIFE INSURANCE: HEDGING INSURABLE INTEREST

Written By:

David T. McDowell
Thomas F.A. Hetherington
Jarrett E. Ganer

Edison, McDowell & Hetherington LLP
3200 Southwest Freeway Suite 2920
Houston, Texas 77027
(713) 337-5580

david.mcdowell@emhllp.com
tom.hetherington@emhllp.com
jarrett.ganer@emhllp.com

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STOLI: Hedging Insurable Interest

I. Introduction

Traditionally, life insurance has been a device for individuals and families to protect themselves from the economic devastation caused by untimely death. Life insurance companies have flourished by designing products that help families fulfill this need. However, over the past decade, the life insurance industry has seen the development and expansion of a new gray market in life insurance: Stranger Originated Life Insurance ("STOLI").[1] These speculators treat life insurance not as a means to financially protect against tragedy, but as an investment in a commodities market—the human commodities market. STOLI arises out of a manufactured demand for death benefit coverage initiated by investors whose goal is to exploit the insurability of elderly Americans for the investor's own financial gain. The STOLI investor seeks the profit that traditionally went to either the life insurance company or (in the case of early mortality) the insured's beneficiaries. As such, by its very nature, STOLI presents a clear economic risk to the life insurer. This risk is magnified by the investor whose insurable interest in the life of the insured is questionable and who often seeks to maximize profits through misrepresentations in applying for insurance coverage.[2] The ever-evolving STOLI threat requires that life insurance companies take a proactive and analytical view of STOLI and be vigilant both in preventing its issuance and in removing STOLI-related policies from the in-force ledger.

II. Life Insurance Generally

Life insurance can be considered from a number of different perspectives. The perspective chosen will likely influence the light in which STOLI is viewed. Some may choose

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[1] Also commonly referred to as investor or stranger owned life insurance ("SOLI" and/or "IOLI").

[2] The negative consequences of STOLI have already led to opposition from associations of insurers and underwriters. *See, e.g.*, Jim Edwards, *Woods Expresses Industry Concerns over Stranger Owned Life Insurance at NAIC Hearing*, *available at* http://www.naifa.org/newsevents/releases/20060503_soli.cfm.

to view life insurance as a wager between the insurer and the insured as to when the insured will die (with the insurer betting later rather than sooner). More realistically, life insurance is viewed as a device designed to diminish the economic effects of an identifiable risk upon a particular individual by spreading the risk's aggregate costs across a large number of similarly situated individuals. A responsible, productive member of society, whose unexpected death would cause their dependents to suffer economic hardship, if not devastation, will likely choose to purchase life insurance in order to minimize that risk.[3] For most individuals then, procuring life insurance is not a profit-driven decision.

The government has an interest in individuals participating in private risk spreading. Congress encourages this behavior by offering favorable tax treatment to life insurance. In the economic context, this creates a market demand for products that will both spread risk and allow for maximum utilization of the favorable tax treatment. Whole and universal life policies, which accumulate cash value and often allow the insured to borrow against the accumulated cash value, utilize the favorable tax treatment to attract customers who might otherwise inadequately insure. STOLI promoters are exploiting these protections for their personal gain, at the expense of both insurers and society as a whole.

III. STOLI

A. Forms of STOLI

The generic term "STOLI" describes any of several arrangements through which an investor directly or indirectly purchases life insurance on an individual in whose life the investor has no insurable interest. Promoters of STOLI have teamed private equity with institutional banking and trust managers to develop a system through which investors are able to obtain

[3] *See generally* ERIC M. HOLMES AND MARK S. RHODES, HOLMES'S APPLEMAN ON INSURANCE §§ 1.5, 1.25 (West Publishing 1996).

ownership of multi-million dollar life insurance policies insuring the lives of (nominally) complicit individuals.[4] The STOLI market prefers the elderly insured, as they generate a quicker and more predictable return on the premium investment. The insureds must also be wealthy (on the application, if not in reality) in order to qualify for a death benefit large enough to justify the sunk cost of each individual investment. As a rough benchmark, the target insured must be at least 70 years old and qualify for at least $2 million in coverage. The investor funds the policy with the expectation that policy benefits will ultimately flow to the investor. While this is often accomplished through an express transfer of policy ownership to the investor or an entity controlled by the investor, it can also be accomplished through a number of more clandestine methods, such as in the case of trust owned policies where a modification of the trustee or trust beneficiary or the creation of sub-trusts can effectively change policy ownership or control.[5]

STOLI disrupts the traditional economics of the insurance market and provides a new set of economics that promotes fraud. Insurance companies are seeing a reduction in lapse rates and an increase in agent and underwriting fraud driven by the potential returns on a relatively modest investment.[6] Insurers are also concerned with the possibility that the states, the federal government, or both may enact over-inclusive regulation to curb STOLI, and consequently close legitimate markets for life insurance.[7] The emergence of STOLI has generated extreme criticism

[4] *See, e.g.*, Rachel Emma Silverman, *Letting an Investor Bet on When You'll Die*, THE WALL STREET JOURNAL, May 26, 2005, at D1.

[5] *See* Life Product Clearing House LLC v. Angel, 530 F. Supp. 2d 646, 649 (S.D.N.Y. 2008) (describing one STOLI scheme where an insured applied for a policy to be owned by an irrevocable trust under which the insured was named the initially beneficiary, but then sold his beneficial interest in the trust shortly after the policy was issued to the STOLI promoter).

[6] The disparity between the relatively low annual premiums used to procure relatively high death benefits is what makes STOLI, and indeed life insurance fraud in general, so attractive. If the scam works, the return on the perpetrator's premium investment is astronomical. If it fails—that is, if the company successfully rescinds the policies—most states have laws requiring the premium investment to be returned to the perpetrator.

[7] *See* Silverman, *supra* note 4.

from consumer and social advocates[8] who see it as nothing more than a modern day rendition of the long outlawed "dead pool" and are concerned about the potential exploitation of the elderly insureds that have become entangled in these schemes.[9]

STOLI is a market distinct from the "life settlement" and "viatical" markets, which primarily focus on owner/insureds who either own unneeded insurance policies or who are willing to sell policies for which they are now overrated. In other words, due to a decline in insurability since the policy was originally priced and issued, the policy's face value exceeds the benefit a similar premium could purchase were the insured underwritten today. If an investor can negotiate a purchase price less than the policy's discounted face value, he can capture part of the 'profit' that would have otherwise gone to the insured's beneficiary.

Although the life settlement and the STOLI gray markets overlap in some respects, the problems with the traditional secondary market are not nearly as pronounced, as discussed below, as with STOLI.

1. "Front End" STOLI

"Front End" STOLI involves an investor taking policy ownership and/or control from inception. The policy's owner is typically a trust, and the trustee is associated with the investor. The investor will fund premiums either through formal financing, trust contribution, or a hidden reimbursement of premium fronted by the insured. Depending on the trust agreement and applicable law, the investor may have de facto ownership of the policy from the time of issuance. Beneficial trust and/or policy ownership, to the extent necessary, will usually become apparent only after expiration of contestability. Under this arrangement, the insured or the insured's

[8] *See, e.g.*, Karrol Kitt, Comments at Investor Owned Life Insurance Hearing, Life Insurance and Annuities (A) Committee, NAIC Summer National Meeting (June 12, 2005), *available at* http://www.naic.org/documents/committees_a_STOLI-Kitt.pdf.

[9] *See, e.g.*, Stephan R. Leimberg, *Stranger-Owned Life Insurance ("SOLI"): Killing the Goose That Lays Golden Eggs*, available at http://www/pgdc.com/usa/item/?itemID=261283.

family will typically receive a substantial payment, usually measured as some percentage of the death benefit, paid either at the outset or when the policy becomes post-contestable.[10]

2. "Back End" STOLI and the "Free Insurance" Model

"Back End" transactions are often marketed to potential insureds as "free" or "no-cost" insurance. These transactions typically involve explicit or covert non-recourse[11] premium financing at a high interest rate, with large administrative fees, or both.[12] If the insured dies within the first two years, the loan is repaid from the policy proceeds and the remaining benefits (or a portion thereof) go to the insured's beneficiaries. If the insured survives the two years, he or she is given the option of repaying the loan, including accumulated interest and fees, or forfeiting the policy in full satisfaction of the loan (and perhaps netting a small break up fee).[13] The investment is typically structured in such a way to all but require that the policy be ceded to the investor, due to the high interest rate and fees. Though not a necessary feature, trusts are included in these transactions as well.[14] The chief advantage of the trust is that the trustee can consent to changes of the collateral assignee, should the initial financer choose to transfer the note prior to the "free insurance" period expiration.

3. Hybrid Models

The front and back end models do not exist in isolation and are not mutually exclusive. Any number of variations exists that alter the dynamics of the insured/investor relationship. The

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[10] *See Angel*, 530 F. Supp. 2d at 647 (describing a STOLI scheme in which an inured received $300,000 from an investor six days after a $10 Million policy was issued).

[11] Meaning that the insured is not personally liable on the loan, which is secured only by the policy.

[12] This situation should be distinguished from more legitimate forms of premium financing that are secured beyond the policy and which are marketed at competitive interest rates. In the STOLI situation, there is no risk to the lender, as the money lent is solely used to ensure the protection of the collateral.

[13] *See* Silverman, *supra* note 4. It is also worth noting that this arrangement may give rise to a taxable event for the insured, if the I.R.S. were to consider this interest forgiven. *Id.*; *see also* STOLI ALERT (Am. Council of Life Ins. and Nat'l Assoc. of Ins. & Fin. Advisers, Dec. 2007) Volume 1, Issue 5, at 3. ("Two senior members of the House Ways and Means Committee have asked the U.S. Treasury Department to alert elderly taxpayers of the adverse tax consequences of participating in STOLI transactions.").

[14] *See* Silverman, *supra* note 4.

transaction could be structured along the lines of the back end model but the insured could be given put options allowing policy forfeiture prior to the expiration of the two-year period for a specified (and decreasing) percentage of the face value.

A cynic may wonder what difference investors' exploitation of an elderly individuals' insurability would make to a life insurance company, or why a life insurance company would care from whom they are receiving premium dollars, or why having STOLI on its books would make a difference to a life insurance company. However, as will be seen, the negative effects of STOLI on the insurance market and the industry in general will ultimately harm insurers and consumers alike.

B. Problems with STOLI

1. Persistency and the Insurance Business Model

Insurers are experts in assessing risk and probabilities. The entire business model of the insurance industry is based on the occurrence and non-occurrence of certain events. While life insurance companies may or may not profit from an individual policy, insurers are able to profit in the aggregate due to the predictability of mortality rates across a given category of the population.[15] When rating and issuing policies, insurers must not only assess the external risks that face the public, they must also assess the risks and probabilities associated with their policies. Insurance companies in turn price compete with each other based on both actuarial and economic probabilities. The insurer who makes the best assessment of all the risks, internal and external, associated with each policy class will ultimately secure the greatest possible profit.

Part of the internal assessment entails predicting what level of puffing, misrepresentation, and outright fraud take place within every class of application. This task is difficult enough when the preferences of the policy owner are aligned with those of the insured. In STOLI, from

[15] *See* Leimberg, *supra* note 9.

step one of the application, the preferences of the insured and the owner are in discord. The ordinary consumer purchases life insurance as part of a plan to hedge against risks. Some of these consumers will inevitably allow their policies to lapse or will borrow against or cash out their policies. STOLI promoters have identified this as a variable that forces policy pricing down in the aggregate population. Since the investor will not allow policies to lapse, policies owned by the investor are more likely to be underpriced, enhancing the probability that the investor will profit. This discord in behavior, between the ordinary consumer and the investor, disrupts the income model insurers use when setting policy rates.[16]

The most common solution offered by commentators addressing this problem is for insurers simply to reduce or eliminate the lapse assumption from their projections, which indeed they have been forced to do.[17] This solution, however, is inadequate and fails to address the underlying issue. It is inadequate in that a reduction in the lapse assumption requires a correlative increase in premium pricing. A rise in price will necessarily force some individuals out of the market. Some people will purchase less insurance and some will not obtain insurance at all. This causes a detriment to society because risk that befalls these individuals is no longer distributed. Raising prices and forcing would-be participants out of the primary market simply to accommodate the gray market intruder is a bad policy solution for society as a whole.

2. Fraud

Over the long run, for an entrepreneur to truly profit by purchasing policies on the lives of others, he would have to predict the mortality risk with greater accuracy than the insurance company issuing the policy. Life insurance, in this sense, would simply be a human

[16] *See, e.g.*, John Tiller, presentation to Society of Actuaries 2006 Annual Meeting, *available at* http://handouts.soa.org/conted/cearchive/Chicago-october06/094bk_rev.pdf.

[17] *See, e.g.*, Joseph M. Belth, statement before the Life Insurance and Annuities (A) committee of the NAIC (May 3, 2006), *available at* http://www.naic.org/documents/committees_a_Belth_Testimony.doc.

commodities market. An investor may rely on a 50% life expectancy rating rather than the 85% rating the underwriter used and then place a wager that the commodity in question (the insured) is not more than a couple standard deviations above mean life expectancy.[18] In this case, some investors will win and some will lose. As with almost any commodities market though, the only way to ensure a safe return is to have more accurate information than the rest of the market. While in dealing with citrus commodities, it is rather hard to divine significantly more accurate information concerning developing weather patterns in Florida than available to the rest of the market, in the human commodity market, it is rather easy to ensure that you have more accurate information concerning the viability of the insured than does the insurer.

In a normal life insurance situation, the consumer's goal is to obtain a certain level of coverage, consistent with the particular needs of his family, within a certain premium budget. If he is willing to 'tweak' the application, he will do so just enough so that the policy gets issued at the premium he is willing to pay. Additionally, most of the fraud and misrepresentation would take place in the medical underwriting section. STOLI on the other hand, presents a different situation. The motives of the insured are taken completely out of the equation. The true customer is the investor and the investor profits by 'out underwriting' the insurer.[19] The greater the disparity between the insured's true actuarial rating and the rate at which the policy is issued, the greater the investor's profit.

Additionally, much of the fraud takes place in the economic underwriting section, and likely without the explicit knowledge of the insured. For instance, an agent will approach an elderly individual with the offer of free insurance and perhaps an upfront payment. As an added bonus, the agent will fill out all the paperwork, and the insured need only sign the forms.

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[18] *See, e.g.*, Roger Annin, presentation at Product Development Symposium, *available at* http://handouts.soa.org/product-development/RogerAnnin-1C.pdf.

[19] *Id.*

Although the insured is living in a modest home and is a retiree of relatively modest means, the application will state several million dollars in various assets. Even if a consumer wished to perpetrate this type of fraud, the premium would likely be well out of his or her budget. Only through the investors' deep pockets is this type of fraud feasible.

3. Insurable Interest

Most states require that a life insurance policy's initial owner, beneficiary, or both, possess an insurable interest in the life of the insured.[20] Insurable interest is a matter of public policy and not a contractual right held by the insurer. In determining whether an insurable interest exists, most states have requirements similar to those found under Maryland law: a person must be shown to either: 1) be "related closely by blood or law;" 2) have "a substantial interest engendered by love and affection;" or 3) have "a lawful and substantial economic interest in the continuation of the life, health, or bodily safety of the individual."[21] The policy preference of requiring an insurable interest spawned from the belief that life insurance without an insurable interest was nothing more than a morbid form of gambling.[22] The advent of life insurance brought with it a very disturbing side-effect. Over three centuries ago, the "dead pool" was popularized in Great Brittan as gamblers placed bets as to which of several chosen royals would perish first. This in turn led to speculators taking out life insurance policies on these celebrities

[20] *See infra* text accompanying note 35.

[21] *See* MD. CODE ANN., INS. § 12-201. (LexisNexis 2006). The following twenty-one states have substantially similar statutes defining "insurable interest:" Arizona, Arkansas, Hawaii, Idaho, Kentucky, Louisiana, Mississippi, Montana, Nevada, New Jersey, New Mexico, New York, North Dakota, Oklahoma, Rhode Island, South Dakota, Utah, Virginia, Washington, West Virginia, and Wyoming. However, almost all states have some kind of requirement that the purchaser of a life insurance policy on the life of another have an insurable interest in that person's life (i.e., an expectation of economic benefit from the insured's continued life, or of a loss at the insured's death). Mississippi for instance requires the individual and the insured to be "related closely by blood or by law, a substantial relationship engendered by love and affection." MISS. CODE ANN. § 83-5-251(3)(a) (2007). Courts interpreting that statute have found that an interest through love and affection alone are not enough, but that a relationship by blood is required. First Colony Life Ins. Co. v. Sanford, 180 F.Supp. 870, 875 (S.D. Miss. 2007).

[22] *See* Grisby v. Russell, 222 U.S. 149, 156 (1911) (stating that the original policy objection to life insurance without an insurable interest was the concern with the wagering aspect rather than the temptation to murder the insured).

and other strangers. Parliament responded in 1774 with the Life Assurance Act, which prohibited the making of any policy on the life of a person without the existence of an insurable interest.[23]

The insurable interest requirement was subsequently reinforced in American public policy by the notion that we do not especially want one citizen to have a direct economic incentive to hasten the earthly demise of another citizen.[24] Life insurance is meant to hedge against risks, not create them. The central case of American law regarding insurable interest is *Grisby v. Russell*.[25] In *Grisby*, Justice Oliver Wendell Holmes reiterated the basic policies behind insurable interest: "A contract of insurance upon a life in which the insured has no interest is a pure wager that gives the insured a sinister counter interest in having the life come to an end."[26] The question in *Grisby*, though, was whether an insured could assign an otherwise valid policy to a third party who did not have an insurable interest in the insured. The Court found that due to the beneficial nature of life insurance, it was, "[s]o far as reasonable safety permits, desirable to give to life policies the ordinary characteristics of property."[27] As such, an

[23] Life Assurance Act, 1774, 14 Geo. 3, c. 48.

[24] Critics of insurable interest laws, especially promoters of STOLI, point to these policy goals regarding wagering contracts and declare that insurable interest is an outdated, paternalistic concept that is unnecessary in our modern, advanced society. *See generally* Erich W. Sippel & Alan H. Buerger, *A Free Market for Life Insurance*, CONTINGENCIES (March/April 2002), *available at* http://www.lifeasset.com/free_market.htm. They view insurability as a commodity to be traded, and insurance as no more gambling than any investment into the securities market. *See, e.g.*, Roy Kreitner, *Speculations of Contract, or How Contract Law Stopped Worrying and Learned to Love Risk*, 100 COLUM. L. REV. 1096, 1116 (2000) (arguing that laws regarding insurable interest largely developed based on a religious aversion to gambling, which is no longer seen with the same stigma). Additionally, critics argue that STOLI investors are hedge funds, not the mob. White collar investors are not likely to rub out grandma to ensure a good return on their investments. Even assuming these justifications for insurable interest no longer apply, the macroeconomic justifications for life insurance (and the policy preferences accorded it) are based on the belief that life insurance is a positive commodity that spreads the economic risks associated with mortality across a large segment of the population. The goal of spreading risks, however, is achieved most thoroughly where the beneficiaries of the policy are those who would otherwise be subjected to the risk of loss.

[25] 222 U.S. 149 (1911).

[26] *Id*. at 154.

[27] *Id.* at 156.

already in force policy could be transferred as could any piece of property, regardless of insurable interest.[28]

Holmes noted that this ruling applied only where "an honest contract is sold in good faith" and expressly did not apply to situations in which "a person having an interest lends himself to one without any as a cloak to what is in its inception a wager."[29] Those situations would continue to be governed by the Court's ruling in *Warnock v. Davis*.[30] In *Warnock*, the Court held invalid as against public policy an assignment of ninety percent of the proceeds of a life insurance policy executed concurrently with the policy's application. The Court found that the contemplated "assignment of a policy to a party not having an insurable interest is as objectionable as the taking out of a policy in his name."[31] A potential argument thus exists, in states retaining the *Warnock's* rationale, that a policy made in contemplation of a change of ownership to an entity that lacks an insurable interest is as void as if the application had been made in the entity's name.[32] For instance, in a recent opinion examining New York insurable interest law, and seeking guidance from both *Grisby* and *Warnock*, the United States District Court for the Southern District of New York held that in order for an insured to validly transfer his interest in an insurance policy to an investor, the policy had been issued to the insured "on [the insured's] 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

[28] *See, e.g.* Travelers Cas. & Sur. Co. of Am., Inc. v. Northwestern Mut. Life Ins. Co., 480 F.3d 499, 502 (7th Cir. 2007) (internal quotations omitted) (noting that *Grisby* allows an owner of a policy to voluntarily assign an in-force policy).

[29] *Grisby*, 222 U.S. at 156.

[30] 104 U.S. 775 (1881).

[31] *Id. at* 779.

[32] *See, e.g.*, Lakin v. Postal Life & Cas. Ins. Co., 316 S.W.2d 542 (Mo. 1958) (finding that immediate transfer of ownership to one with no insurable interest violated ban on wagering contracts).

what would otherwise be a gambling transaction by a stranger on his life."[33] Other courts have agreed.[34] Additionally, as is discussed further herein, at several state departments of insurance advocate this more expansive view of insurable interest in the context of STOLI.

Today, almost every state justifies its insurable interest laws on the theory that such laws are needed to prevent others from wagering on the life of the insured.[35] The cases cited in

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[33] *See Angel*, 530 F. Supp. 2d at 653, 656 (holding that an immediate transfer or assignment of a policy is valid only if the initial acquisition of the policy was in good faith and without an intent to transfer it to an otherwise disinterested investor).

[34] *See, e.g., Lincoln Nat'l Life Ins. Co. v. Calhoun, et al.*, 596 F.Supp.2d 882, 889 (D. N.J. 2009)

[35] *See, e.g.*, **Alabama:** Brewton v. Ala. Farm Bureau Mut. Cas. Ins. Co., 474 So. 2d 1120, 1122 (Ala. 1985); **Alaska:** State Farm Auto. Ins. Co. v. Raymer, 977 P.2d 706, 710 (Alaska 1999) (insurable interest prevents insurance contracts from being used as a means of wagering); **Arkansas:** Corning Bank & Trust Co. v. Foster, 74 S.W.2d 797, 800 (Ark. 1934) ("a wagering contract of insurance is contrary to public policy, and void"); **California:** Jimenez v. Protective Life Ins. Co., 8 Cal. App. 4th 528, 536 (1992) (if there is no insurable interest "the policy is a mere wager on the life of the person insured, and . . . void as against public policy"); **D.C.:** Watson v. Mass. Mut. Life Ins. Co., 140 F.2d 673, 676 (D.C. App. 1943) (purpose of an insurable interest is "to limit [the] speculative business of buying and selling insurance … on the lives of others");**Delaware:** Baltimore Life Ins. Co. v. Floyd, 91 A. 653, 656 (Del. 1914) ("insurance procured upon a life by one or in favor of one under circumstances of speculation or hazard amounts to a wager contract and is therefore void"); **Florida:** Life Ins. Co. of Georgia v. Lopez, 443 So. 2d 947, 950 (Fla. 1983) (in "the absence of an insurable interest, the law condemns such policies as mere wagering contracts"); **Georgia:** Burton v. John Hancock Mut. Life Ins. Co., 298 S.E.2d 575, 578 (Ga. 1982) ("'wager' contracts procured on another by a beneficiary having no 'insurable interest' … in the life of the insured are void"); **Illinois:** Colgrove v. Lowe, 175 N.E. 569 (Ill. 1931) ("contract of insurance upon a life in which the [owner] has no interest is a pure wager, that gives the [owner] a sinister counter-interest in having the life come to an end"); **Indiana:** Salem Lodge No. 21, F. & A. M. v. Swails, 197 N.E. 837, 839 (Ind. 1935) (a policy … taken out by one upon the life of another when [there is] no insurable interest in the life [is] … violative of public policy); **Iowa:** Hult v. Home Life Ins. Co., 213 Iowa 890; 240 N.W. 218, 227 (Iowa 1932) (a life insurance contract must be based upon an insurable interest, in the absence of which it becomes a wager contract and void); **Kansas:** Geisler v. Mut. Benefit Health & Accident Ass'n, 163 Kan. 518; 183 P.2d 853, 857 (Kan. 1947) (contracts are against public policy if (a) "they are … wagering in character and (b) … afford an incentive to crime"); **Kentucky:** Ficke v. Prudential Ins. Co., 202 S.W.2d 429, 431 (Ky 1947) ("the lack of an insurable interest creates … wager policies, which are invalid"); **Louisiana:** Adam Miguez Funeral Home, Inc. v. First Nat'l Life Ins. Co., 234 So. 2d 496, 499 (La. Ct. 3d Cir. 1970) ("the public policy purpose of requiring an insurable interest is to prevent wagering contracts on insurance risks"); **Maine:** Getchell v. Mercantile & Mfrs.' Mut. Fire Ins. Co., 83 A. 801, 802 (Me. 1912) ("Wagering policies are forbidden as against public policy"); **Maryland:** Hopkins v. Hopkins, 614 A.2d 96, 100 (Md. App. 1992) (the "requirement of insurable interest was intended to prevent wagering on human lives"); **Michigan:** Hicks v. Cary, 52 N.W.2d 351, 354 (Mich. 1952) ("a life insurance policy naming as beneficiary one who has no insurable interest in the life of the assured is a wagering contract, void as against public policy"); **Missouri:** Estate of Bean v. Hazel, 972 S.W.2d 290, 292 (Mo. 1998) ("one must have an insurable interest in a person's life in order to take out a valid policy of insurance on that person's life"); **New Hampshire:** Mechanics' Nat'l Bank v. Comins, 55 A. 191, 193 (N.H. 1903) ("insurance procured by one person upon the life of another, the former having no insurable interest in the latter, was void as a wager contract"); **New York:** Scarola v. Ins. Co. of N. Am., 323 N.Y.S.2d 1001 (N.Y. App. Term 1971) (the "vice sought to be avoided by requiring insurable interest is to prevent the insurance policy from becoming a wagering contract"); **North Carolina:** Wharton v. Home Sec.

Footnote 35 overwhelmingly reflect that the business of wagering on the lives of others is against public policy and provides an incentive to injure or destroy the insured's life.[36] One court recently confirmed the importance of this public policy by stating, "the public interest, as protected by the insurable interest doctrine, is 'of paramount importance.'"[37]

IV. Litigation by Insurers

Many insurers have confronted the STOLI threat by aggressively seeking rescission of policies suspected of being products of STOLI schemes. Insurers seeking to rescind policies have several options available to them. The exact nature of the legal steps involved must be assessed on an ad hoc basis and will depend on whether there is evidence of fraud in the application process and whether the policy in question is within the contestability period.

A. Fraud and Misrepresentation – Policies within Contestability Period

As a matter of contractual and regulatory law, virtually every jurisdiction in the United

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Life Ins. Co., 173 S.E. 338, 339 (N.C. 1934) ("a person cannot take out a … policy of insurance for his own benefit on the life of a person in which he has no insurable interest"); **Ohio:** Westfall v. Am. States Ins. Co., 334 N.E.2d 523, 525 (Ohio Ct. App. 1974) (a "'wager policy" is one in which the insured has interest only in the loss or destruction of the property" or thing insured); **Oklahoma:** Delk v. Markel Am. Ins. Co., 81 P.3d 629, 634 (Okla. 2003) (the "insurable interest requirement was to prohibit wagering contracts in the guise of insurance"); **Oregon:** Brett v. Warnick, 75 P. 1061, 1063-64 (Ore. 1904) ("before one can be permitted to take out a policy of insurance upon the life of another for the former's benefit he must have an insurable interest in the life of the latter"); **Pennsylvania:** Van Cure v. Hartford Fire Ins. Co., 253 A.2d 663, 664 (1969) ("insurable interest is founded upon the public policy against wagering"); **South Carolina:** Warren v. Pilgrim Health & Life Ins. Co., 60 S.E.2d 891, 893 (S.C. 1950) ("one cannot obtain valid insurance upon the life of another in whom he has no insurable interest"); **Tennessee:** Duncan v. State Farm Fire & Casualty Co., 587 S.W.2d 375, 376 (Tenn. 1979) (finding an insurable interest "essential" or "the contract amounts to no more than a wager and is void"); **Texas:** Cheeves v. Anders, 28 S.W. 274, 276 (Tex. 1894) (it "is against public policy for one to be interested in the death of another when he has no interest in the continuance of his life"); **Virginia:** Green v. Southwestern Voluntary Ass'n, 20 S.E.2d 694, 696 (1942) ("it has long been held that in the absence of an insurable interest, a policy on the life of another is contrary to public policy and cannot be enforced"); **Washington:** Buckner v. Ridgely Protective Ass'n, 229 P. 313, 316 (1924).

[36] *See also*, Stephan R. Leimberg, *Stranger-Initiated Life Insurance: Scorpion or Frog?*, ¶ 310.1 (2007) (noting that a "life insurance policy is void *ab initio* if the person to whom the policy is issued or to whom the benefits are paid (or both, depending on controlling state law), lacks an insurable interest in the life of the insured.") (quoting M. Mancini and H Zaritsky, *Insurable Interests: Apres Chawla, Le Deluge?*, 32 ACTEC Journal 193).

[37] *See Chawla v. Transamerica Occidental Life Ins. Co.*, 2005 U.S. Dist. LEXIS 3473, Civ. Action No. 03-1215 (E.D. Va. Feb. 3, 2005), *aff'd in part, vacated as moot in part,* 440 F.3d 639 (4th Cir. 2006).

States allows a life insurance company to rescind a life insurance contract within two years of the policy's issue date under certain circumstances.[38] The contestability period acts as a statute of limitations whereby a company is required to investigate the information provided on the application within two years typically from the date of issue.[39] In virtually all states, once this contestability period ends, the fact that a policy was obtained through fraud does not prevent a company from being bound to a life insurance contract.[40] New Jersey is a notable exception to the rule, concluding in *Ledley v. William Penn Life Insurance Co.*[41] that "even after the expiration of the contestability period, an insurer may deny a claim if the insured committed fraud in the policy application."[42]

A company considering rescission must assess whether it can meet the required standard for rescission in the state in question. All states have adopted, either by statute or common law, a standard that an insurance company must meet in order to rescind a policy. The standard varies from state to state, and it is very important that a company knows the standard for the state in

[38] *See, e.g.,* CAL. INS. CODE § 10113.5 (Deering 2006) ("An individual life insurance policy delivered or issued for delivery in this state shall contain a provision that it is incontestable after it has been in force, during the lifetime of the insured, for a period of not more than two years after its date of issue"); FLA. STAT. § 627.455 (LexisNexis 2006) ("[e]very insurance contract shall provide that the policy shall be incontestable after it has been in force during the lifetime of the insured for a period of 2 years from its date of issue "); TEX. INS. CODE § 1101.006 (Vernon 2006) ("Except as provided by Subsection (b), a life insurance policy must provide that a policy in force for two years from its date of issue during the lifetime of the insured is incontestable, except for nonpayment of premiums").

[39] For example, the Eleventh Circuit Court of Appeals concluded that Florida's appellate courts have held that "once the incontestability clause becomes effective, insurers are barred from attempting to rescind or cancel the insurance policy based on allegations that the insured engaged in fraud or misrepresentation." Allstate Life Insurance Co. v. Miller, 424 F.3d 1113, 1115 (11th Cir. 2005); s*ee also* Galanty v. Paul Revere Life Ins. Co., 23 Cal. 4th 368, 1 P.3d 658, 667 (Cal. 2000) ("During the two-year period of contestability, however, the insurer may investigate the insured's statements in the application, and the policy remains subject to rescission for fraud."); Minn. Mut. Life Ins. Co. v. Morse, 487 S.W.2d 317, 320 (Tex. 1972) (the "purpose of incontestability clauses in insurance policies . . . is to protect the insured from a contest as to the validity of the policy after the expiration of the set period").

[40] *See Miller*, 424 F.3d at 1116.

[41] 651 A.2d 92 (N.J. 1995).

[42] *Id*. at 95.

which it seeks the rescission. Most states have a statutory standard that is similar to that adopted by Alabama:

> All statements and descriptions in any application for an insurance policy . . . by . . . the insured . . . shall be deemed to be representations and not warranties. Misrepresentations, omissions, concealment of facts and incorrect statements shall not prevent a recovery under the policy or contract unless [they are] either: (1) fraudulent; (2) material to either the acceptance of the risk or to the hazard assumed by the insurer; or (3) the insurer in good faith would not have issued the policy or contract, or would not have issued a policy or contract at the premium rate as applied for, or would not have issued a policy or contract in as large an amount or would not have provided coverage with respect to the hazard resulting in the loss if the true facts had been made known to the insurer as required by the application for the policy or contract or otherwise.[43]

Under this standard for rescission, it is enough for the insurance company to show that the misrepresentations were material to the risk. Intent to deceive need not be shown. A minority of states, such as Texas and Iowa,[44] not only require a showing that the misrepresentation was material but also that it was made with the intent to deceive. Proving that a person intended to deceive the insurance company is a far greater burden than simply proving the existence of a material misrepresentation, and it often precludes summary disposition of the matter.

The bottom line is that if the policy is within the two-year contestability period, a company that has built a strong fraud case stands a very good chance of rescinding the policy and removing the death benefit from the company's in-force ledger. Most economic and medical misrepresentations and fraud will be considered material to the risk assumed. In addition to evidence of fraud in the medical or economic underwriting, an insurance company can potentially claim that all STOLI policies are subject to fraud or misrepresentation based on the owner of the policy listed on the application.

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[43] ALA. CODE § 27-14-7 (2006).

[44] *See, e.g.,* Rubes v. Mega Life & Health Ins. Co., Inc., 642 N.W.2d 263 (Iowa 2002); Mayes v. Mass Mut. Life Ins. Co., 608 S.W.2d 612 (Tex. 1980).

Misrepresentation of the owner's true identity may well be a viable claim, but it is not without its challenges. Insurers face an uphill battle in showing that the misrepresentation was material to the risk insured. Even though investor ownership of policies materially affects the overall market and the way that risks are insured, on an individual basis, the risk insured against is the death of a particular individual. Proving a statistically significant actuarial correlation between life expectancy and a person's willingness to participate as the insured in a STOLI scheme may be difficult. A legitimate connection, however, may exist between ownership and misrepresentations concerning economic status. As with net worth or income level, the ownership of a policy is strong indicia of the legitimacy of the insured's need for the policy. Further, as noted in the next section, third party ownership may also be a relevant component in an insurable interest inquiry.

B. Lack of Insurable Interest – Applicable to All STOLI Policies

In the absence of fraud or misrepresentations, or if the policy is no longer within the contestability period, an insurer's strongest argument for rescission of STOLI policies is the lack of a true insurable interest from the policy's inception. Because insurable interest is a theory arising out of public policy and not a contract based defense, a life insurance contract's incontestability provision should not trump public policy. A contract to illegally distribute narcotics or to pay a hit man to murder someone becomes no less offensive to public policy simply by the passage of time. Similarly, New York and Michigan law notwithstanding,[45] a life insurance policy procured by someone that does not have an insurable interest in the life of the insured becomes no less offensive to public policy simply because the life insurance contract has been in force for longer than two years. If incontestability rises above the public policy behind

[45] In an odd pairing, New York and Michigan consider insurable interest to be required by public policy, but also considers a lack of insurable interest waived if not raised during the contestability period. *See infra* text accompanying note **Error! Bookmark not defined.**.

insurable interest, someone would have no remedy under the law to contest or seek the rescission of a life insurance contract insuring their life of which they had no prior knowledge, if the contract had been in force longer than two years. The absurdity of this result clearly justifies the conclusion that the issue of insurable interest should trump the issue of incontestability.

The key to achieving rescission under a claim of lack of insurable interest is proving that a transfer or assignment was contemplated at the policy's inception. Indeed, at least one court has required not only a showing of intent but the identification of the specific third party to whom the sale is to be made.[46] While in most STOLI situations the desired outcome is the ultimate transfer of the policy, it may be difficult to show that this outcome was guaranteed or that the insured was complicit in the scheme. STOLI transactions almost always leave the insured the option of repaying the loans and fees and keeping the policy in force. The beauty of STOLI, from the perspective of investors, is that it appears to be three legitimate activities rolled into one: (1) the sale of an insurance policy, (2) using premium financing, (3) followed by a life settlement transfer. Assuming the STOLI promoters comply with all applicable regulations of these three activities, all of the documentation involved may very well appear legitimate. In these situations, it may be difficult to successfully challenge them solely based on the lack of an insurable interest, as the insurer would have the intensive factual burden of proving that the transfer was a sham perpetrated from the policy's inception.

C. A Tale of Two Cases

Courts are beginning to weigh in on insurers' efforts to combat STOLI through litigation. Not surprisingly, judicial opinion is somewhat inconsistent even when faced with similar facts.

[46] In *Sun Life Assurance Co. of Canada v. Paulson*, the United States District Court for the District of Minnesota ruled that the insurer seeking to rescind coverage on insurable interest grounds must allege not only an intent on the insured's part to transfer the policy after issuance but the insurer must also identify to whom the insured intended to transfer the policy interest. *See* 2008 WL 5120953, *2 (D. Minn.). The Court opined that the insured's intent is "irrelevant" without facts establishing that the third party to whom the policy was to be transferred lacked an insurable interest in the insured's life. *See id.* at *4.

1. Teren

In *The Lincoln Life and Annuity Co. of N.Y. v. Jack Teren and Jonathan S. Berck, as Trustee of the Jack Teren Insurance Trust* ("Teren"), a California state court found that the life insurer was not only entitled to rescission but that it need not return the premiums received to the policyowner due to the extent of the STOLI fraud involved. *See* Statement of Decision with Findings of Fact and Conclusions of Law, *Lincoln Life and Annuity Co. of N.Y. v. Teren*, No. 37-2008-83905 (Cal. Sup. Ct. Aug. 27, 2009).

In *Teren*, Lincoln was seeking rescission of a large, trust-owned policy obtained through significant misrepresentations on the policy application and made during the application process. The Court found that Lincoln was entitled to rescission. Perhaps more importantly, the Court also ruled that the Teren Trust and Trustee were not entitled to a return of premiums paid on the life insurance policies owned by the Teren Trust, even though the Court found that Lincoln was entitled to rescission. The Court's ruling was based on four legal principles:

> First, the Trustee's request for a premium refund was barred by the doctrine of unclean hands, which requires that a party must "act fairly in the matter for which he seeks a remedy." *See Kendall-Jackson Winery, Ltd. v. Superior Court*, 76 Cal. App. 4th 970, 978 (1999). Under the doctrine, a party "must come into court with clean hands, and keep them clean, or he will be denied relief." Id. . . .
>
> Second, under California Insurance Code § 483(c), a policy owner or insured is not entitled to a premium refund when it engages in "actual fraud." The fraudulent conduct set forth above, constitutes "actual fraud" precluding the Trust and the Trustee from receiving a premium refund on the Teren Policies. *See* California Civil Code § 1572 (defining "actual fraud").
>
> Third, this Court has the power in a rescission action under California Civil Code § 1692 to "adjust the equities between the parties." Here, given the egregious nature of the fraud committed, this Court finds that the equities weigh in favor of a decision precluding any refund of premiums to the Trust and the Trustee. Any contrary decision would lead to a "heads I win, tails you lose situation"—heads,

> the fraud goes undetected and the policy owner collects a death benefit upon Jack Teren's death or tails, the fraud is detected and the policy owner receives a premium refund on the fraudulently procured policies.
>
> Fourth, this Court's decision that the Teren Trust and Trustee is not entitled to a premium refund on the Teren Policies is warranted by the equitable principle that a wrongdoer cannot be allowed to take advantage of his own wrong. *See* California Civil Code § 3517 ("[n]o one can take advantage of his own wrong"); *Atwater Elementary Sch. Dist. v. California Dept. of Social Servs*., 41 Cal. 4th 227,232–33 (2007) (recognizing equitable estoppel based upon the "equitable principle that no man (may) profit from his own wrongdoing in a court of justice").

The *Teren* opinion, which is currently on appeal, is obviously a terrific result for the life insurance industry, because it not only permits rescission, but does so in a way that protects the life insurer from having to choice commissions paid to producers. Yet, what one California court gives, another can take away.

2. Fishman

In *Lincoln Nat'l Life Ins. Co. v. The Gordon R.A. Fishman Irrevocable Life Trust*, the United States District Court for the Central District of California considered Lincoln National's efforts to rescind three life insurance policies totaling $30 million in death benefit coverage on the life of Dr. Gordon Fishman. 2009 WL 2330771 (C.D. Cal.). The policies were issued to The Gordon R.A. Fishman Irrevocable Life Trust allegedly as part of a STOLI scheme. Of ultimate significance to the Court was that the Trust was formed with the insured's consent and the insured knew that the Trust would own at least one life insurance policy insuring the insured's life. The Trust's putative beneficiaries were the insured's four sons, all of whom clearly had an insurable interest in their father's life. *See id.* at *4

After reviewing the concept of insurable interest under California law, the Court granted summary judgment against Lincoln, finding that the insured had consented to the Trust's formation, that an irrevocable life insurance trust "may purchase and hold life insurance policies on the life of its settler," that the Trust's beneficiaries were the insured's four sons, and that the financing entity's interest was only in the form of a collateral assignment. While the Court recognized Lincoln's "valiant attempts to expose [the STOLI promoter's] alleged scheme for the true 'charade' it is, the simple fact remains that the law, as it is currently structured, allows for an arrangement as that concocted by [the STOLI promoter]." *See id.* at *8. The Court expressly discounted authority cited by Lincoln from other jurisdictions that sought to enforce the spirit of insurable interest laws, and noted the lack of California authority on the subject. *See id.* In concluding its analysis, the Court found that "[the STOLI promoter's] finance program skirts close to the letter, and certainly can be viewed as violating the spirit, of the law . . .. In such circumstances [though], it is perhaps best to follow the wisdom expressed long ago by President Ulysses S. Grant, who said that 'the best way to get rid of a bad law is to enforce it.'" *See id.* at *9

D. But What About The Commissions?

Life insurers are increasingly encountering STOLI promoters and other litigants who are happy to agree to policy rescission in exchange for a return of all premiums – an interesting equitable formula where, having been discovered, the STOLI promoter is made whole while the life insurer must chase commissions in order to avoid a substantial loss.

Across the United States, courts are beginning to adjudicate cases involving the rescission of fraudulent policies procured by highly organized and well funded STOLI promoters. These cases show that rescission of STOLI policies is different from more traditional rescissions involving only the insured and the insurer and involving only misrepresentation.

Recent decisions in these cases show that where an insurer has been able to develop, through discovery, the full nature of the fraud at issue, Courts have permitted insurers to retain premiums, either as an offset against damages incurred by the insurer or to prevent the return of the premium investment to a defrauding party.

The United States Court of Appeals for the Sixth Circuit—the highest court to address the disposition of premiums following the rescission of fraudulently procured life insurance policies—recently held that a defrauded insurer can offset commissions paid and expenses incurred from the premiums paid by a defrauding party. *See Wuliger v. Mfr. Life Ins. Co*., 567 F.3d 787 (6th Cir. 2009). The court in *Wuliger* noted the absurdity of Defendant's position:

> [a rule that] an insured who commits fraud may announce the fraud and receive a refund on any premiums paid to date — would have the perverse effect of reducing the defrauder's risk relative to the honest policyholders; any defrauder could commit to paying premiums knowing that if the premiums ever became unaffordable, he could simply declare his fraud and receive all of the previously paid premiums back.

Id. at 797. Indeed, one could easily imagine a set of economic circumstances whereby a STOLI promoter strapped for cash by a sudden economic downturn would be better off admitting fraud and receiving a refund of premiums paid rather than continuing to try to meet an ongoing premium obligation.

In the same vein as *Wuliger*, on August 27, 2009, the Superior Court for the State of California for the County of San Diego issued its Statement of Decision with Findings of Fact and Conclusions of Law in *The Lincoln Life and Annuity Co. of New York v. Jack Teren and Jonathan S. Berck, as Trustee of the Jack Teren Ins. Trust,* No. 37-2008-83905-CU-CO-CTL (*Mar. 20, 2006)* ("*Teren*"). Addressing facts of clear and unequivocal fraud, the Court found that the Teren Trust and Trustee were not entitled to a refund of premiums paid on the life insurance policies owned by the Trust, even though the *Teren* Court found that Lincoln Life was entitled to rescission. The *Teren* Court determined that a return of premium was not required based, among other reasons, upon the doctrine of unclean hands, the court's power to adjust the equities, and the court's ultimate interest in preventing a wrongdoer from taking advantage of his own wrong. *See* Ex. 1, at p. 6–7.

Most recently, on March 3, 2010, Phoenix obtained a judgment in a case dealing with virtually identical facts to this case. Chief Judge Michael J. Davis of the United States District Court for the District of Minnesota issued a Memorandum Opinion and Order permitting Phoenix to offset premiums returned against damages it had suffered. *See* Memorandum Opinion and Order, *PHL Variable Ins. Co. v. Lucille E. Morello 2007 Irrevocable Trust*; No. 08-cv-00572 (D. Minn. Mar. 3, 2010).

In November 2007, the Lucille E. Morello 2007 Irrevocable Trust (the "Morello Trust") submitted a claim to Phoenix, seeking payment of $10,000,000 in death benefits. *Id.* at p. 8. After Phoenix's contestability investigation did not substantiate the financial representations made in the application — that Ms. Morello had a net worth of $34 million and income in excess of $800,000 annually — Phoenix filed suit, seeking to rescind the policy while also seeking to offset premiums paid by the Trust against the damages Phoenix had suffered, including commissions paid to insurance producers and its attorney's fees. *Id.* at pp. 9–10. After discovery revealed the expansive nature of the fraud, the Morello Trust agreed to policy rescission and retention of premiums by Phoenix. *See* Ex. 2, p. 9–10. Premium financier New

Stream Insurance, LLC, intervened, seeking to preclude Phoenix from rescinding the policy without fully refunding premiums. *Id.*, p. 1. After extensive briefing and argument by the parties, the Court issued a Memorandum Opinion and Order, ruling in Phoenix's favor on all issues and holding that Phoenix would be permitted to retain premiums paid on the policy as a partial offset against the damages it had suffered, including commissions and its attorneys' fees expended in seeking policy rescission. *Id.* at pp. 14–15.

Morello is significant, because it squarely rejects the time-tested notion that premium return automatically accompanies policy rescission. STOLI promoters built into their business models a heads I win, tails you lose proposition. If they avoid being discovered they received a sizable death benefit upon the insureds death; if discovered, they get their money back. *Morello*, and to a lesser extent *Teren* and *Wuliger*, place STOLI promoters on notice that courts may not be so willing to validate this business model.

V. Conclusion

The spirit of life insurance is the protection against unforeseeable risk. The insurance industry is faced with developing gray market graft in the form of STOLI, which disrupts the natural economics of the industry and installs a new set of economics based on investor profit rather than family protection. Private investors are thus capitalizing on the dissipation of insurance opportunities from the public at large. STOLI policies are rife with fraud and misrepresentations and are issued without the existence of a true insurable interest. This is not in accordance with the policy preferences of our society and must properly be addressed by the courts and legislatures.

Insurers wishing to proceed with legal action against STOLI promoters have several options available to them, and the general common law concerning insurable interest is much more favorable to challenging STOLI transfers than it was to preventing life-settlement transfers. The particular case law surrounding insurable interest requirements in individual states would need to be further examined before the likelihood of success within a particular jurisdiction could be assessed. Additionally, insurers have fought individualized battles against fraud by both agents and insureds and have seen capital funded grafting take place in the life settlement and viatical markets. However, in the STOLI context, all of these prior problems have combined in a way that is very disturbing to both the insurance industry and to insurance consumers at large. Insurers need to be vigilant and proactive in combating the STOLI gray market.