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The Life Settlement Industry Tests State Insurable Interest Rules

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Abstract: *As world financial markets become more interdependent, the demand for uncorrelated investments continues to increase. Institutional investors and sophisticated individual investors are searching for investment returns that are not linked to bonds, equities, or commodities. In the late 1990s investment bankers and hedge fund investment managers turned to the secondary market for life insurance to create such an investment class—life settlement-backed securities. The demand for the new securities had been so great, prior to the financial crisis that began last fall, that syndicators and promoters required amounts of life insurance on older-age individuals that exceeded the supply available through normal functioning of the secondary market. The unprecedented demand for life policies on older-aged individuals produced life insurance applications and arrangements that tested the boundaries of state insurable interest laws. This article will explain the tension between life settlement-backed securities and state insurable interest laws. The article also will overview regulatory developments that should assuage this tension.*

The once obscure concept of “insurable interest” has been garnering much attention from insurance regulators, state legislators, insurance companies, insurance agents, investment bankers, hedge fund managers, and the courts. The increased interest in the concept stems from the emergence and dramatic growth of a secondary market for individual life insurance policies. This article will discuss the insurable interest rule in the context of a controversial byproduct of this rapidly growing market—investor-owned life insurance, also known as stranger-owned life insurance (STOLI). In order to understand the role that the insurable interest rule plays with regard to investor-owned life insurance and investor-influenced life insurance,[1] it is necessary to first consider the secondary market itself.

The secondary market for life insurance originated with the viatical settlement market, a market that was spawned by the AIDS crisis of the 1980s.[2] Back then groups of investors bought life insurance policies from AIDS patients who needed up-front cash to pay for medical care or for basic living expenses. In the early and mid-1980s, a diagnosis of AIDS meant that the patient’s life expectancy was no more than two years. At the time, most medical experts were forecasting that the medical community would not be able to rein in AIDS any time soon.[3] Viatical settlements turned out to be a financial disaster for investors as the pharmaceutical industry discovered drug regimens to keep the condition at bay.[4]

Today the secondary market is dominated by “life settlements” which, by number of transactions and dollar amounts involved, dwarf viatical settlements, an area that has expanded beyond AIDs to include any terminal illness. The experts forecast that the number of life settlement transactions will continue to increase at a rapid rate as baby boomers enter their retirement years.[5] The expectation is that some baby boomers may decide that once their children are grown and educated and their mortgages are paid, they no longer need as much life insurance coverage. Other baby boomers who have been maintaining coverage to protect their spouses may decide to drop the coverage if the spouse passes first. Still other baby boomers whose net worths have been diminished by the recent financial crisis may decide that they have other, more pressing, concerns than possible estate tax exposure. The financial crisis has been so severe that many have come to refer to their 401(k) accounts as 201(k)s. Aging baby boomers in this circumstance may opt to sell their life insurance policies in the secondary market as a source of supplemental retirement income.

There is also a demand aspect of the growing life settlement market. This demand interest in life settlements comes from the “uncorrelated” nature of life settlement-backed securities. An uncorrelated asset is one with a financial return that is not tied to what is happening in a particular market or in the economy at large. Death rates, which determine the rate of return on life settlement bonds, are independent of whether the S&P 500 is rising or falling, whether the interest rate yield curve is normal or inverted, or whether the price per barrel of oil is testing new highs or new lows. The globalization of financial markets has made it more difficult for investors to identify uncorrelated asset classes.

The market for life settlement-backed securities has, in turn, created a considerable demand for large face amount life insurance policies on individuals ages 70 and older. In general, life expectancy norms and standard deviations of the same for individuals younger than age 70 (65 for some programs) are too long and unpredictable to work under the financial models used by investment bankers and hedge fund managers in pricing and syndicating these securities. The demand for large life insurance policies on older-aged individuals, along with the promise of a significant lifetime cash return for such an insured, has created an atmosphere conducive to fraud. Greed has prompted some insurance agents and insurance applicants to overstate the applicants’ net worths and incomes. Greed has also operated to cause some agents and insurance applicants to conceal or omit adverse medical history and maladies from insurance applications.

Insurable Interest—A Brief History

The requirement that an insurable interest be present at the time of application applies to all forms of insurance. In the context of life insurance, the term “insurable interest” means: (a) in the case of persons closely related by blood or by law, a substantial interest engendered by love and affection, and (b) in the case of other persons, a lawful substantial economic interest in the continued life, health, or bodily safety of the person insured, as distinguished from an interest that would arise only by, or be enhanced and valued by, the death, disablement, or injury of the insured.[6]

The idea that an insurance application be supported by an insurable interest is rooted in England’s common law and has been part of the legal fabric of the United States for over a century.[7] For example, in 1876 the U.S. Supreme Court was called upon to consider the insurable interest rule in the context of a husband and wife who divorced years after they had acquired a joint life policy—a first-to-die policy. The estate of the deceased husband claimed the proceeds as did the deceased’s ex-wife, the coinsured. In ruling for the ex-wife the court concluded, “We do not hesitate to say, however, that a policy taken out in good faith, and valid at its inception, is not avoided by the cessation of the insurable interest….”[8] In this case the divorce had extinguished the insurable interest of the coinsured.

In 1911, the Supreme Court considered the insurable interest rule from another perspective.[9] Chief Justice Holmes stated the opinion in a case involving an insured who needed surgery and who was lacking the necessary funds. The patient sold his life policy to his surgeon for $100. The court first observed that a contract of insurance upon a life where there is no interest is a wager and as such, is void. However, the court agreed that this situation was different in that the holder of a valid policy upon his own life should be permitted to transfer the policy to someone whom he is not afraid to trust.

Today it is a well-established principle of state insurance law that an insurable interest must be present at policy inception. Case law in some states provides that any policy issued without the requisite insurable interest is void.[10] In general, a contract that is void will not be enforced by the courts. The laws of many states provide by statute that proceeds from a policy under which insurable interest is lacking are payable to the estate of the insured.[11] State law insurable interest requirements do not, however, impact the right of a policyowner to name whomever he/she may choose as beneficiary.[12] Moreover, insurable interest requirements do not directly impact the right of the policyowner to assign his/her policy to whomever he/she chooses.[13]

The law of contracts also allows for the idea that contracts can be voidable under some circumstances. There is an important distinction between a contract that is void and one that is voidable. Briefly, a contract that would not have been effected but for a material representation by one of the parties is voidable so long as the innocent party asserts his/her rights within a reasonable time after discovering the falsehood. Much of the recent case law on insurable interest also involves misrepresentations in life applications. In considering this case law, it is important to understand when a court is talking about a policy being void versus a policy being voidable.

Recent Case Law

Case law from the federal courts and from the various states reveals that courts have, on occasion, been called upon to consider the insurable interest rule. Prior to the spate of cases that center on corporate-owned life insurance as a corporate financing device, the few reported decisions reflected isolated circumstances that did not impact insurance or investment communities at large. In contrast, recent federal litigation involving state insurable interest law requirements has the potential to involve hundreds of millions of dollars. This litigation, which will be reviewed in this article, is likely a precursor to more litigation that will involve a number of insurers, insurance agents, hedge funds, investment bankers, pension funds, and other sophisticated investors.

The New York Case: A Death Claim

The *Life Product Clearing LLC (LPC) v. Linda Angel*[14] lawsuit involves a $10 million life insurance policy issued on the life of Leon Lobel, a retired butcher. On January 22, 2008, the U.S. District Court, Southern District of New York, ruled on a motion on the pleadings filed by the plaintiff, LPC. Briefly, LPC contended that the material facts were undisputed and they were entitled to a judgment in their favor, as a matter of law.

LPC pointed to §3205(b)(1) of the New York insurance law as authority to support its position that it was entitled to summary judgment, at least vis-à-vis the competing claim of Angel, the representative of the Lobel estate. Section 3205(b)(1) provides as follows:

> Any person of lawful age may on his own initiative procure or effect a contract of insurance upon his own person for the benefit of any person, firm, association or corporation. *Nothing herein shall be deemed to prohibit the immediate transfer of a contract so procured or affected.* (emphasis added)
>
> In construing the statute the Court stated:
>
> Only one who obtains a life insurance policy on himself on his own initiative and in good faith—that is with a genuine intent to obtain insurance protection for a family member, loved one, or business partner, rather than an intent to disguise what would otherwise be a gambling transaction by a stranger on his life—may freely assign the policy to one who does not have an insurable interest in him.[15]

The facts of the case as pleaded by Angel support the conclusion that even though an individual has an unlimited insurable interest in his/her life, a person cannot obtain a life insurance policy at the behest of investors, even if the insured or his/her trust is the nominal policyowner.

The court reviewed allegations of Angel that supported the idea that the Lobel life policy was not a valid policy. In this regard, the court observed that allegedly the insurance agent involved had presented life insurance to Lobel as a financial opportunity whereby he could receive an immediate and substantial cash payment by taking out a policy on himself for the benefit of an investor. The court noted the allegation that the proposal contemplated that neither Lobel nor his family would ever own the policy or have a beneficial interest in it, nor would Lobel have a realistic option to retain the policy for his own use. The court also observed that, according to Angel, Lobel would never pay any premium himself, nor would he receive financing from the investor to pay premium.

The court's recital regarding premiums indicates that perhaps if Lobel had received premium financing and if Lobel had a realistic option to retain the policy for his own use by paying the debt, then the life policy involved would have been valid under New York law. This question is important to many premium finance lenders, insurance companies, hedge funds, and other sophisticated investors. The ultimate outcome of this type of financial-insurance transaction will be decided in the courts.

Note that Lincoln Life, the company that issued the Lobel policy, is not a party to the LPC lawsuit. The lawsuit involves competing claims of LPC and the estate of Leon Lobel as to the insurance proceeds that Lincoln Life had paid to Linda Angel, as executrix. Could Lincoln have denied all claims to the proceeds, arguing that the policy was void for lack of insurable interest? It appears that New York law recognizes, in some circumstances, the idea that no proceeds are payable under a life policy issued without the requisite insurable interest. In one of the cases cited with approval by the Lobel court, a federal district court from New York appeared to be favorably disposed to the idea that a policy issued without the requisite insurable interest would be void[16] The court in the earlier case did not, however, cancel the policy in question, because in its view the plaintiff (insurance company) did not offer any evidence in support of its argument that the assignee of the policy had been involved with the application for the policy.

It is possible that if Lincoln Life had asserted that the Lobel policy was void for want of the requisite insurable

interest, the court would have ruled in its favor. In the alternative, the facts pleaded by Angel suggest that the Lobel policy may have been voidable because of misrepresentations in the application. In this regard, a footnote to the summary judgment decision observes that although Angel's counterclaim does not explicitly allege that Lobel could not afford a $10 million life insurance policy, the estate implied the same and would be willing to amend motion papers to add these allegations. Such allegations hint at the idea that there may have been financial misrepresentation in the Lobel application. Of course, neither LPC nor Angel would collect any proceeds if Lincoln had established that there had been a financial misrepresentation in the Lobel application and that it should not be charged with knowledge of the misrepresentation.

The Minnesota Case: What about the Contestability Clause?

In *Sun Life Insurance Co. of Canada v. Paulsen, et al.,*[17] Sun Life asked the U.S. District Court for the District of Minnesota to declare that a certain life insurance policy that had been issued on the life of John Paulsen was void. Sun Life claimed that the policy, which had been issued more than two years prior to the date Sun commenced litigation, violated Minnesota's insurable interest statute. The time frame is important because state law requires that life insurance policies include a standard provision—the incontestable clause—that precludes insurance companies from asserting, after two years from issue, that the policy is voidable because of material misrepresentation made in the application for the policy. The codefendants asked that the court dismiss Sun's lawsuit on the grounds that Sun's attempt to rescind the policy was barred by the incontestable clause. It is noteworthy that the Sun Life case does not involve a death claim.

The Sun Life court cited an earlier Minnesota court decision for its determination that under Minnesota law, a life insurance policy is void as against public policy if the policy was procured under a scheme, purpose, or agreement to transfer or assign the policy to a person without an insurable interest in order to evade the law against wagering contracts.

The court's ruling stands for the proposition that an insurer can avoid obligations under a life insurance policy, even after the contestable period has expired, if the insured can establish lack of insurable interest. The court ruled that in order to prevail, the carrier would have to prove that the insured intended to sell the policy and *that a particular third party intended to purchase the policy.*

> The court, in criticizing Sun Life's complaint, stated:
>
> Paulsen's intent, however, is irrelevant without facts or allegations suggesting that a third party lacking an insurable interest intended, at the time Paulsen procured the 360 policy, to acquire the policy upon expiration of the contestability period.[18]

Sun Life, in response to the court's decision to grant the codefendant's (Coventry) motion to dismiss, asked the court for permission to amend its pleading to state facts in support of its argument that there was a preconceived agreement surrounding the Paulsen policy. On February 15, 2008, the court denied Sun Life's motion to amend its complaint. Sun Life attempted another tack. Specifically, Sun Life asked the federal court to submit the following question to the Minnesota Supreme Court: "Does Minnesota law require evidence of an agreement between insured/policyholder and an entity lacking an insurable interest at the time the life insurance policy is procured in order to establish that a policy is void *ab initio* for lack of an insurable interest?" Late last year the federal court denied Sun Life's request, thereby putting the *Sun Life v. Paulsen* case to rest.

The Ohio Case: Premium Refunds

Wuliger v. Manufacturers Life Insurance Company[19] is another lawsuit that provides insight as to the scope of the insurable interest requirement and its implications. *Wuliger* shows us another side of the insurable interest requirement. In this case, the bankruptcy court-appointed receiver for Capital Fund Leasing (CFL) and Viatical Escrow Services, LLC (VES) asked the U.S. District Court for the Northern District of Ohio to declare that the three insurance policies that had been acquired by CFL and VES were void. The receiver asked the court to order Manufacturers Life to refund all premiums paid under the three policies. Manufacturers resisted the receiver's claim, arguing that the lack of insurable interest is a legal principle that can only be used by an insurer to defeat a claim under a life insurance policy. Manufacturers also argued that even if lack of insurable interest could, in some circumstances, be asserted by a policy-owner as basis for a premium refund claim, such a claim must fail here. In support of this argument, Manufacturer's Life pointed out that agents of the entities under receivership had perpetrated a fraud on Manufacturers incident to acquiring the three policies.

The court acknowledged the general principle that the law does not allow a remedy to someone "who has been

guilty of unlawful conduct, in the matter with relation to which he seeks relief."[20] The court somehow distinguished the status of the receiver from that of a claimant seeking redress in his/her own right. The court observed that the receivership was not functioning to benefit the perpetrators of alleged frauds but rather the creditors of entities whom the perpetrators had represented.

Aspects of the decision are confusing. In reviewing the history of the receivership, the court recites that the receiver was appointed based upon the following conclusions of law:

1. There is an imminent danger that the funds managed by CFL for the benefit of the investors, Liberte and Alpha, will be lost, concealed, or diminished in value to the detriment of the plaintiff, the intervening plaintiff, and the investors in viatical contracts.
2. The investors, Alpha and Liberte have no adequate remedy at law.
3. The interests of Liberte and Alpha will be served by the appointment of a receiver.[21]

It is noteworthy that here the focus was on the interest of the investors.

Later in the decision the court justifies its rejection of Manufacturer's claim that the investors should not benefit from fraudulent conduct that is directly related to the acquisition of assets (the policy) that supported their investments. The district court would have allowed the receiver to avoid this seemingly equitable defense on the basis that the receiver was acting to protect the interest of creditors of the defunct entities.

The court in the *Wuliger v. Manufacturers Life Insurance Co.* summary judgment decision pointed out that the subject case is one of many related lawsuits created by a viatical insurance debacle initiated in the *Liberte v. Capwell*[22] lawsuit. Notwithstanding the complexity of the lawsuits, the facts and circumstances of the *Wuliger* case did not seem to support the court's decision to allow the premium refund claim. Manufacturer's Life appealed the district court ruling.

On May 28, the Sixth Circuit Court of Appeals reversed the district court's ruling and sided with Manufacturer's Life.[23] In doing so, the court of appeals noted that to accept "the receiver's proposed rule—that an insured who commits insurance fraud may announce the fraud and receive a refund on any premiums paid to date—would have the perverse effect of reversing the defrauders' risk relative to honest policyholders; any defrauder could commit to paying premiums on his fraudulently procured policy knowing that if the premiums ever became unaffordable, he could declare his fraud and receive all of the previously paid premiums back."[24]

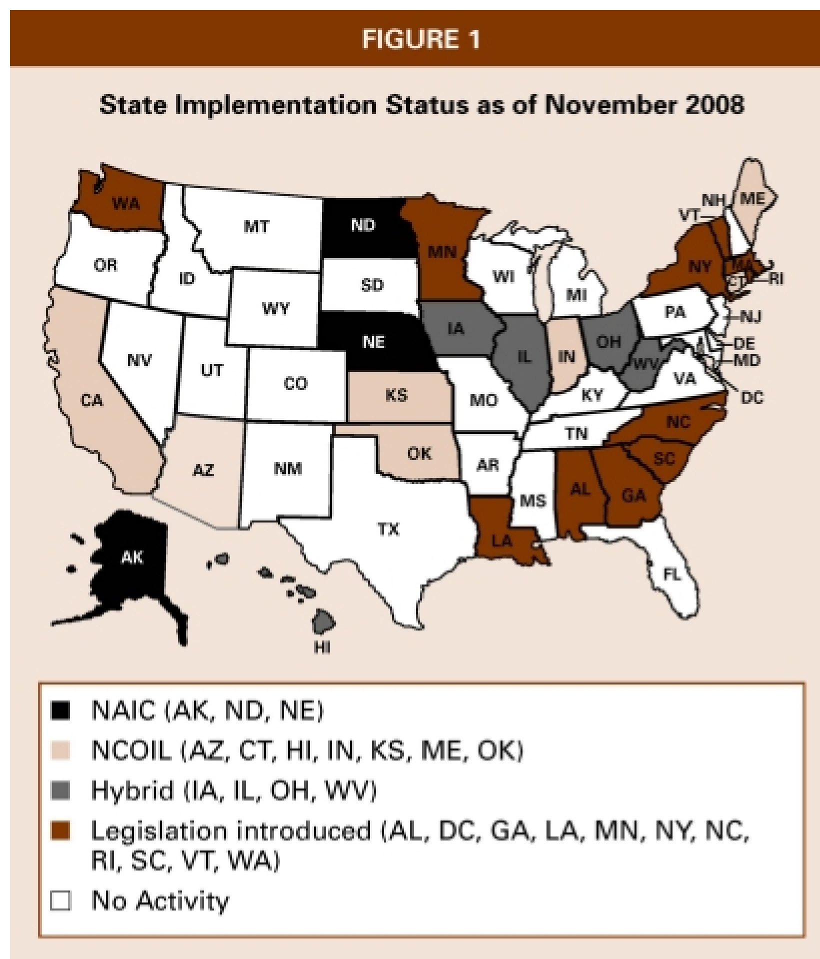
This economic perspective makes it clear that, absent peculiar circumstances, premium refund claims will not be available in any STOLI arrangement that violates state insurable interest rules.

New Rules

State insurance regulators and lawmakers began looking at STOLI in late 2006. The National Association of Insurance Commissioners (NAIC) voted in April to amend its viatical settlements model to address aspects of STOLI.[25] The National Conference of Insurance Legislatures (NCOIL) approved revisions to its life insurance settlements model act in November 2007.[26] The NAIC's amendments to the Viatical Settlements Model Act[27] target the most prevalent form of STOLI—transactions involving a policy settlement. The model prohibits policy transfers within five years of issue, but it includes broad exceptions. This five-year restriction will block most STOLI schemes, and it will significantly reduce the incentive for abusive transactions. At the same time, the broad exceptions protect the rights of good faith policyowners.

NCOIL's Life Settlements Model Act addresses all forms of STOLI by, among other things, defining and prohibiting premium finance companies from having a stake in the death benefits of the policies they finance. The new regulations and laws will also increase the penalties associated with certain fraudulent acts. A key factor here is that some such acts will now be classified as criminal fraud, which means that a transgressor cannot escape sanction by the simple expedient of bankruptcy. In contrast, one who is liable to another for having committed a commercial wrong can avoid civil liability by declaring bankruptcy. As a practical matter, a debtor would consider this option only if the liability amount exceeded his/her net worth.

Figure 1 indicates which states have enacted legislation (NAIC, NCOIL, or a hybrid of the two), which states are considering legislation, and which have yet to act. These new regulations and laws requiring disclo-sure to consumers, the licensing of settlement brokers, reporting by funders, and restrictions on premium financing companies will improve the reputation of the life settlement business. They will assuage concerns of investors. Investors will have a degree of confidence that the life settlement securities transactions will be respected by regulators and upheld by courts.



Conclusion

The court cases discussed here will undoubtedly prompt more litigation involving life insurance companies, policyowners, estates of deceased insureds, life settlement brokers, settlement funders, and holders of life settlement-backed securities. While this litigation may temporarily destabilize the life settlement business, the increase in supply of policies associated with the aging of the baby boomer generation and the increase in demand for uncorrelated assets will fuel stability and growth in the settlement business. Insurance department directives, new insurance regulations, and legislation directed toward excesses in the life insurance settlement industry will reduce the opportunities for fraud and eliminate schemes designed to avoid insurable interest requirements, thereby adding stability to the life settlement business. The move to regulate the life settlement business and the transactions themselves can only benefit the settlement business in the long run.

The emergence of life settlements in general has proven to be a positive development for individuals who have owned life insurance for many years and whose needs have changed to the point where the life insurance is no longer needed or suitable. Insurance agents are benefiting in two ways. First, life settlements are complex transactions. Most individuals looking to settle a policy will need the assistance of a knowledgeable insurance agent. Second, as more and more individuals become aware of the existence of the life settlement market, it becomes easier for them to say “yes” to a new life insurance proposal. Informed individuals are coming to appreciate that a life insurance contract has the potential to provide more benefits than just protection for survivors.

Insurance companies will also benefit from a significant increase in demand for life insurance as prospective purchasers come to see life insurance as an asset— something more than a protection product.

APPENDIX
Secondary Market Timeline
1980 to 1985
• First AIDS case identified in U.S.
1986 to 1990
• Federal Drug Administration approves AZT, the first drug to show promise in keeping HIV in check.
• Living Benefits, Inc. of Albuquerque, NM, purchases life insurance policy from terminally ill AIDS patient.
• Insurance companies introduced accelerated death benefit riders.
1991 to 1995
• Viaticus, a subsidiary of CNA Financial, enters market.
• The Viatical Association of America (VAA) is founded as a nonprofit trade association.
1996 to 2000
• U.S. Court of Appeals (4th Circ.) rules that life settlements are not securities (*SEC v Life Partners*).
• National Conference of Insurance Legislators (NCOIL) adopted Life Settlements Model Act.
• U.S. Tax Code amended to make viatical settlements and accelerated death benefits tax-free.
• VAA changes its name to the Viatical and Life Settlement Association of America (VLSAA), to reflect the emerging life settlement market.
2001 to 2005
• VLSAA changes its names to The Life Insurance Settlements Association of America (LISA).
• NAIC adopted Viatical Model Settlements Act.
• NCOIL reviews its Life Settlements Model Act.
• U.S. Court of Appeals (11th Circ.) ruled that life settlements are securities (*SEC v Mutual Benefits*).
2006 to 2008
• (March 2006) Financial Accounting Standards Board (FASB) issues FASB Staff Position to Bulletin 85-4 allowing investors to account for life insurance at fair market value or under an investment method.
• Investment banks create Institutional Life Markets Association (ILMA), a trade group focusing on industry best practices for life settlements.
• (2006) New York State Attorney General's office brings fraud suit against Coventry, a leading life settlement funder.
• NAIC revises its Viatical Settlement Model Act to address STOLI.
• NCOIL revives its Life Settlement Model Act to address STOLI.

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(1) The term "investor-influenced life insurance" can be used to describe life insurance purchased by someone who is aware of the secondary market but whose primary motivation in acquiring the insurance is to accomplish personal estate planning objectives. This insurance purchaser is intrigued by the idea that someday he/she may have an opportunity to sell the policy in the secondary market.

(2) Jessica Maria Perez, "You Can Bet Your Life on It; Regulating Senior Settlements to Be a Financial Alternative for the Elderly," *Elder Law Journal* 10 (2002): 425, 427.

(3) *Ibid.*

(4) Miriam R. Albert, "The Future of Death Futures: Why Viatical Settlements Must Be Classified as Securities," *Pace Law Review* 19 (1999): 345, 354.

(5) M. Goldstein, "Profiting from Mortality," BusinessWeek (July 30, 2007); Suneet Kamath and Timothy Sledge, Timothy, "Life Insurance Long View—Life Settlements Need Not Be Unsettling," *Bernstein Research Call* (March 4, 2005).

(6) N.Y. Ins Law §3205 (e)(1). States with insurable interest statutes identical or similar to the New York statute are: Alabama, Alaska, Arizona, Arkansas, Delaware, Georgia, Hawaii, Idaho, Kentucky, Louisiana, Maine, Maryland, Mississippi, Montana, Nevada, New Jersey, New Mexico, Oklahoma, Pennsylvania, South Dakota, Utah, Vermont, Virginia, Washington, West Virginia and Wyoming.

(7) Bertram Harnett & Irving J. Lesnick, *The Law of Life and Health Insurance* (Volume 1), §2.01(1) (LEXISNEXIS).

(8) *Connecticut Mutual Life Insurance Association v Schoeter,* 94 U.S. 457, 460 (1876).

(9) *Grigsby v Russell,* 222 U.S. 149, 156 (1911).

(10) See *Beard v. American Agency Life Ins. Co.* 314 M 235, 550 A.2d 677 (1988); *First Colony Life Ins. Co. v. Sanford,* 480 F.Supp.2d 870 (S.D. Miss. 2007).

(11)Supra note 8 at §2.02 (1).

(12) Supra note 8 at §2.04 (1)(b).

(13) Supra note 8 at §2.01 (6)(c).

(14) 530 F Supp. 2d 646 (S.D.N.Y. 2008).

(15) *Ibid.* at 661.

(16) *Travelers Ins. Co. v. Reiziz et. al.,* 13 F. Supp. 819 (E.D.N.Y. 1935).

(17) 2008 U.S. Dist. LEXIS 11719 (D. Minn. Feb 15, 2008).

(18) *Ibid.* at 7.

(19) 2008 U.S. Dist. (LEXIS 9809) (N.D. Oh 2008).

(20) *Ibid.* at 5.

(21) *Ibid.* at 3

(22) 229 F. Supp. 2d 799 (N.D. Ohio 2002).

(23) No. 08-3342 (6th Cir., May 28, 2009).

(24) *Ibid.*, p. 13.

(25) “NAIC Adopts Viatical Settlements Model Act Revision,” NAIC press release (June 4, 2007).

(26) “NCOIL Closes in on Illegal STOLI, Unanimously Adopts Amended Model Act,” NCOIL press release (Nov. 20, 2007).

(27) “NAIC Adopts Viatical Settlements Model Act Revision,” NAIC press release (June 4, 2007).