FEDERATION OF REGULATORY COUNSEL, INC.

WHAT WAS HE THINKING AND WHEN DID HE THINK IT?

A Report and Comment on STOLI in Florida and Elsewhere

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The issues regarding Stranger Owned/Originated Life Insurance, referred to throughout this article as STOLI, are myriad according to the regulators of various states, including my own, Florida. What is it? Who are its victims? How are those victims harmed by it? How should the states regulate it? Is it regulated already?

In an effort to address the relevant issues, the Florida Office of Insurance Regulation convened a public hearing on August 28, 2008, to take testimony and gather information regarding STOLI. On February 5, 2009, Florida Insurance Commissioner Kevin M. McCarty released his report entitled "Stranger-Originated Life Insurance ('STOLI') and the Use of Fraudulent Activity to Circumvent the Intent of Florida's Insurable Interest Law," referred to herein as the Florida Report. (A copy of the complete report can be downloaded at: http://www.floir.com/stoli.aspx). What follows is a report on the Florida Report and commentary on the struggle to reconcile the irreconcilable conflict at the center of any STOLI analysis. Every regulator and court contemplating a STOLI program is required to try to balance the competing interests in insurance as an asset and the public policy against wagering contracts. Yet, the two will not balance.

The starting point for an analysis of STOLI, including that set forth within the Florida Report, is a discussion of insurable interest. The Florida Report describes the historically based reason for insurable interest laws, which is that gamblers in old England were permitted to wager on the anticipated dates of death of the seriously ill among them.[1] The British Parliament, in 1774, put an end to the use of such contracts by passing a law that any life insurance contract held by a person without an insurable interest in the life of the insured would henceforth be null and void.[2] Legislatures and courts since then have endeavored to establish that an interest in the continued life of the insured by the beneficiary of the life insurance is a necessary component to the issuance of a policy. The core of the public policy, codified in statutory and common law, is that if someone stands to benefit from your death, you are in danger of that someone. Inasmuch, the law seeks to protect you by requiring that only those who stand to benefit from your continued life are beneficiaries of your life insurance. The ancient public policy which underpins the entire insurable interest analysis, however, does not comport with modern reality. The use of public policy within legal analysis, as described below, is supposed to provide the "why" for a statute or a court holding, but there is no modern day evidentiary support for the theory that people who invest in strangers' life insurance policies are encouraged to kill the insured strangers.

Indeed, the statutory and common laws of most states recognize that life insurance is an asset of the insured, and the insured is free to transfer that asset. Many state laws, such as Florida's, conform to the holdings of cases such as *Grigsby v. Russell*, that an assignment is not automatically condemned when the assignee lacks an insurable interest, so long as there is no prior agreement to assign.[3] It is that last clause, "so long as there is no prior agreement to assign," that cannot be reconciled with the language of the laws of many states. Florida's insurable interest law, for instance, was amended in 2008 to clarify that, "The insurable interest [necessary for the validity of a life insurance policy] need not exist after the inception date of coverage under the contract."[4] The problem, therefore, is if an insurance policy can be transferred to one without an insurable

interest in the insured at any time "after the inception date" of the policy, then how can courts invalidate a transferred policy because an insured was contemplating what the law allows him freely to do?

Courts, historically and today, base their holdings invalidating insurance transferred to strangers on the public policy against wagering contracts, noted above, opining that an insured who plans to transfer his policy will circumvent the public policy against having a stranger benefit from his death. The near universal focus of the judiciary on this topic is the "intent" of the insured when he obtained the policy. It's an easy "out" for courts considering STOLI to declare a policy invalid when the insured intended its transfer to one without an insurable interest, because the court is protecting the insured from a stranger's wager on his death. More than several courts have recently been called upon to examine a challenged STOLI transaction. The three cases discussed below are only a sample. Yet, in this context, a sample is enough, because the courts' analyses are mostly consistent.

The Minnesota District Court, in *Sun Life Assurance Company of Canada v. Paulson*, held that when ascertaining whether or not a STOLI transaction is an unlawful "scheme," the courts must look at the mutual intent of the parties to the transaction, the insured and the assignee.[5] In the event it can be established that both parties intended for the original purchase of the policy to be a part of a plan to assign the policy thereafter, then the policy will be considered void *ab initio*. The case of *Life Product Clearing, LLC v. Angel*, in New York is similar in conclusion.[6] The court there indicated that enough facts were alleged to show that the insured purchased the policy with the prior intent to transfer the policy to a person without an insurable interest. The New York court defined its purpose as having to assess whether a policy was procured with a view to its immediate assignment in order to determine whether the transaction is merely to secure a wagering policy for a stranger. And, here in Florida, *AXA Equitable Life Insurance Company v. Infinity Financial Group, LLC*, identified sufficient facts to establish a "scheme" to perpetuate a wagering policy in violation of Florida statutory and long established insurable interest case law.[7] While the AXA case is short on analysis, it clearly indicates that, although assignments to persons without insurable interest is legal in Florida, this rule extends only to assignments made in good faith and not as a cover for sham assignments made to circumvent the public policy against wagering contracts.

Each of the three courts discussed above is focused on the intent of the insured at the time of the policy application/inception. The "intent" test seeks to ascertain the mindset of the applicant at the time the policy is purchased and declares it unacceptable for the insured to think of a policy transfer then, but it therefore acknowledges that the same mindset at another time is acceptable. And, since the law expressly allows for such transfers, should the insured's thought as to transfer be the polestar for determining whether a transfer is valid or not?

Without exception, those testifying at the Florida STOLI hearing recognized, and some even praised, "legitimate" life settlements, those in which an insured holding a life insurance policy he no longer needed, could no longer afford or no longer wanted, transfers the policy to a stranger. The legitimacy of such life settlements is established by a conclusion that the insured did not plan to transfer the policy when he obtained it. But, statutory law, specifically in Florida, allows an insured to transfer the policy at any time after he obtains it. So, why are the legitimate transfers only those that the insured was not planning on? If the answer is to keep the insurance out of the hands of a malevolent stranger who might harm the insured, the answer is fallacious, because in the event of a "legitimate" and not pre-planned life settlement, the policy ends up in the hands of a stranger just as it does when the insured planned it that way from the start.

It does not seem that the concept of "don't think of transferring your life insurance policy to a stranger at the outset, because you might put yourself in danger," can be reconciled with "you can transfer your policy anytime after you buy it." Not only do those concepts fail reconciliation because the "danger" is simply not a reality today, but also, since the market for transferring policies exists, we cannot forbid a potential insured from thinking of it or planning to use it.

While the Florida Report does not address the dilemma discussed above per se, Commissioner McCarty smartly focused in the Florida Report on the "real" dangers to consumers. There are certainly competing views on whether the issues raised within the Florida Report are actual dangers to consumers; however, there is no dispute that consumers contemplating STOLI transactions must be made aware of these items, so they transact their business from a place of information, rather than naiveté. The Florida Report identified four harms that could befall a consumer within a STOLI transaction: capacity to purchase insurance, tax liability, non-tax liability and increasing insurance premiums.[8]

The issue of "capacity" has been festering under the surface of the STOLI marketplace, but has only recently begun to be widely discussed by commentators and regulators. An insured's capacity to purchase life insurance has traditionally been based on an insured's net worth. Insurers carefully review the financial statements of a potential insured when issuing a large face value policy. The capacity analysis does not take into consideration who owns or who will benefit from the life insurance in force on a particular consumer, just the amount of insurance in force. Thus, when a consumer buys a policy and transfers it to another, that policy still counts against the insured's capacity and may result in the insured's inability to protect his own estate in favor of benefitting a stranger. Agents licensed in Florida are broadly obligated to explain the products they sell to potential insureds or risk being disciplined by the regulators.[9]

The Florida Report states that "the incentives used by STOLI promoters to induce seniors to apply for life insurance policies and the STOLI transaction may create an unexpected tax liability for seniors."[10] The key word, however, in that sentence appears to be "may," because, as of today, the proceeds from life insurance policies remain non-taxable.[11] Issues were raised by some who testified at the Florida STOLI hearing about whether the non-recourse premium finance components to some STOLI programs trigger tax consequences, but no definitive answers are provided within the Florida Report.[12]

The Florida Report touched briefly on the potential non-tax liability to seniors involved in STOLI transactions that are unwound by courts declaring the subject insurance policies void.[13]

Finally, the Florida Report identified what many proponents of STOLI programs deem the most spurious argument against STOLI, which is the ultimate increase in life insurance premiums. Interestingly, what was addressed only briefly in the testimony at the Florida STOLI hearing was the argument advanced by many life insurers about lapse pricing: more policies in force to death benefit, result in higher premiums for everyone. The lapse pricing argument was advanced repeatedly during the NAIC Life Insurance A Committee hearings, but it has receded to the background in more recent discussions of STOLI. Noteworthy is that the Florida Report's treatment of increasing life insurance rates refers to lapse pricing for support.[14] The Florida Report also quotes one of the hearing witnesses, who suggested that STOLI transactions reduce the availability of life insurance for people over age 70.[15] There was, however, testimony at the hearing that STOLI programs actually increase life insurance sales.[16] This is likely, because people view the products as their own alienable assets, rather than just traditional protection for their loved ones.

The ultimate question for Florida consumers, companies, agents and STOLI promoters is: "What will Florida do now?" Considering the body of established anti-STOLI case law and the provisions of the Insurance Code which get at the alleged evils of STOLI transactions, such as misrepresentation and "free insurance," the Florida regulators could rely on what's currently available to them. Pressure was applied on the national level for states to adopt either the NAIC Viatical Settlements Model Act or the NCOIL Life Settlements Model Act. Some, but not many, states have adopted one model or the other. During the 2009 Florida legislative session, two STOLI bills were introduced which proposed sweeping revisions to the treatment of STOLI in Florida, Senate Bills 1882 and 1924, but they were not passed. The concept and treatment of STOLI will continue to evolve and provide fodder for legislatures, courts and commentators for years to come.

Endnotes

1. Stranger-Oriented Life Insurance ("STOLI") and the Use of Fraudulent Activity to Circumvent the Intent of Florida's Insurance Interest Law; Report of Commissioner, Kevin M. McCarty, Florida Office of Insurance Regulation; January 2009; p. 6.

2. *Id*.

3. *Id*. at 9.

4. *Id*. at 10.

5. *Sun Life Assurance Company of Canada v. Paulson*, No. 07-CIV-3877, D.Minn. 2008 WESTLAW 451054 (D.Minn., February 15, 2008) and 2008 WESTLAW 5120953 (D.Minn., December 3, 2008).

6. *Life Product Clearing LLC v. Angel*, 530 F.Supp.2d 646 (S.D.N.Y., January 22, 2008).

7. *AXA Equitable Life Insurance Company v. Infinity Financial Group, LLC, et. al*., No. 08-80611-CIV-HURLEY, 08-80611-CIV-HOPKINS, 2008 S. Dist. Fla. 2009 WESTLAW 931011 (S.D.Fla., March 31, 2009) at page 24.

8. Stranger-Oriented Life Insurance ("STOLI") and the Use of Fraudulent Activity to Circumvent the Intent of Florida's Insurance Interest Law; Report of Commissioner, Kevin M. McCarty, Florida Office of Insurance Regulation; January 2009; pp. 17-22.

9. *Id*. at 25.

10. *Id*. at 18.

11. *Id*. at 19.

12. *Id*.

13. *Id*. at 20.

14. *Id*. at 22.

15. *Id*. at 21.

16. *Id*. at 22.