



# STOLI:

## *The Problem and the Appropriate State Response*



AALU, NAIFA, and ACLI believe that stranger-originated life insurance (“STOLI”) represents a threat to both consumers and the life insurance industry. The intended purpose of life insurance is to protect the financial futures of families and businesses, not to make strangers money. This is a story that state legislators across the country should understand. We also believe there is an appropriate state by state legislative response to this problem. This primer addresses three important topics:

- Part I. Why is STOLI a problem?**
- Part II. What is the most effective state by state response?**
- Part III. What are the myths being spread by those who would like to see STOLI continue?**

## Part I: Why is STOLI a Problem?

To understand why STOLI is a problem, one needs to address some key questions. They are as follows:

### **QUESTION: What is stranger-originated life insurance (“STOLI”)?**

**ANSWER:** STOLI is a contrived transaction designed to evade state insurable interest and other laws and allow investors to use life insurance to profit from the deaths of people they don’t know. In STOLI schemes, investors entice seniors to take out policies, with the intent to transfer most of the benefit to those investors who then profit when they die. The sooner the policyholder dies, the greater the investor’s profit. In effect, STOLI promotes wagering on human life. Also, STOLI threatens to expose consumers to unexpected taxes, loss of privacy, and inability to obtain needed life insurance in the future.



### **How does STOLI work?**

- Investors, such as hedge funds, induce senior citizens to purchase life insurance. The seniors purchase the policies in their own names but agree to an arrangement where the investors, after a period of time (usually the expiration of a two-year contestability period), get beneficial ownership of the policy.
- The seniors receive some financial inducement for this: be it an upfront payment, a portion of the profit when policies are sold or a small continuing interest in the death benefit.
- Investors often agree to finance the premiums with a loan that does not require repayment, but instead transfer of the policy.
- The investors typically profit by collecting the death benefits after the seniors die. The sooner the seniors die, the higher the profit.

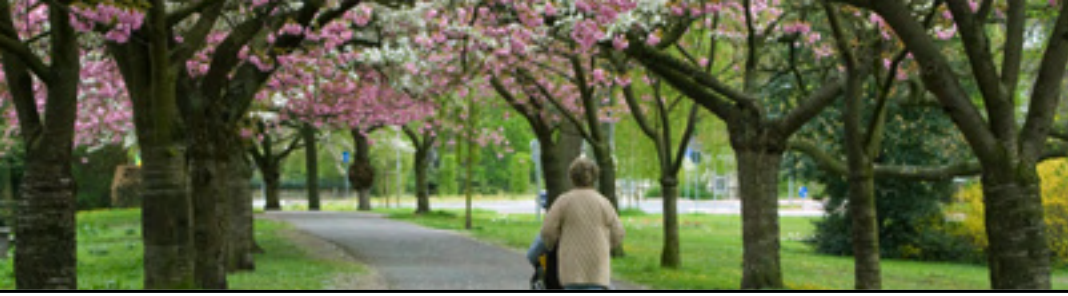


## What are the risks to consumers?

- Senior citizens participating in these arrangements may not be aware that the income, including the cost of insurance coverage during the “free period,” is generally taxable and they may receive substantially less compensation than expected.
- The seniors may not be aware that the life insurance policies may be far more valuable to them as estate protection rather than as a scheme for making a quick buck.
- The prevalence of STOLI may even increase costs of legitimate policies, since companies have to devote significant resources to detect these schemes, which both increases the cost and time that it takes to issue policies to legitimate purchasers.
- Seniors participating in STOLI may use up their insurance capacity and be unable to purchase life insurance in the future for estate planning and other legitimate needs.
- Through these transactions, seniors will be giving permission for someone to “check periodically” if they are still alive.
- Seniors need to be aware that any misstatements or lies on the application, including those questions completed by an agent that they acknowledge with their signature, could have adverse consequences. This includes the voiding of the insurance contract. Indeed, there are also many legal issues associated with STOLI. For example, STOLI applicants who mislead insurance companies on the policy applications could face legal liability or the risks of litigation.

## Wagering on human life

- Life insurance is designed to help families and businesses cope financially following the unexpected death of a loved one, a business owner, or a key employee. Beneficiaries should have an interest in the insureds’ continued lives, not their early demise. With STOLI schemes, investors are betting that the early demise of an insured will lead to a profitable payday.
- Our nation decided long ago to prohibit wagering on human life, which is exactly what STOLI represents.



## What is wrong with STOLI?

STOLI violates the essential social purpose of life insurance, which is protection. Life insurance protects families from the unexpected death of a breadwinner; or businesses from the financial consequences of the death of an owner or key employee. Life insurance is not meant to be used as a vehicle for financial speculation on human life. The essential social purpose of life insurance is enshrined in state insurable interest laws and numerous rulings by the United States Supreme Court. STOLI undermines the integrity of life insurance and flouts the public policy concerns voiced by state legislatures and the Supreme Court.

## What is the difference between life settlements and STOLI?

The crucial factor is whether all the rules were followed from the start, including the existence of an insurable interest at the time the policy is issued. In a life settlement, the policy was purchased for its intended use—to protect family members or a small business from the risk of a premature death. But after the policy is purchased, something changes in the life of the policy owner which leads him or her to decide that the policy is no longer needed. This could be the death of the intended beneficiary, divorce or the need for immediate cash due to illness or other loss. In such cases, the policy owner may decide to sell the policy to a third party. The life insurance industry does not support the enactment of laws that prevent transactions where the policy was acquired in good faith.

But in STOLI transactions, the life insurance policies are not acquired in good faith. The parties intend at the outset that the investors, who have no insurable interest in the insured, receive the death benefit, directly or indirectly, depending on how the deal is structured. These transactions violate public policy interests and can be summed up in concerns expressed by the United States Supreme Court as far back as 1876 that life insurance should not be used as a vehicle for wagering on human life. "Any person has a right to procure an insurance on his own life and assign it to another, provided it be not done by way of cover for a wager policy." *Connecticut Mutual Life v. Schaefer*, 94 U.S. 457 (1876).

## How are consumers hurt by STOLI transactions?

Consumers participating in STOLI deals face many potential pitfalls. First, they may not be aware that the income from STOLI transactions is generally taxable and that numerous legal fees and other expenses must be paid before the deal is complete. Thus, consumers may receive substantially less than they expect.

In addition, consumers may not be aware that life insurance may be far more valuable to them as estate protection rather than as an immediate income gimmick. Indeed, consumers participating in STOLI may use up their insurance capacity and be unable to purchase life insurance in the future for estate planning and other legitimate needs.

There are also many legal issues associated with STOLI. For example, STOLI applicants who mislead insurance companies on the policy applications could face the risks of litigation and potential legal liability to insurers, settlement companies, lenders or investors.

## How is the insurance industry harmed by STOLI?

Life insurance and annuity products, by their nature, establish a long-term relationship between insurance companies and their policyholders. We have already seen though, that when a STOLI scandal erupts, it is the life insurance industry's reputation that unfairly takes the hit. And so it is the established life insurance industry that suffers the potential loss of reputation while being stuck with cleaning up the STOLI mess. The life insurance industry wants to be proactive and enact laws to address STOLI before consumers are harmed and our reputations sullied. Companies also have to devote significant resources to detect these schemes, which both increases the cost and time that it takes to issue policies to legitimate purchasers.

## Part II. The Most Effective State by State Response to STOLI

AALU, NAIFA, and ACLI strongly support enactment of legislation to address the abuses occurring in the marketplace today from stranger-originated life insurance (“STOLI”). We believe the best legislation can be achieved by combining provisions from the NAIC Viatical Settlements Model Act with provisions from the NCOIL Life Settlements Model Act. The best way to accomplish this is to use the provisions and format of the NAIC Model Act as the basis for the legislation.

### The NAIC model contains the following key features:

- A limited 5-year settlement prohibition targeting transactions with characteristics of STOLI such as non-recourse financing, settlement guarantees, and life expectancy evaluations. (NAIC Model § 11A)
- Protection of consumer property rights by permitting settlements at any time for cause such as death of spouse; divorce; disability; bankruptcy; loss of job; or chronic or terminal illness. It allows settlements after two years when customers purchase policies with their own funds. It would not apply to consumers who want to sell their policies due to a change in life circumstances, such as illness, divorce or the death of the beneficiary. (NAIC Model § 11A)
- Expanded consumer right to rescind a settlement contract to 60 days. (NAIC Model § 10C)
- Settlement reporting requirements to enable regulators to identify and stop STOLI transactions. (NAIC Model § 6A)
- Prohibition of advertising representing that insurance is “free” or “no cost”. (NAIC Model §§ 12D and 13E)
- Disclosure to insurers of any plan to originate, renew or finance a policy prior to or within 5 years of policy issue. (NAIC Model § 9)
- Elimination of the “accredited investor” exemption from the definition of “viator”, which would otherwise allow transactions involving policy owners with \$1 million or more in net worth to completely escape regulation and engage in “wet ink” STOLI transactions. (NAIC Model § 2T)
- A comprehensive definition of “life settlement contract” which includes policy transfers regardless of when they occur if they include indicia of STOLI, and transfers which do not fall within a legitimate settlement exception, such as non-recourse financing arrangements, debt forgiveness, or settlement guarantees. (NAIC Model § 2N)

### AALU, NAIFA, and ACLI recommend inclusion provisions from the NCOIL Model Act, including:

- The broad definition of STOLI to address trust and premium finance STOLI arrangements
- The prohibition of engaging in STOLI transactions
- Reporting and penalty provisions





## Part III. Myths and Facts: Stranger-Originated Life Insurance



State legislators have an unprecedented opportunity to take a leading role in protecting consumers from a growing national abuse that threatens to undermine the social purpose of life insurance. This abuse, called stranger-originated life insurance (“STOLI”), uses life insurance as a vehicle for wagering on human life.

STOLI promoters have been spreading misinformation about this issue, particularly the NAIC’s proposal. It is vital that legislators have the complete picture.



**MYTH: NAIC’s proposal would prevent all consumers from selling their life insurance policies for five years.**

**FACT:** The five-year settlement moratorium is strictly limited and would only apply to STOLI transactions. For example, the moratorium would not apply to consumers who purchased their policies with their own funds. It would not apply to consumers who want to sell their policies due to a change in life circumstances, such as illness, divorce or the death of the beneficiary. Suggestions that the NAIC model imposes a blanket five-year moratorium are false.



**MYTH: NAIC’s proposal unconstitutionally interferes with the property rights of life insurance policy owners.**

**FACT:** The property rights of policy owners are fully protected. The real issue is not property rights, but the authority of state legislators to regulate commercial transactions. Just as legislators, through zoning laws, can limit the use of real property to single-family dwellings as opposed to commercial development, legislators can limit the sale of life insurance policies obtained as STOLI. Every United States Supreme Court decision that has dealt with this issue has clearly recognized the right of legislators to address the public policy concerns that arise from using life insurance as a vehicle for wagering on human life.



**MYTH: The life insurance industry is trying to derail the secondary market for life insurance policies.**

**FACT:** Many life insurance companies are themselves participating in the secondary market. These companies believe that the secondary market offers them another opportunity to serve their customers.

Yet, every life insurance company that participates in the secondary market supports the NAIC model and the five-year moratorium. Why? Because they recognize that STOLI threatens to undermine the very purpose of life insurance, which is protection. In fact, the NAIC model protects their investment in the secondary market by targeting only abusive STOLI transactions.

**MYTH: Life insurance companies are using STOLI as a stalking horse to undermine all life settlements because they profit from high lapse rates.**

**FACT:** This complaint is a red herring. According to LIMRA International, the lapse rate for the types of policies most likely to be settled is only 10 percent. STOLI has nothing to do with lapses. STOLI is about investors purchasing life insurance policies that were taken out in bad faith. The NAIC model is targeted to these bad faith transactions.

Life insurance is meant to protect individuals and businesses that stand to suffer economic loss following the untimely death of a family member, business owner or key employee. STOLI turns that purpose on its head. STOLI promoters profit from the death of the insured. Combining the best features of the NAIC and NCOIL models will reduce the incentive for STOLI while fully protecting the rights of legitimate policy owners.





Founded in 1957, the Association for Advanced Life Underwriting (AALU) is a professional trade association representing 2,000 life and health insurance agents and financial advisors nationwide. Most members are engaged in complex uses of life insurance such as in business continuation planning, estate planning, charitable planning, retirement planning, deferred compensation and employee benefit planning. The mission of AALU is to promote, preserve and protect advanced life insurance planning for the benefit of its members, their clients, the industry and the general public. AALU's website can be accessed at [www.aalu.org](http://www.aalu.org).

101 Constitution Avenue, NW  
Suite 703 East  
Washington, D.C. 20001  
(888) 275-0092 Toll-free



Founded in 1890 as the National Association of Life Underwriters, the National Association of Insurance and Financial Advisors (NAIFA) is comprised of 700 state and local associations representing the business interests of 225,000 members and their employees nationwide. Members focus their practices on one or more of the following: life insurance and annuities, health insurance and employee benefits, multiline, and financial advising and investments. NAIFA's mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its members. NAIFA's website can be accessed at [www.naifa.org](http://www.naifa.org).

2901 Telestar Court  
Falls Church, VA 22042  
(877) TO-NAIFA



The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association whose 353 member companies account for 93 percent of the life insurance industry's total assets in the United States, 93 percent of life insurance premiums and 94 percent of annuity considerations. In addition to life insurance and annuities, ACLI member companies offer pensions, including 401(k)s, long-term care insurance, disability income insurance and other retirement and financial protection products, as well as reinsurance. ACLI's public website can be accessed at [www.acli.com](http://www.acli.com).

101 Constitution Avenue, NW  
Washington, DC 20001-2133  
(202) 624-2000