

WHERE WE STAND

Life insurance serves many critical social functions. Most importantly, 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. The life insurance community supports amendments to the Viatical Settlements Model Act approved by the National Association of Insurance Commissioners. The amendments would deter STOLI without harming the interests of policy owners who acquired their coverage legitimately.

Moreover, 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.

The American Council of Life Insurers (ACLI) and National Association of Insurance and Financial Advisors (NAIFA) will also continue working with state insurance departments to develop new tools to fight STOLI.

INSURANCE DEPARTMENTS, LEGISLATURES TAKE STEPS AGAINST STOLI

Insurance departments around the nation are stepping up to the plate to warn senior citizens about abusive STOLI transactions.

In California, Texas, North Carolina and Florida, insurance regulators have issued bulletins or backed legislation reasserting the need for an insurable interest to exist at the time an insurance policy is purchased. The New York Department of Insurance is drafting a proposal that would establish new consumer protections in the settlement marketplace.

California

The California Department of Insurance is warning senior citizens to exercise caution if they are offered “free” life insurance and other economic benefits, and to be sure they understand the implications of participating in these schemes.

“While it is tempting to enter into such agreements due to the potential financial gain, seniors are cautioned to secure independent advice as to the personal, legal and financial consequences of such ‘investor-driven’ purchases of life insurance,” the department said in a warning posted on its Web site.

These issues, the department said, include the legality of the arrangement, loss of insurance capacity, loss of privacy and potential tax consequences. Moreover, the department said, under California law, an insurable interest must exist when a life insurance policy is first taken out.

“Simply put, an ‘insurable interest’ exists where the owner of the policy is closely related to the insured, or otherwise

continued on page 2

has a financial interest in the continued life of the insured," the department said. "For example a person has an insurable interest in his or her own life, in the life of a spouse or children, and a creditor has an insurable interest in the life of a debtor, to the extent of the debt owed.

"An investor, or 'stranger,' on the other hand, has no insurable interest in the life of the insured. Therefore, the transaction must be carefully analyzed to make sure that a legitimate insurable interest exists when the policy is first taken out, otherwise, the insurance company could declare the policy void," the department said.

The department also urged consumers considering a life insurance settlement to be aware of possible results of such a transaction, including that an investor will have a financial interest in the insured's death. Investors will have the right to inspect the insured's private medical records and to periodically contact the insured to determine his or her health status, the department added.

Texas

The insurance department took a major step towards monitoring potential STOLI transactions to assure senior citizens are not duped by STOLI promoters into participating in abusive schemes.

The department issued *Commissioner's Bulletin B-002-07* that reminded viatical and life settlement providers, representatives and brokers that all advertising materials must be filed with the department on or before the date they are used. These materials include, but are not limited to, all printed information, video and audio presentations, prepared sales presentations, telephone scripts, solicitations and letters, billboards, radio and television, proposals and Web sites.

ACLI and NAIFA praised the department's action.

"The Commissioner's Bulletin will help the Texas Department of Insurance monitor the life insurance settlement market to assure that the state's insurable interest law is honored and consumers are not abused," said Frank Keating, president and CEO of ACLI. "We've seen a rash of solicitations in

which senior citizens are offered incentives to allow investors to purchase insurance on them in order to profit from their deaths. While these schemes are often touted as 'free insurance,' there are hidden costs, dangers and legal issues which unscrupulous promoters fail to disclose. It is vital that law enforcement authorities keep track of these come-ons to protect consumers and maintain the integrity of the life insurance product.

"Fortunately, the word is getting out," Keating added. "We are seeing more and more news articles shining a spotlight on the dangers of STOLI. Insurance regulators are also stepping up the plate to protect consumers. The Commissioner's Bulletin issued in Texas is another major step in the right direction."

North Carolina

Insurance Commissioner Jim Long announced his support for legislation aimed at deterring STOLI transactions. The legislation, HB 1489, is patterned after the amendments to the Viatical Settlements Model Act that received the overwhelming approval of the National Association of Insurance Commissioners.

"We need to stop these deals from happening in the first place, and the best way to do that is to make investors wait five years before they can get their hands on a policy."

Jim Long, Insurance Commissioner, North Carolina

The heart of the legislation is a five-year moratorium on the settlement of a life insurance policy only in those circumstances where there are strong indications of STOLI. Legitimate life settlements, such as when policy owners no longer need coverage due to a change in their economic or family circumstances, would not be affected by the legislation. The five-year moratorium would remove much

June 2007

TIMELINE

NAIC: The National Association of Insurance Commissioners approves amendments to the Viatical Settlements Model Act calling for a limited five-year moratorium on life insurance settlements that have the earmarks of stranger-originated life insurance and better disclosure to policy owners of the financial and legal terms of a policy settlement.

STATES

- Alabama: The Insurance Department issues a bulletin requiring specific documentation by life insurance companies contemplating developing or marketing zero premium life insurance, which includes STOLI.
- Texas: The Insurance Department issues Bulletin B-0026-07, which reminds viatical and life settlement

providers, representatives and brokers that all advertising material—including printed material, audio and video presentations, solicitations and letters—must be filed with the department on or before the date the material is used.

of the economic incentive for STOLI transactions by forcing investors to wait for their expected pay-off.

"I am a strong supporter of this legislation, which will give us the tools we need to combat these schemes and protect our seniors," Long said. "We need to stop these deals from happening in the first place, and the best way to do that is to make investors wait five years before they can get their hands on a policy."

HB 1489 is sponsored by House Majority Leader Hugh Holliman (D) and was approved by the North Carolina House of Representatives in May. It is on track for consideration by the North Carolina Senate in the next session.

New York

The Department of Insurance is drafting a viatical settlement bill that could go a long way towards protecting senior citizens from abusive STOLI transactions.

The draft legislation contains important consumer safeguards such as licensing of viatical settlement brokers, clear disclosure of producer compensation, annual reporting requirements, privacy and a listing of prohibited practices. In addition, the draft would grant authority to the New York Department to implement the legislation and issue rules that safeguard the public policy goals embodied in the state's insurable interest requirements.

ACLI and NAIFA support the efforts of the Department to protect consumers by tackling the problem of STOLI. The associations believe the draft could be strengthened by adding a provision which would establish that a pattern of transactions involving such factors as settlement of policies shortly after the two-year "wet ink" period has expired and other STOLI indicators are regarded as prima facie evidence that the settlement company is engaging in STOLI.

Specifically, the current draft requires all settlement brokers to be licensed, subject to a criminal background investigation and to pass a competency examination. In addition, a broker would have to identify in writing the source of his or her

compensation. If the broker receives or expects to receive compensation from the consumer, he or she would be barred from receiving additional compensation from the settlement company.

All disclosure information would be provided to the consumer before the settlement application is signed. The disclosures would have to be conspicuously displayed to the consumer. The superintendent would be authorized to assess penalties against a broker if disclosure information is omitted or delayed to the material detriment of the consumer.

As for prohibited practices, these include:

- Payment of referral fees under certain situations;
- Discrimination;
- Undisclosed broker compensation arrangements;
- Unfair or deceptive trade practices;
- Agreements or acts that restrict the consumer's ability to seek competitive bids;
- Agreements to fix or limit value paid to consumers for their policies; and
- Other acts of misrepresentation and concealment.

In addition, the draft would make viatical settlement transactions subject to New York's Unfair Trade Practices Act.

The draft would also protect the privacy of consumers by prohibiting a settlement broker or company having knowledge of the identity of a consumer involved in a settlement transaction from disclosing that identity, subject to specified and limited exceptions.

Settlement companies would be required to file annual statements with the superintendent specifying the number of policies settled, their face amounts and proceeds of policies viaticated during the previous year.

Florida

A rule proposed by the State's Office of Insurance Regulation would require settlement companies to disclose to consumers settling a life insurance policy the full details of the compensation paid to settlement brokers.

Continued on page 4

July 2007

NCOIL

The National Conference of Insurance Legislators continues work on model legislation that would apply a two-year moratorium on settlements that have the earmarks of STOLI.

STATE

- California: The Insurance Department posts a bulletin on its web site alerting consumers to be wary of offers of "free" life insurance and noting that for an insurance policy to be valid, the owner of the policy must have an insurable interest in the life of the insured.

- North Carolina: Insurance Commissioner Jim Long announces his support for legislation based on the NAIC model. The legislation, House Bill 1489, was approved by the North Carolina House of Representatives in May and is now pending before the Senate.

MEDIA

- *BusinessWeek*: The July 30 issues carries three articles on what are called "death bonds," highlighting the growing trend of third parties investing in the life insurance policies of strangers.

Under the proposed rule, settlement companies would provide consumers with the name of each settlement broker receiving compensation from the transaction and the amount of that compensation. In addition, settlement companies would provide consumers with a document that compares the gross offer for the policy made by the settlement company—that is, the total amount the settlement company is paying for the policy, including commissions, fees and other related expenditures—to the amount actually received by the consumer.

The consumer would have to read and sign these disclosure statements before the settlement transaction is completed.

NEWS ARTICLES, RATING AGENCY WARN ABOUT DANGERS OF STOLI

The word is getting out.

News articles and a rating agency are warning consumers and investors to be wary of life insurance schemes that sound too good to be true.

The July 30, 2007 issue of *BusinessWeek* featured a cover story on the risks associated with life insurance settlement investments which the article called “death bonds.” The September 9, 2007 issue of *Newsday* warned consumers they may get “much less” than they expect if they participate in a stranger-originated life insurance scheme. The September 4, 2007 issue of the *Sacramento Bee* profiled senior citizens who were the victims of an alleged settlement scam.

The *BusinessWeek* feature focused on the issue from the investors’ perspective, noting that all-too-often, investors are unaware of the risks associated with life settlement

investments. Although the article covered life settlement investments in general, it noted the prevalence of STOLI.

“Many life settlement providers, for example, are trying to lure people who don’t even hold insurance,” *BusinessWeek* wrote. “In this tail-wagging-the-dog scenario, speculators take out policies on the individuals’ behalf, pay them something upfront, cover the premiums, and then wait for the people to die so they can collect. At the most outlandish extreme, one outfit devised a plan involving the population of the Federation of St. Kitts and Nevis in the Caribbean.”

BusinessWeek notes that the promoters of the St. Kitts and Nevis deal claimed that the government of the affiliated islands was behind it. The government, however, denied it. Moreover, the deal got a “cool reception” on Wall Street. Nonetheless, *BusinessWeek* reports, STOLI promoters remain hard at work.

“Yet hedge funds and other finance firms have been diving into other stranger-initiated deals in the past two years, wooing seniors into taking out policies by offering cruises and other gifts,” *BusinessWeek* wrote. “Industry sources estimate that \$10 billion to \$20 billion in such policies have been created since 2004. Some state insurance commissioners have joined with insurers in calling for a crackdown.”

In her *Newsday* article, family finance columnist Lynn Brenner identified the dangers of STOLI in response to a question from a reader who said he is considering participation in a STOLI scheme.

While STOLI may be technically legal, *Newsday’s* Brenner said, it violates the spirit of state insurable interest laws.

“That’s why the settlement company needs you to buy the policy from the insurer,” Brenner told her reader. “You’ll probably have to lie when you do, because many insurers now require a signed statement that you’re not borrowing to buy a policy you intend to sell. This requirement has made non-recourse financed policies less attractive to settlement firms: If an insurer can show you lied on its application, it can contest a claim beyond the usual two-year limit.”

September 2007

STATES

- Missouri: The Senate Interim Committee on Consumer and Financial Protection conducts a hearing on STOLI.

MEDIA

- *Sacramento Bee*: A feature story in the Sept. 4 edition focuses on the losses suffered by investors who purchased interests in the life insurance policies of strangers. The investors are said to be victims of a “Ponzi scheme.”

- *Newsday*: A financial advice columnist on Sept. 9 warns consumers considering participation in a STOLI transaction that there are many pitfalls and legal issues. Moreover, the article warns consumers they will probably receive much less than they expect.

As for the consumer, Brenner said the pay-off from STOLI may be much less than expected. The finance company and the settlement broker receive substantial compensation in the transaction. Meanwhile, she wrote, the policy's sale price depends on whether the consumer's health had deteriorated. If not, the STOLI investors will pay only a relatively modest price for the policy.

"After everyone else has been paid, there may be little or nothing left for you."

Lynn Brenner, Newsday

"After everyone else has been paid, there may be little or nothing left for you," Brenner concluded.

The *Sacramento Bee* article featured the fallout to senior citizens who invested in an allegedly fraudulent life settlement scheme. The *Bee* cited officials who called the alleged fraud a "\$25 million Ponzi scheme."

Specifically, the *Bee* reported on a complaint filed by the Securities and Exchange Commission against a firm called "Secure Investment Services, Inc." which sold shares in life insurance policies to senior citizens. According to the SEC's lawsuit, the *Bee* reported, the firm used a fake doctor to mislead investors about the life expectancies of the people selling their policies. A bonding company, which was supposed to pay investors if the policyholders did not die on time, proved to be a fraud, the *Bee* said.

As the alleged scheme unraveled, the *Bee* reported, Secure Investment used cash from new investors to keep up premium payments so the old policies wouldn't lapse. The investors, who were mainly residents of a senior citizen complex, are facing huge losses.

Among rating agencies, Fitch Ratings issued a September 12 Special Report detailing the risks of STOLI to insurers, investors and consumers. Consumers, Fitch reported, will likely face "confusion and sales abuses" in life settlement transactions, including STOLI.

One problem, Fitch said, is that the life settlement market is "non-transparent."

"There are no complete and reliable statistics on the size of the market, its growth to date and prospects for future growth," Fitch said. "Reports on the growing size of the settlement market largely emanate from parties that collect transaction fees such as originators, agents/brokers and underwriters. These reports may not be reliable, as the parties have a vested interest in promoting this business."

In addition, Fitch said, the settlement market has "limited" regulation, and consumers may not fully understand settlement agreements and terms such as "non-recourse loans" and "free" insurance. Fitch added that the model law approved by the National Association of Insurance Commissioners establishing, among other things, a five-year moratorium on the settlement of policies that have the earmarks of STOLI, would go a long way towards solving the problem.

"If passed into law, this regulation would likely eliminate the STOLI market," Fitch said.

GAPS IN LEGAL SYSTEM EXPOSE INSURERS, CONSUMERS TO STOLI FRAUD

In many cases, life insurance companies acting in good faith are being victimized twice; once by policy applicants who lie on applications, and again by unscrupulous settlement providers and brokers who aid and abet these deceptions. Ultimately, the cost of these frauds is borne by the life insurance system, affecting companies, investors and consumers.

Accurate information on the policy application is vital to the insurance underwriting process. Life insurers must know certain facts if a policy is to be priced and issued properly. In the STOLI context, insurers need to ascertain whether the intended beneficiary has an insurable interest in the life of the policy owner, or is simply a third-party investor betting on the policy owner's early death.

Under basic contract law principles, a party who is the victim of fraud has the right to invalidate the contract. But in the life insurance world, the situation is murky. In the battle against insurance fraud, there is a limited period in some states, usually two years, for the insurer to discover the fraud and contest the validity of the policy. While insurers generally have greater ability to invalidate and rescind a policy when an insurable interest is absent at the inception of the contract, STOLI transactions are cleverly designed to skirt, rather than clearly violate, state insurable interest laws. Moreover, some courts interpret noncontestability clauses so broadly that middlemen who aid and abet schemes to violate state laws are claiming, and receiving, protection from litigation.

A case currently pending before the United States Supreme Court highlights this point. While the case involves viatical settlements of policies owned by severely ill people, the lessons can be applied to STOLI.

The case is *American United Life, et al. v. Martinez* (11th Circuit Docket Number, 05-14920; Supreme Court Docket Number, Pending). Key issues in this complicated case include fraudulent misrepresentation and a court's interpretation of the noncontestability clause in life insurance policies.

Mutual Benefit Corp. (MBC) is a now-bankrupt life settlement company that acquired life insurance policies from gravely ill people and sold interests in the death benefits to investors. It

is alleged that in many instances, the policy owners who sold their policies to MBC lied about their health status on their policy applications, failing to disclose that they were terminally ill.

continued on page 6

MBC allegedly aided and abetted this scheme by actively seeking out and acquiring policies that it knew were procured by fraud, according to the complaint filed by the life insurance company victims of the scheme. By mid-2004, MBC had acquired some 9,000 policies with a total face value of \$1.067 billion. The complaint says that some officials estimated that 40 percent of the policies were tainted by fraud in the application.

Once the fraud was uncovered, the insurance companies sought to file fraud actions not against the policy beneficiaries, but against MBC and others who helped accomplish the fraud. However, their actions were barred by the trial court, citing the two-year noncontestability clause. That ruling was upheld by the 11th U.S. Circuit Court of Appeals.

The insurers insist that that the noncontestability period was never intended to provide a liability shield for third parties who aid and abet fraud.

“Are they immune from independent liability?” the insurers asked in court documents. “MBC wagered—successfully, if the Panel decision stands—that the answer was ‘yes;’ it could seek out, acquire, maintain and profit from fraudulent policies with utter impunity.”

The insurers said they acknowledge that an incontestability clause often—and rightly—prevents beneficiaries, who are usually widows and children, from being forced to defend allegations of fraud many years after a policy’s inception.

“But it is not an impenetrable shield for admitted criminals who have amassed tens of millions of dollars through fraudulent schemes,” they said.

“The financial marketplace is full of products and instruments ready to be made fair game, as life insurance policies were here,” the insurers added. “So, beyond being unjust (for who but a group of life insurers being told they have no right to sue convicted fraudsters for fraud?), the decision is unwise.”

STOLI is a perfect candidate for the type of fraudulent transaction outlined in the allegations of the MBC case. The unfairly expansive interpretation of the noncontestability clause by the courts means that insurance companies will find it very difficult to detect and remedy fraud. Fraud imposes costs on the entire system, with the real victims being consumers.

A five-year moratorium on settlement transactions that have the earmarks of STOLI will help deter fraud while protecting the rights of consumers to settle legitimately-acquired policies.

SIZE OF LEGITIMATE LIFE SETTLEMENT MARKET MAY BE OVERSTATED

Often-repeated estimates that the life insurance settlement market could reach as much as \$160 billion annually are starting to raise eyebrows—and raise questions about whether STOLI transactions are fueling this projection.

A July 2007 *Research Brief* published by LIMRA International reports on a survey that examined interest in life settlements among more than 500 affluent life insurance policy owners over age 50. The results suggest that the market for legitimate life settlements—that is, settlements that do not involve STOLI—may be smaller than settlement advocates suggest.

“LIMRA concluded that a low number of viable sellers with an interest in selling a life insurance policy suggest that a prediction that the market for life settlements could reach \$160 billion is too high...Unless, that is, stranger-initiated policies are going to be used.”

North Dakota State Rep. Jim Kasper (R)

One key result: Only 10 percent of respondents said they would have even minimal interest in selling the life insurance policy they currently own.

In a recent speech, North Dakota Rep. Jim Kasper (R) cited this and other results of the LIMRA survey to raise a fundamental question: Are STOLI advocates exaggerating estimates of the market for legitimate life settlements in order to hide abusive STOLI transactions?

“LIMRA concluded that a low number of viable sellers with an interest in selling a life insurance policy suggest that a prediction that the market for life settlements could reach \$160 billion is too high,” Rep. Kasper said. “Unless, that is, stranger-initiated policies are going to be used.”

LIMRA, which conducted the survey this past April, asked the following question:

There is a life insurance concept called a life settlement. This is a transaction where the owner of an individually-purchased life insurance policy sells it for cash. The sale price is usually greater than what the insurance company would pay if you dropped the policy, but less than the face amount of the policy. The buyer of the policy takes over paying the premiums, and is the beneficiary when the seller of the policy eventually dies. Life settlements are of interest to people who

own a large life insurance policy, but because of their age or financial reasons, no longer feel they need that amount of life insurance. Have you heard about the life settlement concept before now?

The average age of the respondents was 65, which, LIMRA noted, is clearly an appropriate market for life settlements. The respondents were asked if they have ever heard of the life concept settlement. To provide a comparison, the survey also asked about six other life insurance concepts, such as using life insurance to make a charitable donation.

In addition to finding just 10 percent of respondents said they would have even minimal interest in selling the life insurance policy they currently own, the survey discovered limited knowledge of life settlements: 39 percent said they have heard about the transaction. This was the second lowest of the seven concepts presented, with only the concept of a combination life/long-term care policy generating a response of less awareness.

LIMRA reported that only about 50 individual respondents indicated some interest in selling their life insurance policies, and only about half of those fit any of the typical characteristics of a candidate for a life settlement. These characteristics are: age 65 and over, a permanent life insurance policy with a face value of \$250,000 or more and no further need for the policy.

“Companies that buy life insurance policies are not interested in young sellers because they have to wait too long for a return on their investment, and they are not interested in sellers with small policies since the return does not cover their costs,” LIMRA said. “Therefore, on top of a lack of interest in life settlements, four-in-five of those interested would not qualify to sell their policy.”

The lack of knowledge and an even lower number of viable sellers with an interest in selling a life insurance policy suggest that the prediction of a \$160 billion market for legitimate life settlements is too high, LIMRA said.

ACLI and NAIFA urge legislators and regulators to demand that life settlement companies provide detailed information about the life settlement market to better determine why the estimates of market size appear to greatly exceed the reality.

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

FIVE-YEAR MORATORIUM IS A VITAL COMPONENT OF EFFORT TO COMBAT STOLI

Reducing the economic incentive for stranger-originated life insurance (STOLI) is a vital element in the effort to deter these abusive transactions.

It is often extremely difficult to detect STOLI when the parties to the transaction embark on a scheme to withhold information critical to the insurer's decision of whether or not to issue a policy. And because of strict interpretations of the two-year contestability period under the laws of most states, by the time the insurer discovers and acts on the fraud, it is often too late. A five-year moratorium on life settlements sharply focused on STOLI transactions is the most effective and efficient way of preventing STOLI-related fraud.

As an example of the difficulties life insurers can face in detecting and responding to fraudulent transactions, consider the case of *First Penn-Pacific Life Insurance Co. v. Evans* (United States District Court for the District of Maryland; Civil No. AMD 05-444; June 21, 2007).

Beginning about September 1997, one Stanley Moore embarked on a scheme under which he would falsely represent that he suffered from a terminal illness, thus permitting him to viaticate numerous insurance policies he purchased on his own life. Moore obtained the policies by misrepresenting information requested in the policy applications, information which would have led to denial of the applications had it been presented.

Moore began the scheme by first requesting that his personal physician falsify his medical records to state he had a terminal illness. Although the physician refused to do so, and, in fact, made a note of Moore's request in his medical records, Moore was undaunted. He began applying for life insurance policies from five companies.

In his application with First Penn-Pacific, which was for a policy with a face value of \$2 million, Moore certified that he had not applied for life insurance with any other company in the 90 days immediately preceding his application with First Penn-Pacific and that he had only \$500,000 of life insurance in force. In fact, he had \$4 million of life insurance in force and two other applications were pending.

As the district court says, “The record shows indisputably that if Moore had made this disclosure, First Penn-Pacific would not have issued the policy that is the subject of this dispute.”

continued on page 8

continued from page 7

All told, Moore obtained a total of \$8.5 million in life insurance coverage from several different life insurance companies between December 19, 1997, and February 20, 1998. Working through a settlement broker, Moore viaticated six of the policies having a total face value of \$8 million. He managed to settle the policies by falsely describing himself as terminally ill.

In early October 1999, First Penn-Pacific's reinsurer discovered Moore's scheme and informed the company. First Penn-Pacific sent a letter to Moore and to the new owner of the policy giving notice of rescission. First Penn-Pacific also tendered a check refunding all the premiums paid. *continued on page 7*

continued from page 7

The dispute in this case centered around an interpretation of Arizona's law governing the two-year contestability period in life insurance contracts. The specific question was whether First Penn-Pacific was obliged to initiate a judicial action within the two-year period in order to rescind the contracts. The district court ruled that under Arizona law, First Penn-Pacific's rescission letters were insufficient and that the company had to initiate a judicial action within the two-year period to successfully rescind the contracts.

The court acknowledged that Moore obtained the policy "through the execution of a scheme to defraud plaintiff and numerous others." Nonetheless, the judge said, "I am persuaded that, under the circumstances presented here, the Arizona Supreme Court would very likely permit the fraud to go unremedied...."

This case demonstrates the difficulty life insurers can face in trying to rescind a fraudulently obtained insurance policy.

In this case, the defendant left a substantial paper trail in terms of the number of policies acquired, which alerted First Penn-Pacific's reinsurer to the fraudulent scheme. However, in most STOLI transactions, there will be no such trail. A STOLI promoter will induce a senior citizen to acquire a single policy from a single company. The underlying nature of the transaction will be hidden both from the insurance company and the reinsurer. It will be difficult, if not impossible, to detect abusive STOLI transactions within the two-year contestability period.

To prevent abuse, it is vital to reduce the economic incentives for STOLI. A carefully targeted five-year settlement moratorium on STOLI transactions is the most efficient and economical way of deterring abuses without excessively taxing the resources of law enforcement authorities and insurance companies.



American Council of Life Insurers

101 Constitution Ave., NW, Suite 700, Washington, DC 20001
www.acli.com

National Association of Insurance and Financial Advisors

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