

The Distinction Between Legitimate Life Settlements & STOLI Goes Back More Than 130 Years.

For more than 130 years, the United States Supreme Court has said clearly and repeatedly that life insurance policies purchased for the sole purpose of speculating on human life represent a violation of the public policy considerations behind state insurable interest laws. The high court has also said that once a policy is acquired for valid reasons, the owner has every right to sell it to a third party. *Connecticut Mutual Life v. Schaefer*, 94 U.S. 457 (1876)

“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)

In the *Schaefer* case, a life insurance policy was issued on July 25, 1868 on the joint lives of a married couple, George F. and Franzisca Schaefer. The policy was payable to the survivor on the death of either. The Schaeferes were divorced in January, 1870. About one year later, George died, and Franzisca tried to collect the death benefit. The Supreme Court addressed the question of whether Franzisca’s insurable interest in the policy ended upon the divorce. (continued on page 2)

WHERE WE STAND

Life insurance serves many critical social functions. Most important, it protects and provides tremendous benefits to individuals, families, businesses and employees. The increasing use of life insurance by speculators promoting Stranger-Originated Life Insurance (STOLI)—who attempt to circumvent insurable interest laws by initiating policies with the intent to settle the policy — is a clear abuse of life insurance’s social purpose.

Insurable interest is a fundamental concept in a well-functioning life insurance marketplace. The concept preserves the social purpose of life insurance and helps to assure that the product will not be abused. Insurable interest statutes demonstrate the widespread belief among the nation’s lawmakers that society is diminished when life insurance is used as a vehicle for gambling on human life. Stranger-originated life insurance violates the concept of insurable interest. Changes to state viatical settlement laws, which deal with life and viatical settlement issues, are necessary to prevent STOLI promoters from evading state insurable interest laws and violating the social purpose of life insurance.

The life insurance community recognizes that many circumstances may lead the owner of a life insurance policy to explore a life insurance settlement. We have always supported—and will continue to support—legitimate life settlements. The life insurance community also supports the National Association of Insurance Commissioners (NAIC) Life Insurance and Annuities (A) Committee’s proposed amendments to the Viatical Settlements Model Act that will deter STOLI without harming the interests of policy owners who acquired their coverage legitimately.

Life insurers urge the NAIC Executive Committee and Plenary to adopt the amendments. The amendments are self-executing, meaning that they will address STOLI without imposing any major new enforcement burdens on state insurance departments. Life insurers will spare no effort to promote passage of the amendments in every state legislature in the nation.

(continued from page 1)

The court said that the key is whether the policy was obtained in good faith and whether an insurable interest existed at the time the contract was signed.

The court noted that generally, “any reasonable expectation of pecuniary benefit or advantage from the continued life of another creates an insurable interest in such life.” The court emphasized that “an interest of some sort in the insured life must exist.”

“The essential thing is that the policy shall be obtained in good faith, and not for the purpose of speculating upon the hazard of a life in which the insured has no interest.”

Connecticut Mutual Life v. Schaefer, 94 U.S. 457 (1876)

“It is generally agreed that mere wager policies—that is, policies in which the insured party has no interest in the matter insured, but only an interest in its loss or destruction—are void as against public policy,” the court added.

Subsequently, in the case of *Warnock v. Davis, 104 U.S. 775 (1881)*, the court applied this distinction between legitimate life insurance policies and wager policies by ruling that an arrangement in which a group of investors agreed to finance the purchase of a life insurance policy in exchange for receiving the lion’s share of the death benefit violated the public policy against wager policies and was invalid.

A married man named Henry Crosser entered into a contract with a group of investors called the Scioto Trust Association. Under the agreement, Crosser would purchase a large life insurance policy while Scioto would pay the premiums and any other fees. Crosser would have no liability to repay Scioto.

The agreement called for Scioto to keep 90 percent of the death benefit, with the remaining 10 percent going to Crosser’s widow. Following Crosser’s death, the administrator of his estate sued Scioto for its 90 percent share of the death

benefit. The Supreme Court held that Scioto had no insurable interest in Crosser’s life and thus no legal right to the policy proceeds beyond the premiums it paid.

The Supreme Court said it is not easy to define what will, in all cases, constitute an insurable interest. However, the court said, there must be “such an interest, arising from the relations of the party obtaining the insurance, either as creditor or surety for the assured, or from the ties of blood or marriage to him, as will justify a reasonable expectation of advantage for benefit from the continuance of his life.”

It did not matter to the court that Crosser’s widow received a portion of the death benefit. The main point was that at the inception of the policy, Scioto’s interest was in the death, rather than the life, of the insured.

The distinction between stranger-originated life insurance and legitimate life insurance settlements remains a fixture in American jurisprudence to this very day. Just recently, nationally-renowned legal scholar Judge Richard Posner cited the *Schaefer* case in a unanimous 7th Circuit Court of Appeals ruling rejecting the attempt of a corporate party to benefit from an insurance policy on the life of a stranger. *Travelers Casualty & Surety v. Northwestern Mutual Life, 7th Circuit Court of Appeals Docket No. 05-4134 (March 13, 2007)*.

But now, some STOLI advocates are trying to blur that long-standing distinction. Their goal is to falsely imply that carefully-crafted efforts to deter STOLI, such as the amendments to the Viatical Settlements Model Act recently approved by the National Association of Insurance Commissioners Life Insurance and Annuities (A) Committee, would prevent owners of properly-acquired policies from settling them.

In fact, the NAIC proposal fully protects the right of policy owners who acquired their policies in compliance with the letter and spirit of state insurable interest laws to settle if and when they no longer need or want their coverage.

A five-year moratorium on life settlements that applies only to those policies acquired in violation of the spirit and intent of insurable interest statutes will help eliminate the financial incentive for STOLI transactions and prevent wrongdoers from skirting the law.

March 2007

April 2007

TIMELINE

COURTS

Broker Mark Ross files a lawsuit against a premium finance agency charging that it created a deceptive program that defrauded seniors out of hundreds of millions of dollars in life insurance protection. The premium financing agency obtained a preliminary injunction against Ross,

claiming his lawsuit was intended to devalue its portfolio of premium finance loans.

NAIC

The National Association of Insurance Commissioners Life Insurance and Annuities (A) Committee unanimously approves proposed amendments to the Viatical Settlements Model Act which, in part, addresses stranger-originated life insurance (STOLI). The amendments will be put before the full NAIC for consideration in June.

SEC COMPLAINT AGAINST STOLI

SEC Complaint Highlights Danger of STOLI Transactions

A complaint filed by the Securities and Exchange Commission (SEC) against an “investment” fund and two of its principals highlights the potential danger to consumers, investors and insurance companies from STOLI transactions.

In the case of *SEC v. Lydia Capital, LLC, et al.*, (1:07-cv-10712-RGS; *United States District Court for the District of Massachusetts*), the SEC charges that the defendants engaged in an “ongoing fraudulent investment scheme” that included soliciting senior citizens to make false representations on life insurance policy applications.

According to the SEC’s complaint, the defendants presented themselves as legitimate participants in the life insurance settlement market who purchase existing life insurance policies on people age 65 and older with a life expectancy of between two and 10 years. But contrary to these statements, the SEC charges, the defendants solicited individual seniors to purchase life insurance policies by obtaining a medical underwriter’s evaluation of the life expectancy of those senior citizens prior to the application.

On approximately half the applications, the SEC alleges, the individuals falsely claimed that they had no intention to sell their policies, when, in fact, they obtained the policies intending to sell them to the defendants’ agents.

Life insurance companies have a right to rescind insurance policies based on false representations in the applications, the SEC notes. Rescission, the SEC adds, would render the policies nearly worthless and diminish or obliterate the value of the “investment” fund.

The defendants, SEC said, “knew of this material risk because they set into motion the process whereby individuals would obtain the policies by making false statements and then the defendants took possession of the policies and fraudulent applications upon the fund’s purchase of the policies from the individuals.”

A Private Placement Memorandum (PPM) developed by Lydia Capital to solicit investors was misleading in that it failed to disclose this significant risk, the SEC alleges. In addition, the SEC says, the PPM failed to disclose that the value of the fund is dependent on numerous insurance policies that have been obtained through false statements. The defendants, the SEC charges, used the fraudulent PPM to solicit investors for the fund.

If the allegations are proven, the SEC will have taken one step towards deterring STOLI abuse. But as a practical matter, it is impossible for regulators—whether state or federal—to monitor every life insurance transaction to assure it is valid and in full compliance with state insurable interest statutes and that the policy owners have answered all questions on the policy application honestly.

One solution is for states to follow the lead of North Dakota and enact legislation patterned on the amendments to the National Association of Insurance Commissioners’ Model Viatical Settlements Act. (see *Focus on STOLI*, page 4.)

NCOIL

The National Conference of Insurance Legislators meets in Washington, DC, to continue drafting revisions to its Life Settlements Model Act. Further discussion is scheduled for NCOIL’s July meeting in Seattle.

STATES

- **Idaho** Insurance Department issues Bulletin 07-03 stating that STOLI violates state insurable interest law, similar to bulletins issued by New York, Utah and Louisiana.
- **North Dakota** becomes the first state to enact legislation based on the proposed revisions to the NAIC Viatical Settlements Model Act.

COURTS

- Securities and Exchange Commission and State of Massachusetts file actions against Lydia Capital Ltd. charging that the defendants defrauded investors by failing to disclose material risks associated with a STOLI scheme.
- United States Court of Appeals for the 4th Circuit affirms the authority of states to regulate viatical settlements. The ruling clarifies many aspects of the relationship of settlements to insurers and acknowledges state interest in preventing settlement fraud against insurance companies.

FOCUS ON STOLI

Legislators, Regulators Examine STOLI

Stranger-originated life insurance is a high priority among state regulators and legislators.

The National Association of Insurance Commissioners (NAIC) is developing a model law aimed at deterring a practice that nearly all policymakers agree could threaten the life insurance marketplace for senior citizens. For examples of the risks to senior citizens, see the article entitled "The High Price of Free Insurance" in the April 23, 2007, issue of *Business Week* (http://www.businessweek.com/magazine/content/07_17/b4031103.htm?chan=search). See summary of the article on page five of this issue of *STOLI Alert*. Meanwhile, the state legislature of North Dakota and the Idaho Insurance Department have advanced measures to combat STOLI.

"In STOLI arrangements, the value of human life essentially is reduced to a commodity that is auctioned off in the futures market to the highest bidder. That's not what life insurance is all about."

*Frank Keating
ACLI President and CEO*

In mid-April, North Dakota became the first state to protect consumers against STOLI transactions when Governor John Hoeven signed into law S.B. 2268, legislation patterned after the NAIC proposal calling for a five-year settlement moratorium relating to STOLI arrangements.

The American Council of Life Insurers (ACLI) and the National Association of Insurance and Financial Advisors (NAIFA) praised Gov. Hoeven, Sen. Jerry Klein, Rep. Jim Kasper and Insurance Commissioner Jim Poolman for their leadership on this vital consumer protection initiative.

According to ACLI President and CEO Frank Keating: "In STOLI arrangements, the value of human life essentially is reduced to a commodity that is auctioned off in the futures market to the highest bidder. That's not what life insurance is all about."

"There is no good public policy reason to turn a product designed to provide long-term financial security for families and businesses into a way for speculators to make a quick buck."

*David F. Woods
NAIFA Chief Executive Officer*

NAIFA CEO David F. Woods added, "Life insurance is designed to be long-term protection for families and businesses, and Congress provides incentives to keep the product for the long term. There is no good public policy reason to turn a product designed to provide long-term financial security for families and businesses into a way for speculators to make a quick buck."

In Idaho, Insurance Director William W. Deal issued a Compliance Bulletin in early April reinforcing the state's insurable interest law. Bulletin No. 07-03 notes that Idaho law requires a life insurance policy owner to have a "lawful and substantial economic interest" in having the life of the insured continue, as opposed to an interest that would be enhanced by the insured's death.

STOLI transactions are structured so as to evade this insurable interest requirement when a policy is issued. Bulletin No. 07-03 says that the insurance department will try to identify abusive transactions by reviewing the entirety of an agreement to determine whether the underlying intent is to circumvent the law.

May 2007

STATES:

- **Georgia** Department of Insurance issues a directive regarding "zero premium" life insurance solicitations; announces investigation to determine if this marketing program violates Georgia laws or regulations. The department cautions producers to refrain from participating in such marketing programs until the results of

the investigation are completed.

- **Florida** Office of Insurance Regulation issues Notice and Order to Show Cause to Coventry First, a viatical settlement company, alleging violations of the Florida Insurance Code and fraudulent or dishonest practices. Allegations include payments to

brokers to suppress competitive bids, payments to brokers not involved with a specific transaction and payments to a broker to encourage a different broker not to seek a competitive bid.

- **Massachusetts** Secretary of State charges broker Joseph Gennaco with fraudulently selling insurance-related

investment schemes that targeted the elderly. In one of the alleged schemes, Gennaco sold seniors life insurance policies with two years' free premiums and a cash "kicker." Gennaco would broker a loan to the senior secured by the policy. The loan would be used to finance the premiums for the first two years. However, the loans

PITFALLS OF STOLI

BusinessWeek Article Exposes Pitfalls of STOLI

Unanticipated tax liabilities. High legal fees. Increased life insurance premiums for senior citizens. Inability to obtain needed life insurance in the future.

Those are just a few of the potential pitfalls awaiting senior citizens who are approached to purchase stranger-originated life insurance, according to an article in the April 23, 2007, issue of *Business Week* (http://www.businessweek.com/magazine/content/07_17/b4031103.htm?chan=search).

Entitled "The High Price of Free Insurance," the article by Anne Tergesen examines the unseen risks to consumers of STOLI. While STOLI is often touted as offering "free insurance," "free money" and "no risk," the article reveals some unsettling truths.

In particular, the article addresses what it calls the "thorny tax issues" related to STOLI. The article notes that because the tax code doesn't specifically address STOLI transactions, the rules aren't always clear. For example, the article says, senior citizens who receive cash, cars or other sign-up bonuses must pay income tax on the value of those "goodies." In addition, those who sell their policies are required to pay tax on the gains.

Moreover, there may even be a tax liability if the sale price of a policy falls short of the loan that financed it, the article says. Indeed, although a senior can satisfy a loan by turning the policy over to the lender, the IRS could levy income tax on at least some of the amount of the debt that is forgiven.

In addition, the article says, the senior might also have to pay tax on the two years of "free" insurance he or she received. In such a situation, the senior may end up sustaining a loss, even though the STOLI transaction was presented to the senior as risk-free. (*continued on page 7*)

Gov. Keating praised Commissioner Deal not only for issuing Bulletin 07-03, but also for announcing his intent to pursue model legislation aimed at eliminating the economic incentives for STOLI transactions while protecting the right of policy owners to settle their contracts legitimately.

Gov. Keating noted that while the bulletin will help protect consumers from abusive transactions, as a practical matter, it is impossible for the Idaho department to review every life insurance contract to assure compliance. Legislation focused on reducing or eliminating the economic incentives for STOLI is the best way to resolve this expanding concern.

The NAIC Executive Committee and Plenary Committee will consider such legislation at its Summer National Meeting in San Francisco. Revised amendments to the Viatical Settlements Model Act were approved unanimously by the Life Insurance and Annuities (A) Committee on April 2, 2007.

The amendments address three vital concerns. First, they uphold state regulation of the settlement market. Second, they establish important consumer protections for policy owners pursuing a settlement. Third, they reduce the economic incentives for STOLI by mandating a five-year moratorium on the settlement of policies likely to be purchased for sale in the secondary market. The five-year moratorium assures that policy applicants lacking an insurable interest—including those misrepresenting their own interest in obtaining a policy not for insurance but as an investment—will not get a "free pass." The moratorium is narrowly-crafted so as not to adversely impact legitimate life insurance and life settlements.

The National Conference of Insurance Legislators is also examining STOLI. NCOIL is working separately on its own model legislation and in April conducted an all-day drafting session where different groups presented their views on specific provisions. That effort that will continue at NCOIL's upcoming meeting in Seattle, scheduled for July 19-22.

carried interest of more than 100 percent over two years, and when the senior was unable to pay, the lender could take over the policy.

COURTS

- Ritchie Capital Management, an alternative asset management firm, files suit against Coventry First, a settlement company, seeking \$2 billion in damages under the Racketeer Influenced and Corrupt Organizations Act. Ritchie charged that Coventry First "participated in numerous racketeering activities and

fraud, such as bid-rigging and concealing both unlawful conduct and an investigation by the Attorney General of New York."

- Two former managers of Mutual Benefits, a settlement company sentenced to five years in federal prison and ordered to pay \$826 million in restitution to some 30,000 investors

allegedly defrauded by the company. Authorities alleged the firm used misleading life expectancies in determining when an insured would die. When the insured outlived their life expectancies, authorities said the firm used money from new investors to pay premiums on those insurance policies.

RIGHT OF STATES TO REGULATE STOLI

Federal Appellate Court Upholds Right of States to Regulate STOLI

Insurance companies could become targets of fraud unless states take strong steps to end stranger-originated life insurance. The United States Court of Appeals for the Fourth Circuit issued a ruling on April 30, 2007, that acknowledges the potential for fraud in the viatical settlements market, concerns that apply just as strongly to STOLI. And the court reasserted the right of states to regulate these transactions.

The court ruled that life insurance settlements constitute the “business of insurance” as defined by the United States Supreme Court in a series of cases interpreting the McCarran-Ferguson Act. The McCarran-Ferguson Act—which was enacted into law in 1945—assigns regulation of the “business of insurance” to the states and provides a limited antitrust exemption to the business of insurance to the extent the states exercise their regulatory authority.

Moreover, the court said, states have a legitimate interest in regulating these transactions, in part because of the risk that insurance companies will be victims of fraud perpetrated by potential insureds who seek to hide their health conditions and purchase policies in order to sell them to settlement companies.

In the case of *Life Partners v. Morrison* (Docket No. 06-1370), the 4th Circuit upheld the validity of the Virginia Viatical Settlements Act, which is based on the National Association of Insurance Commissioners’ model act, in a dispute involving a life insurance settlement.

(ACLI and NAIFA acknowledge the right of policyholders who acquired their policies in compliance with the letter and spirit of state insurable interest laws to sell their policies in the secondary market. We cite the Life Partners case not to challenge life settlements but to emphasize the regulatory authority of the states. A life settlement is an integral part of a STOLI transaction. Therefore, the 4th Circuit’s opinion upholding the right of states to regulate life settlements applies to STOLI.)

Facts of the Case

The *Life Partners* case involved a terminally ill policy owner, identified as “Jane Doe,” who sought a viatical settlement of her \$115,000 life insurance policy. Doe, a Virginia resident, hired a settlement broker, who contacted Life Partners, a Texas-based settlement company that does business nationally. After some negotiations, Doe accepted Life Partners’ offer of \$29,000 for the policy.

However, Doe subsequently contacted Life Partners and demanded more money based on the Virginia Viatical Settlements Act. The Act mandates that settlement

companies pay specified percentages of the policy’s face value, depending on the life expectancy of the seller. Doe said that under the Act, she should have received at least \$69,000.

Life Partners rejected Doe’s demand and offered to rescind the transaction. Doe refused and filed a complaint with the Virginia Bureau of Insurance. Life Partners challenged the authority of the Bureau and Virginia law enforcement officials to conduct an investigation of its action. Life Partners argued that the Virginia law placed an undue burden on interstate commerce and should be preempted under the Commerce Clause of the United States Constitution.

The State of Virginia replied that it has an important and legitimate interest in regulating life insurance settlements and that Congress delegated that authority to the states under the McCarran-Ferguson Act.

Fourth Circuit Cites Risk of Fraud

A United States District Court upheld the Virginia law and the 4th Circuit affirmed. In doing so, the 4th Circuit noted the need for regulation of the viatical settlement business.

“The power imbalance between the viator and the provider creates a substantial potential for abuse. The viator is usually in a weakened physical condition, often facing imminent death, often in financial hardship due to medical and healthcare costs, and often ignorant of industry practices. The provider, on the other hand, has extensive resources, is usually backed by investors and is armed with sophisticated industry knowledge,” the court said.

“In addition, the life insurance industry began to face new risks, including the risk of fraud, as potential insureds sought to hide their illnesses in order to obtain policies and thereafter to sell them to viatical settlement providers,” the court added (emphasis added).

In holding that states have the right to regulate life settlements under the McCarran-Ferguson Act, the 4th Circuit noted that the subject of every viatical settlement is a life insurance policy.

“At its essence, a viatical settlement is a transaction that fractures the two-part insurance contract between the insurer and the insured and create a new tripartite arrangement (albeit not a three-party agreement) among the insurer, insured and the insured’s assignee—the viatical settlement provider,” the court said. “Because of this new tripartite arrangement, each party has, with respect to the preexisting insurance contract, new or different obligations and benefits.”

The 4th Circuit added that states have vital interests at stake regarding settlements. **“Not only are the parties to insurance contracts affected by viatical settlements,**

PITFALLS OF STOLI

(continued from page 5)

Meanwhile, the article notes, insurance companies are being forced to respond to STOLI as best they can. The article quotes one insurance company as raising its rates on life insurance policies sold to individuals over age 70 because of the actuarial implications of STOLI. Other insurance companies have initiated legal action against seniors who falsely stated on policy applications that they did not intend to resell their policies.

“So much for the free life insurance pitch,” the article concludes.

but the state too has interests, especially in ensuring (1) that its residents not be subjected to unscrupulous conduct by the viatical settlement providers who might defraud, harass, or abuse insureds in the state and (2) that its residents not defraud insurance companies in an effort to realize a quick financial return by entering into insurance contracts while hiding the fact that they will soon, within a determinable time, die,” the court said (emphasis added).

The court noted that under United States Supreme Court precedents, the term “business of insurance,” as used in the McCarran-Ferguson Act, applies to the relationship between the insurance company and the policyholder. The 4th Circuit said that given the impact a settlement has on that relationship, it has “little difficulty” in concluding that the Virginia Viatical Settlements Act relates to the regulation of the business of insurance and does not violate the Commerce Clause of the U.S. Constitution.

STOLI Alert is published by the American Council of Life Insurers and the National Association of Insurance and Financial Advisors.

Readers are encouraged to copy and share the information contained in *STOLI Alert*.

For further information about *STOLI Alert* and the issue of stranger-originated life insurance, please contact us.

American Council of Life Insurers

101 Constitution Ave., NW, Suite 700, Washington, DC 20001
Bruce Ferguson & Michael Lovendusky, 202-624-2000 www.acli.com

National Association of Insurance and Financial Advisors

2901 Telestar Court, P.O. Box 12012, Falls Church, VA 22042
Gary Sanders & Roland Panneton, 703-770-8100 www.naifa.org



American Council of Life Insurers

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www.acli.com

National Association of Insurance and Financial Advisors

2901 Telestar Court, P.O. Box 12012, Falls Church, VA 22042
www.naifa.org