

STOLI PROMOTERS ON THE RUN AS STATES ACROSS NATION ENACT CONSUMER PROTECTIONS

Eleven states from Maine to Hawaii have now enacted legislation to protect senior citizens from a fraudulent use of life insurance that promotes wagering on human life and potentially exposes seniors to unexpected taxes and legal liability.

The legislation targets stranger-originated life insurance (STOLI), a transaction in which investors such as hedge funds finance a program that induces senior citizens to obtain insurance for the sole purpose of transferring the death benefits to the investors. The investors hope to profit when the seniors die and the sooner they die, the higher the profit.

The state bills are based on model laws developed separately by the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL), the two leading associations of state government officials responsible for insurance oversight. The model laws were approved by the associations in 2007.

"It is gratifying that barely one year after the models were approved, more than 20 percent of the states have enacted laws to deter this ugly and twisted misuse of life insurance. This shows that lawmakers across the nation are deeply concerned over the impact of STOLI on seniors and the life insurance marketplace," said Frank Keating, president and CEO of the American Council of Life Insurers (ACLI).

"We are encouraged to see a growing number of states taking action to stop STOLI abuses. Life insurance is meant to be a source of protection and security in the event of the unthinkable. It was never intended to be a vehicle for investors to speculate on human lives," commented Jeffrey J. Taggart, CLU ChFC, LUTCF, president of the National Association of Insurance and Financial Advisors (NAIFA).

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WHERE WE STAND

While the life insurance industry is greatly encouraged by the rapid actions in many state legislatures across the nation to enact laws deterring STOLI, it is important for every jurisdiction to have an effective statute on the books to protect seniors from STOLI abuses and to maintain the integrity of life insurance.

STOLI threatens to undermine the life insurance market for senior citizens and expose participants in STOLI schemes to unexpected taxes, potential legal liability and loss of insurance capacity.

Despite their public statements that they oppose STOLI and support the NCOIL model, STOLI promoters have tried to undermine the NCOIL model primarily by gutting its statutory definition of STOLI. The NCOIL model defines STOLI as "a practice or plan to initiate a life insurance policy for the benefit of a third party investor who, at the time of policy origination, has no insurable interest in the insured."

However, in every state that has considered the NCOIL model, STOLI promoters have tried to eliminate this vital component of the model and substitute the following: "Stranger-originated life insurance is the procurement of new life insurance by persons or entities that lack insurable interest on the insured and, at policy inception, such person or entity owns or controls the policy or the majority of the death benefits in the policy and the insured or the insured's beneficiaries receive little or none of the proceeds of the death benefits of the policy."

This so-called "tweak" would substantially weaken the protections contained in the NCOIL model. Under this "definition," the NCOIL model would only apply to circumstances where the STOLI investors own the majority of the death benefits at the instant the policy is issued. In fact, STOLI transactions do not occur in this manner. STOLI transactions are a carefully choreographed ballet in which seniors obtain life insurance under a plan to transfer ownership of the death benefits to the hedge fund investors two years down the road. Thus, while STOLI promoters talk about supporting the NCOIL model, their actions tell a different story.

ACLI and NAIFA will continue to support the strongest possible state actions to address STOLI and provide seniors with the highest level of protection. We believe the best legislation can be achieved by combining provisions from the NAIC Viatical Settlement Model Act with provisions from the NCOIL model.

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The NAIC and NCOIL models take different approaches to combating STOLI. The NAIC model prevents the investors from getting their hands on the death benefits for five years after the policy are issued, thus reducing the economic incentive for STOLI. This moratorium is carefully tailored to apply only to STOLI and not to affect the rights of good-faith policy owners.

The NCOIL model aims to help regulators and insurers identify and deter STOLI before a policy is issued. The model establishes a statutory definition of STOLI and classifies it as a fraudulent act. It also requires settlement providers to report information to state insurance departments that will assist regulators in monitoring STOLI. Moreover, the NCOIL model permits insurance companies to ask questions on policy applications that will help identify STOLI transaction before they occur. For example, the NCOIL model allows insurers to ask policy applicants whether they have been asked to undergo a life expectancy evaluation by any party other than the insurance company.

The NAIC and NCOIL models can be combined into a single piece of legislation that offers consumers the highest standard of protection against STOLI. However, the models can also stand individually as effective measures against this abuse.

The following states have enacted STOLI legislation:

- **NAIC model:** North Dakota, Nebraska.
- **NCOIL model** (either whole or in part): Arizona, Oklahoma, Kansas, Maine, Indiana, Hawaii and Connecticut.
- **Hybrid** (combining features of both the NAIC and NCOIL models): West Virginia, Iowa.



March 2008

TIMELINE

For expanded Timeline, please visit www.acli.com

LEGISLATION

- **West Virginia** enacts comprehensive STOLI legislation combining best features of NAIC and NCOIL models.
- **Indiana** takes the first step towards addressing STOLI by passing legislation that defines STOLI based on language in the NCOIL model.

MEDIA

- **ABC News** airs report on STOLI entitled "Do 'Tombstone Contracts Target the Elderly?'"
- **Kansas City Star** quotes Kansas Insurance Department officials in article entitled "Stranger-Originated Life Insurance a Bad Bet, Regulators Say."
- **Cincinnati Enquirer** personal finance advisor warns consumer to be wary of STOLI in column entitled "Your Life Could Depend on That Free Policy"

April 2008

LEGISLATION

- **Maine** enacts legislation defining STOLI and classifying it as fraud.
- **Kansas** enacts legislation based on the NCOIL model that defines STOLI and classifies it as fraud.
- **Iowa** enacts comprehensive STOLI bill combining best features of NAIC and NCOIL models.
- **Nebraska** enacts strong legislation based on the NAIC model.

PENNSYLVANIA DEPARTMENT WARNS CONSUMERS TO BEWARE OF STOLI

Seniors who become entangled in STOLI arrangements offering “free” insurance face potentially major costs, including ineligibility for government entitlements and programs, says the Pennsylvania Insurance Department.

In a STOLI Notice issued May 5, 2008, entitled “Beware of Unusual Life Insurance Transactions,” the department warns consumers, especially seniors, to be wary of STOLI, which it describes as “investment schemes created by investors (i.e., strangers) who have no relationship with the consumer.” While STOLI promoters try to induce seniors into these arrangements by promising valuable gifts, a lump-sum payment either immediately or in the future and “free” life insurance for a period of time, the true costs to seniors are substantial. These include:

Unanticipated tax liabilities. “Whatever the consumer gains as a result of the STOLI transaction could be considered income for state and federal tax purposes, as opposed to the death benefits payable under the life insurance policy, which are generally not taxable,” the department says.

Ineligibility for government entitlements and programs. “A consumer’s income from the STOLI transaction could render him or her ineligible for certain government benefits by exceeding maximum financial thresholds for such programs, the department says.

The inability to purchase additional life insurance.

“Consumers should be aware that they have an ‘insurance capacity,’ meaning that there is a maximum amount of life insurance that companies will provide to any particular individual. Insurance companies may refuse to provide additional life insurance in the future because any policies purchased as part of a STOLI transaction will be counted against a consumer’s ‘insurance capacity,’” the department says.

The department notes that it does not sanction or approve STOLI. “These transactions and the parties involved in these transactions may be in violation of Pennsylvania’s existing insurance laws and regulations addressing insurable interest requirements,” the department says.

STOLI arrangements go by different names, the department says, including:

- Zero premium life insurance.
- Estate maximization plans.
- No cost to the insured plans.
- New issue life settlements.
- High net worth settlements.

“No matter the name, the common characteristic of STOLI arrangements is that life insurance is purchased purely as an investment vehicle for a third party investor, rather than to provide for financial protection of the policyholder’s chosen beneficiary, and consumers are advised to approach these transactions with caution,” the department says.

Other state insurance departments that have issued STOLI-related warnings include Alabama, Arkansas, Idaho, Illinois, Louisiana, New York, North Carolina, Ohio, Texas and Utah.

May 2008

MEDIA

■ **Fox Business** publishes article entitled “Betting on the Dead.”

■ **Daily Oklahoma** publishes op-ed by ACLI President and CEO Frank Keating entitled “Bill Would Help Protect Seniors,” urging passage of STOLI legislation in Oklahoma.

■ **Columbus Dispatch** publishes editorial strongly backing Ohio legislation to deter STOLI entitled “Grave Investments: Law Should Carefully Regulate Those Who Seek to Profit From Other’s Deaths.”

REGULATION:

■ **Idaho Department of Insurance** publishes item in quarterly newsletter warning consumers to be wary of STOLI.

■ **Pennsylvania Department of Insurance** issues STOLI warning to consumers.

LEGISLATION

- **Connecticut**
- **Oklahoma**
- **Hawaii**
- **Arizona**

All four states enact legislation based on the NCOIL model that defines STOLI, and classifies it as a fraudulent act.

MEDIA:

■ **Columbus Dispatch** publishes letter by Nationwide President Mark Thrasher entitled “Life Insurance shouldn’t be for benefit of strangers.”

■ **California Broker** magazine publishes letter from NAIFA President Jeff Taggart addressing allegations contained in article written by LISA General Counsel.

MISREPRESENTATION OFTEN KEY ELEMENT TO STOLI, HAMPERING ABILITY OF INSURERS TO PREVENT ABUSIVE TRANSACTIONS

Misrepresentation is often a key element of STOLI since it is necessary for STOLI promoters to hide the true nature of these transactions from life insurance companies. As noted in the November issue of *STOLI Alert*, it is very difficult for insurers to identify STOLI transactions because the policy documentation often appears legitimate.

While many STOLI transactions are never detected, one that was discovered provides a clear picture of how STOLI works and why STOLI promoters violate the public interest on many levels. In the case of *American General v. Schoenthal, United States District Court for the Northern District of Georgia (06-cv-0695)*, Judge William S. Duffey Jr. forcefully expressed how the integrity of both the life insurance product and society are compromised by STOLI.

In this case, an 82-year-old man named Samuel Schoenthal was solicited by a promoter to participate in what was called the "Liberty Premium Finance Program." According to the court, the Liberty program involved a "maze of related entities" owned by an Ireland-based company called Horizon Trade and Finance. Horizon set up several trusts that were involved in this transaction.

As part of the Liberty program, Schoenthal submitted an application for life insurance to American General. On the policy application, Schoenthal said he wanted the insurance for "estate planning" purposes. He said his net worth was \$10.7 million and he had an annual income of more than \$150,000. Schoenthal signed his name to these representations. Based on this information, American General issued Schoenthal a \$7 million policy.

Less than one year after the application was submitted, Schoenthal died, and a claim for the death benefits was submitted to American General. After a further examination of the claim, American General discovered that Schoenthal's net worth was \$160,000, not \$10.7 million, and his annual income was \$7,200, not \$150,000.

American General filed an action to rescind the contract based on material misrepresentations in the application. American General said that but for those misrepresentations, it would not have issued the policy. The defendants, which included the Schoenthal family and Liberty, counterclaimed, demanding payment of the death benefits and accusing American General of bad faith.

In ruling in favor of American General, Judge Duffey noted, "The financial misrepresentations in the Schoenthal policy application were deliberate, drastic and objectively material

to a prudent insurer. The presence of an objectively material misrepresentation constitutes reasonable ground to contest the claim."

Moreover, Duffey specifically rejected the defendants' argument that the insurer bears the burden of uncovering false statements in applications.

"The fundamental premise of defendants' argument in this case is that they should not be held responsible for the clear and drastic financial misrepresentations in the application because American did not do a good enough job investigating the truth of the representations. In essence, defendants argue that American had an obligation to discover defendants' deceit," Duffey wrote.

This argument directly contradicts policy judgments made by the Georgia legislature that the risks of material misrepresentations on life insurance policy applications fall on the applicant, not the insurer.

"The Liberty Program was a sophisticated, multi-party enterprise designed to profit from the deaths of elderly individuals. To the extent that the Liberty Program could achieve such profits within the limits of the law, the court has no objection. In this case, however, the Liberty Program seeks now to profit from Samuel Schoenthal's life through flagrantly deceitful representations about his financial worth and income. Without these misrepresentations, Samuel Schoenthal's life would not have generated the payoff defendants—and their affiliates—seek," Duffey said.

"If, as defendants seek to argue, the insurer was responsible for discovering the misrepresentations, enterprises like the Liberty Program would be encouraged to submit insurance applications containing material falsehoods, to the extent that doing so results in increased profits," Duffey added.

The judge concluded by emphasizing the importance of life insurance in American society.

"Life insurance is designed to empower individuals by permitting them to secure their estates and their families against the unknown. Life insurance provides security, financial certainty and a measure of comfort in the face of death. There are significant policy reasons for striving to ensure that the Liberty Program, and other similar enterprises, restrains their speculation in the area of life insurance to the boundaries permitted by law," Duffey said.

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.

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