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CONTENTS

Anti-STOLI Legislation, Panacea or Pandora?

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Lara Queen was looking for ways to get more cash, and came across an advertisement for a "life settlement." She called up Your-Money-Or-Your-Life, the company that placed the ad, and soon she signed an agreement. She would take out a $10,000,000 life insurance policy on herself; Your-Money would pay the premiums. Your-Money would also pay her a sum—say, $550,000—and in exchange would have the right to receive the death benefit payments of $100,000 when she died. Lara was satisfied, since she wanted to pay send some money to her granddaughter for college, plus she had some mounting medical bills, as well as an idea that she and her sister would go on a vacation together. But she was a little concerned when Your-Money had her sign papers that looked like they might be used to try to fool the insurance company into thinking that she, and not Your-Money, was paying the premiums.[1]

Such is the world of STOLI—stranger-originated life insurance—a rogue subset of the life settlement industry. A life settlement involves the sale of a life insurance policy where the policy owner sells the right to collect the death benefit to a third party in exchange for an immediate, discounted lump sum. The purchaser of the life insurance policy then becomes responsible to pay future premiums. Reasons for the sale might include the policy-holder's inability to make premium payments, or a change in circumstances which eliminate the need for the death benefit, or any other reason that might cause an individual to want to tap into an asset that few considered marketable—their own lives.

1. *See* Matt Brady, *Larry King Sues Over Life Settlement Deals*, Life and Health Insurance News, (Nov. 5, 2007), http://www.lifeandhealthinsurancenews.com/News/2007/11/Pages/Larry-King-Sues-Over-Life-Settlement-Deals.aspx.

Life settlements have existed for years, and recently their use has grown substantially, so that the life settlements business could now be described as an industry. A look back at the viatical market reveals some striking—and disturbing—similarities. The viatical settlement market—where, beginning in the 1980s, terminally ill individuals with HIV AIDS sometimes sold their rights to life insurance death benefits in order to pay for medical care—dried up due to a growing amount of fraudulent activity, which made viatical settlements less attractive to investors.[2] After fraud—and improved mortality—ruined viatical settlements as an investment,[3] investors interested in the secondary market for insurance products turned much of their attention to life settlements as the next growth opportunity.

Like the evolution of viatical settlements, fraud now threatens the life settlement market, as certain participants engage in fraud to artificially grow the market—by way of playing a role in procuring the very policies that they intend to purchase. Also called, "disposable policies", STOLI, represents a fraud on the market—a fraud upon the insurers that rely on an insurable interest as well as predictable rates of lapsing policies, and a fraud upon the investors who invest in securitized bonds comprised in part of STOLI policies subject to rescission. In addition, the recent market collapse and increase in the cost of capital has jeopardized the ability of investors to make payments on the premiums. Predicting the slaughter of those that promote STOLI, one commentator has said that the "'hogs' of the life settlement industry are those who seek fraudulent ways of expanding the market."[4] To be sure, there are those who would debate whether the life settlements market offers a service to the life insurance market—by offering a viable liquidity option for when circumstances change. Whether the connection between the life settlements market and life insurance is indeed symbiotic or is never more than a parasitic relationship remains to be seen, and perhaps, at a minimum, will depend on whether the two industries are able to address the risks created by STOLI.

Background of Life Settlements and STOLI

Unlike the secondary market for other insurance products, the secondary market for STOLI plays a role in the creation of the asset that is to be sold. Because of the questionable legality of STOLI, life settlements companies often try to hide their involvement in the manner in which an individual acquires the life insurance—at least until the end of the contestability period. In other words, companies in the STOLI business seek to conceal their involvement in the procurement of the insurance, as well as the individual's intention—at the time the policy is created—to sell the policy upon the conclusion of the contestability period

As this secondary, or "grey" market—the STOLI market—increasingly draws the attention of insurers and regulators, it is worth looking at the evolution of the secondary market for another insurance product. This article considers the evolution of the secondary market for structured settlement annuity payments——the litigation, legislation, and, finally, the effect of that legislation. This review may provide insight as to the future of STOLI, as well as the impact of that burgeoning grey market upon life insurance companies, as well as consumers.

Whether the proliferation of "good" life settlements and fraudulent life settlements (STOLI), overall, will effect the marketability of life insurance products or the favorable tax treatment which forms the basis of the industry remains to be seen. Probably as long as life settlements were appropriate estate planning events, and performed quietly without regulatory oversight, the risks of significant changes in legislation impacting the primary market remained low. The thirst for profit and to grow the market and

2. Kelly J. Bozanic, *An Investment to Die For, From Life Insurance to Death Bonds, the Evolution and Legality of the Life Settlement Industry*, 113 Penn. St. L. Rev. 229, 241 (Summer 2008) ("Although the practice of viatical settlements is not inherently flawed, two issues emerged which would prove fatal to the industry. First, improvements in medical care made mortality assumptions more difficult to approximate. Second, lack of regulation and the motive for profit gave way to fraudulent activity which made viatical settlements a less sound, and ultimately, disfavored investment.").

3. *Id.* ("Because of the difficulty in predicting rates of return, the viatical settlement industry began to decline almost in tandem with advancements in medicine.").

4. Bozanic, *An Investment to Die For, From Life Insurance to Death Bond, supra,* 241.

pitch life settlements to many more consumers by way of advertising rather than by way of the advice of a trusted financial advisor, may diminish or even destroy the market for life insurance. While the competing industry trade associations (LISA[5] and ACLI[6] agree that STOLI and life settlements must be regulated, it is uncertain what impact that regulation will have on detecting STOLI and whether it will relieve insurers of the race to detect STOLI within the contestability period.

Background of Secondary Market for Structured Settlement Payments

Structured settlements involve the settlement of personal injury claims for payments over time, in installments, rather than entirely at the time of settlement. These payments are funded primarily by annuity contracts, which are owned and administered by insurance companies and, for tax reasons, generally cannot be cashed out. During the 1990s, a secondary market in structured settlement payments arose. The market began in an unregulated manner, with many of the secondary market companies seeking to accomplish their transactions—often involving terms that were extremely unfavorable to the individuals selling their rights—via surreptitious means. In the past decade, state regulation has reined in some of the most serious abuses, but the story of the structured settlement factoring business provides some insight in the problems and possibilities posed by other secondary markets, like the life settlements market.

Consider how one of the first national secondary market finance companies was born. Tim Trankina and James Terlizzi formed JUA Funding in 1993 after they saw an opportunity in New Jersey to buy out personal injury claims paid from a state insurance pool. "When that *dried up* after the backlog of settlements was bought out",[7] Trankina and Terlizzi went on to develop structured settlement purchasing at two major secondary market finance companies, Singer Asset Finance and Peachtree Settlement Funding.

Indeed, during the 1990s, the secondary market developed through aggressive marketing directly to structured settlement recipients, enticing them to trade future tax-free payments for immediate cash.[8]

Purchases of structured settlement annuity payments were accomplished by a variety of surreptitious means, aimed at concealing the transaction from the parties with the payment obligations—namely, the owner and issuer of the annuity.[9] The purchase of structured settlement annuity payments typically involved a private agreement between the secondary market company and the personal injury victim; the agreement often included a power of attorney, change of address form or electronic fund transfer ("EFT") request, and signature specimens. The aim of these tools was for the purchaser to acquire the payments made payable to the personal injury victim—by convincing the insurer to send the payments to a post office box or bank account (that was, unbeknownst to the insurer, under the control of the purchaser), where the purchaser could negotiate the checks using a

5. *See* Life Insurance Settlement Association (LISA) brochure concerning STOLI at http://www.thevoiceoftheindustry.com/files/content/docs/Brochures/STOLI.pdf ("LISA supports the enactment of legislation to stop STOLI") and (LISA "supports the NCOIL model act as a basis for legislation.").

6. *See* American Counsel of Life Insurer's publication at http://www.acli.com/ACLI/Issues/47.htm (discussing the ACLI's support of legislation to combat the abuses of STOLI).

7. Mike Billips, *Not just luck: Roswell company is going after winners of lottery*, Atlanta Business Chronicle (Sep. 18, 1998), http://www.bizjournals.com/atlanta/stories/1998/09/21/story6.html (emphasis added).

8. "[A]n active secondary market in structured settlement payment rights developed in the early 1990s. Through aggressive advertising, specialized finance companies—now commonly referred to as structured settlement factoring companies— began persuading structured settlement recipients (referred to herein as "payees") to trade future payments for present cash. Daniel W. Hindert and Craig H. Ulman, *Transfers of Structured Settlement Payment Rights: What Judges Should Know About Structured Settlement Protection Acts*, 44 The Judges Journal 19, Spring 2005 ("Hindert & Ulman").

9. Hindert & Ulman at 19 ("To circumvent the restrictions on assignment of payment rights, factoring companies arranged for payees to redirect their payments to factoring company addresses. The factoring companies would then collect the payments (endorsing checks in the payees' names, using powers of attorney and signature stamps) without informing insurers that payment rights had been assigned.").

signature stamp, purported authorized by a power of attorney. One court described such practices as an "elaborate scheme" designed "to deceive" an insurer "into believing it was still making annuity payments to" a payee was done "in an effort to perpetrate a fraud" on such an insurer—and to avoid the insurer's exercise of its rights that might preclude or negate the transaction.[10]

Even where insurers began to see patterns in the change of address requests or EFT's or other indicia of what was then called a "grey market transaction", insurers were sometimes not sure how to stop or prevent the practices.

The growth of the number of transactions drew the attention of the life insurance companies, who, at the outset, were concerned that the personal injury victim's sale of the payments for discounted lump sums would offend the mandatory tax rules that made the annuities tax-free. Whether the sales of payments would cause a severe tax penalty, or whether Congress eventually would eliminate the favorable tax treatment, the life insurance companies understood that the grey or secondary market threatened their business.

The growth of secondary market transactions in the structured settlement industry also drew the attention of legislators, concerned by examples of unconscionable business practices employed by the secondary market finance companies to acquire annuity payments by any means.[11] The discounts were as high as 70 percent in some cases, but the secondary market companies dressed up the transactions as purchase and sales, rather than loans, to avoid offending usury laws.[12] Defaults arose either where a life insurance company refused to give effect to the assignment — if it was aware that one occurred — or where the original payee redirected payments away from the secondary market company.[13] Insurers responsible for making they believed to be non-assignable payments based on strict tax qualifications became embroiled in default actions in which the factoring companies tried to effectuate the transactions.[14]

Litigation ensued between the life insurance companies and the secondary market companies in forums across the country. The issue primarily was the enforceability of the transfers themselves, in light of contractual anti-assignment provisions in the documents governing the settlements. The secondary market companies were fighting to keep their fledgling industry alive; the life insurance companies were fighting to protect their business, the favorable tax treatment, and the marketability of structured settlements themselves.

The outcome of these forces was the regulation of transfers of structured settlement annuity payments—commencing in 1998 in Illinois, Kentucky and then in Connecticut, which were the first three of the now forty-six states with structured settlement protection acts ("SSPAs") that require court approval for such transfers to become effective. At the same time, annuity providers and secondary market companies worked to support a federal tax bill that would eliminate the primary tax concern while dovetailing with state structured settlement protection acts, and essentially encourage secondary market purchasers to comply with state structured settlement protection acts, or otherwise pay a harsh tax penalty.[15]

Although some may have believed that the

10. *Liberty Life Assur. Co. v. Gilbert*, 2006 WL 1211161 at *2 (describing how the payee "executed an irrevocable durable power of attorney" that granted the factoring company "absolute rights to deal with the periodic payments"; also describing how the payee, pursuant to the transfer agreement, "opened a bank account . . . , directed his annuity payments to said account, and gave . . . power of attorney" to the factoring company so it could access the deposits, and further how the payee notified the annuity issuer "of a change of address to a post office box, which, though being in the name of Gilbert, was controlled" by the factoring company).

11. Hindert & Ulman at 19 ("By fashioning transactions as purchases of future payment rights or as loans originated in states with generous usury laws, factoring companies often charged sharp discounts to payees who were ill equipped to appreciate the value of their future payments or to understand the onerous terms of factoring agreements. In some cases, factoring companies charged discounts equivalent to annual interest rates as high as 70 percent.").

12. *See* IRS Audit Guide, at Chapter 1, subsection entitled "Structured Settlements and the Rise of Factoring" (available at http://www.irs.gov/businesses/small/article/0,,id=185990,00.html)

13. *Id.*

14. *Id.*

regulation of the transfers of structured settlement annuity payments would reduce the administrative burden and costs for the annuity providers, as compared to pre-legislation transfers, the annuity providers saw the proliferation of transfers like never before.[16]

Despite the regulation, the structured settlement industry was changed by the secondary market. The promotion of the unraveling of structured settlements saturates day time television and the internet, and sends messages that appear to be at odds with the long term security espoused by promoters of structured settlements. Litigation continues to affect the structured settlement industry, as secondary market companies choose whether to comply with state statutes or circumvent them.

How Does This History Compare to STOLI?

Like assignments of structured settlement payment rights, life settlements have been around for a long time, often accomplished quietly without the consent or knowledge of the life insurance companies.

Secondary market companies, aware that their life settlement industry is under attack, are suddenly on the offensive, pointing to STOLI as a threat in some respects to legitimacy of the secondary life settlements market. For the life insurance companies, the utility of their life insurance product itself, and its marketability, may be at stake. Moreover, to challenge the legitimacy of the secondary market for life settlements would be to undertake massive commitments of resources, including the expenditure of considerable legal expenses to bring and defend actions in every state across the country, as well as lobbying efforts that likewise may involve efforts in multiple forums.

Insurers have commenced actions seeking rescission of life insurance policies that were procured by way of fraud and misrepresentation, and were arranged to be sold to a third party investor. Thus far, these cases have focused on insurable interest and misrepresentation related to the lack of insurable interest. Proving the fraud and misrepresentation where much effort has been invested on the part of the secondary market to obfuscate the sale of the policy has proven to be difficult and definitely expensive.

Several recent judicial opinions—all decided in 2008 or 2009—provide an overview of the issues involved in STOLI litigation, and the difficulty of uncovering such a surreptitious arrangement.

Insured's Intent Crucial to Proving STOLI

Decided under California and New Jersey law, the opinion of the court in *Lincoln National Life Ins. Co. v. Calhoun*[17] involved a rejection of the insured's position that insurable interest need not exist at the inception of the policy.[18] Although the policy at issue had not yet been transferred to a third party lacking an insurable interest, Lincoln Life alleged that the insured and a third party agreed that the insured would acquire the policy and the third party would pay all the premiums and eventually take an assignment of the policy following the incontestability period.

The *Lincoln Life* court stated that no New Jersey "decision has confronted the circumstances of the instant case, or determined whether a policy can be voided due to lack of an insurable interested based on the unilateral intent of the insured to sell the policy to a stranger, or whether rescission requires there to have been mutual intent on the part of both the insured and the stranger to assign the policy. Compelling policy considerations are raised by either position."[19] Because the court found that issues of

15. Laura J. Koenig, *Lies, Damned Lies, and Statistics? Structured Settlements, Factoring and the Federal Government*, 82 Ind. L.J. 809, 818 (2007) (discussing how the National Structured Settlement Association and the National Association of Settlement Purchasers collaborated to propose a legislative middle ground).
16. Hon. Edward O. Burke, *Structured Settlement Factoring, Panacea or the Road to Ruin?*, 44-MAR Ariz. Att'y 23, 24 (2008) ("In the first eight months of 2007, 176 applications for approval of these sales were filed in the Maricopa County Superior Court. That is a 66 percent increase over the same period in 2006. The applications were filed under the Structured Settlement provisions of A.R.S. § 12-2901, et seq.").
17. *Lincoln National Life Ins. Co. v. Calhoun*, 2009 WL 221946 (D.N.J. Jan. 2, 2009).
18. *Id.* at *5.
19. *Id.* at *6.

intent are "crucial" to the determination, dismissal "would be premature."

Insured's Alleged Collusion with Agent Is One Crux of STOLI Rescission Action

In *Jefferson-Pilot Life Ins. Co. v. Marietta Campbell Ins. Group*[20], Jefferson-Pilot brought a claim to rescind $14 million worth of life insurance procured on a 79-year-old woman.

Jefferson-Pilot alleged that Ms. Campbell's two sons conspired with their friends, the Swansons, to procure life insurance on their mother's life, and then sell the policies to outside investors. As part of this agreement, the Campbell and Swanson brothers worked with an insurance agent who required Marietta Campbell to sign several blank applications for life insurance from Jefferson-Pilot, AIG, Hartford Life Insurance Company, and Allianz.[21]

The insurance agent faxed in the applications for insurance to each of the carriers. The agent disclosed to AIG and Jefferson Pilot that Ms. Campbell had applications for insurance at both carriers. The agent did not disclose to Jefferson-Pilot or AIG the fact that Ms. Campbell also submitted applications to Allianz and Hartford Life. Allianz and Hartford Life issued policies for $2.5 million each.[22]

Thereafter, the insurance agent obtained a fifth policy from Lincoln Benefit Life Insurance Company, which application disclosed only the AIG application but not the Hartford Life, Allianz or Jefferson-Pilot applications.[23]

Following the issuance of the five life insurance policies, the Brothers established limited liability companies to pay for and receive the death benefits from the policies.[24] The Jefferson-Pilot application sought $3 million dollars in coverage, and listed Marietta Campbell as the owner and the estate as the sole beneficiary.

The court denied the defendants' motion for summary judgment, finding that there was an issue of material fact as to whether the brothers relied on Jefferson Pilot's agent to make accurate representations, or whether the brothers colluded with the agent against Jefferson-Pilot.

The court did agree with Jefferson-Pilot that the insured had a duty to update her answer on the insurance applications "if other life insurance applications became pending while Jefferson-Pilot was considering her application" and stated that no party disputed that such a misrepresentation would be a material misrepresentation.[25] This case remains pending.

Uncertainty as to Whether Insured's Unilateral Intent to Transfer Policy Offends Insurable Interest

In *Sun Life Assur. Co. of Canada v. Paulson*,[26] Sun Life filed a complaint seeking rescission of seven life insurance policies totaling $15 million obtained by defendant Paulson. Sun Life alleged that "Paulson, with the assistance of his insurance agents . . . fraudulently obtained the policies with the intent to sell them at the conclusion of their contestability periods."[27] The court previously had concluded that Minnesota law was unclear as to "whether an individual lacks an insurable interest if, at the time he procured the life insurance policy, he intended to transfer it to a third party without an insurable interest."[28] Predicting what the Minnesota Supreme Court would do, the court concluded that the "most important factor in determining the parties' intent is 'whether or not the assignment [from the insured to the third party] was done in pursuance of a preconceived agreement.'"[29] The court concluded that "[b]ased upon the complaint's cursory allegations, ascribing such intent . . . is purely speculative."[30] Because Sun Life had not alleged that a third party

20. *Jefferson-Pilot Life Ins. Co. v. Marietta Campbell Ins. Group*, 2008 WL 3582751 (Aug. 12, 2008).
21. *Id.* at *2.
22. Id.
23. *Id.* at *3.
24. Id.
25. *Id.* at *9.
26. *Sun Life Assurance Co. of Canada v. Paulson*, 2008 WL 5120953 (D. Minn. Dec. 3, 2008).
27. *Id.* at *1.
28. *Sun Life Assurance Co. v. Paulson*, 2008 WL 451054 at *2 (D. Minn. Feb. 15, 2008).
29. *Id.* (quoting 44 Am. Jr. 2d Insurance § 1001(2003)).

intended to purchase Paulson's policy at the time he obtained it, the court dismissed Sun Life's claim. *Id.*

In response, Sun Life filed a motion for leave to file an amended complaint which included additional facts describing how Paulson, "at the age of eighty, obtained thirty life insurance policies with an aggregate face value of $80 million as 'part of an agreement, scheme, purpose and/or plan to transfer or assign' those policies" to the defendant life settlement companies.[31] The magistrate denied without prejudice Sun Life's motion to amend, and held that the "motion was futile, made in bad faith and frivolous." *Id.* at *2. Sun Life appealed from the magistrate's order and also moved to certify the issue of insurable interest to the Minnesota Supreme Court.

Reflecting the difficulty in proving surreptitious secondary market transactions[32], the court in *Sun Life* stated that "[a]fter several months of discovery, Sun Life has no evidence that Coventry, Atticus or Orca [the secondary market companies] communicated with Paulson prior to or contemporaneous with his procurement of the disputed policies or that any of the companies paid the policies premiums. Further, Sun Life has not identified another party with the intent to evade the law against wagering contracts."[33] For its part, Sun Life argued that "Paulson's unilateral intent to transfer the disputed policies at the time their procurement renders the policies void ab initio."[34] Relying on the "law of the case" thus far, the court in Sun Life held that "Paulson's intent 'is irrelevant without facts . . .suggesting that a third party lacking an insurable interest intended, at the time Paulson procured the [policies], to acquire the[m] upon expiration of the contestability period."[35] In addition, the court in *Paulson* denied Sun Life's motion to certify the question, finding that the issue of law had already been decided in the federal district court.[36]

First Penn-Pacific Decision Insulates Secondary Market Participants from Their Own Improvidence.

Consistent with the *Sun Life* opinion, the Fourth Circuit Court of Appeals in *First Penn-Pacific Life Ins. Co. v. Evans*[37], applying Arizona law, rejected First Penn's position that if, at the time the insurance application was made, the policy holder, intended to transfer the policy to a third party investor, the policy was void ab initio for lack of insurable interest.[38] The facts in *First Penn-Pacific* reflect a familiar scenario of an individual applying for multiple life insurance policies, while failing to disclose his existing and pending policies, and accumulating $8.5 million in coverage.[39] The policy holder sold the First Penn policy within 3 months of issuance.

In *First Penn-Pacific*, the court stated that if it had adopted First Penn's reasoning, the result "would be unworkable and would inject uncertainty into the secondary market for insurance."[40] Instead, the result of the *First Penn-Pacific* opinion is that at least some of the secondary market participants who assumed the risk of engaging in surreptitious and questionable activity, were protected from their own improvidence. It is also striking for a court, while considering whether the procurement of the policy violated insurable interest laws, to consider the effect of its legal conclusions upon the secondary market.

Life Settlement Companies Use Insurance to Hedge

30. *Id.* at *2.
31. *Sun Life Assurance Co. of Canada v. Paulson*, 2008 WL 5120953, at *2.
32. The policy holder may have intended to sell the policy immediately upon the expiration of the two-year incontestability period, but did not yet identify a buyer (and may not find a buyer unless his health declines in the two year period which would also dictate the purchase price). Although it is likely that a person intending to sell in two years would have consulted with a broker as to the expected sale price, the insured likely will not subject himself to criminal and civil penalties by making such an admission.
33. *Id.* at *4.
34. *Id.*
35. *Id.* at *4 (quoting *Sun Life Assurance Co.*, 2008 WL 451054 at *2).
36. *Sun Life Assurance Co. of Canada v. Paulson*, 2008 WL 5120953 at *5.
37. No. 07-2020, 2009 WL 497394 (4th Cir. Feb. 26, 2009).
38. *Id.* at *1.
39. *Id.* at *1
40. *Id.* at *3.

Mortality Bets

There also are examples of litigation among various secondary market companies relating to life settlements. In *Life Receivables Trust v. Syndicate 102 at Lloyd's of London*,[41], the court described "the somewhat macabre market for contingent cost insurance which mitigates the risk in purchasing life insurance policies of still-living individuals."

In *Life Receivables Trust v. Synidate 102*, after an insured out-lived her life expectancy, Syndicate 102 refused to pay its obligation to the Trust and assume the policies. Syndicate 102 alleged that the Trust "had fraudulently misrepresented the date on which it acquired the Wang policies and had fraudulently calculated Mr. Wang's life expectancy."[42]

In *Life Receivables Trust*, the court explained the life settlement arrangement:

> Peachtree Life Settlements ("Peachtree") purchases life insurance from elderly insureds, offering them, while still of this world, a cash payment at a discount to the face value of the policies. Peachtree's purchase price is based on a variety of factors, perhaps the mot important of which is its own independent estimate of the insured's life expectancy. Upon purchase, Peachtree becomes the new policy owner and beneficiary, and continues to pay premiums until the insured dies.
>
> Peachtree buys some life insurance policies for its own account and others for the accounts of related entities including Life Receivables Trust (the "Trust"), a special purpose vehicle created for this objective. In these instances, after Peachtree performs the actuarial and financial legwork needed to purchase the policy, it transfers its interest in the policy to the Trust, but continued to receive contractual fees, although it does not hold a financial interest in or beneficially own the Trust. The Trust, on the other hand, pays the premiums on the policy while the insured remains alive in order to keep the policies in force. Upon the insured's demise, the Trust is paid the 'net death benefit' on the policy.[43]

It is worth noting the irony that insurance misrepresentations as to policy procurement (which may result in rescission of the life insurance policy) as well as the life settlement itself (which may result in the rescission of the contingent cost insurance) can hurt investors.

Reinsurance is yet another level of insurance that is affected. Reinsurance protects the life insurer against the risk of mortality miscalculation. Reinsurers also are damaged by STOLI, in that they may pay on policies that otherwise would not be in force or otherwise would lapse. The risk of a reinsurer's rejection of STOLI has propelled life insurers to take diligent steps to detect STOLI, both on the books and going forward.

What Have States Done to Regulate STOLI?

In response to the growing concern about the fraudulent activity underlying STOLI, insurance organizations have drafted model legislation, which already has been enacted by a number of states. The National Association of Life Insurance Commissions, (NAIC) proposed a model act which would impose a five-year moratorium on the sale of any policies, unless the policy owner certifies that certain conditions have changed since the time of the policy procurement, such as the terminal illness, divorce, retirement, or the death of a spouse.[44]

The National Conference of Insurance Legislators (NCOIL) also proposed a model act which imposed a moratorium against life settlement arrangements for two years following policy procurement, unless certain conditions, similar to those outlined in the

41. 549 F.3d 210, 212 (2nd Cir. 2008).
42. *Id.* at 213.
43. *Id.* at 212.
44. NAIC 697-1. The NAIC Model allows a sale after two years, provided that there is no "agreement or understanding to sell" and the owner meets certain conditions, including the payment of premiums with his own assets, and the financing of the purchase based on the policy's cash surrender value.

NAIC model, have occurred.

The NCOIL model defines and prohibits STOLI as a "practice or plan to initiate life insurance for the benefit of a third party investor who, at inception, has no insurable interest in the insured. STOLI practices include, but are not limited to, cases in which life insurance is purchased with resources or guarantees from or through a person, or entity, who, at the time of policy inception, could not lawfully initiate the policy himself or itself, and where, at the time of inception, there is an arrangement or agreement, whether verbal or written, to directly or indirectly transfer the ownership of the policy and/or the policy benefits to a third party."[45] The legislation also addresses the use of trusts which "are created to give the appearance of insurable interest, and are used to initiate policies for investors," stating that such trusts "violate insurable interest laws and the prohibition against wagering on life."[46] The NCOIL model further requires life settlement providers to report to state insurance commissioners its internal policies concerning compliance with the act. Under the NCOIL model, policy holders now should be informed that if they knowingly submit fraudulent information in an insurance application, that such conduct is criminal, and that any person damaged by any violation of the act may bring a civil damages action. Section 15 of the NCOIL Act allows an Insurance Commissioner to seek injunctive relief, and the power to levy a civil penalty for violation of the act.

Currently, at least fourteen states have enacted anti-STOLI legislation based on either the NAIC or NCOIL model acts, or have enacted legislation comprised of portions of both models.[47] Connecticut, for example, in 2008 adopted the NCOIL model, which augmented Connecticut's regulation of viatical settlements to include life settlements.[48]

No courts have yet interpreted or applied these new anti-STOLI statutes, and it is not certain how those statutes will shape future behavior. Few can argue that the statutes will not have some level of deterrence effect, whereby the statutes create private causes of action, impose civil penalties, and have the potential to make void a life settlement contract that violated the applicable statutes. Yet, fraud is almost certain to continue. Certainly while there are states with more favorable anti-STOLI legislation, or no legislation at all, one can predict arrangements which misrepresent a policy holder's true residence, a tactic utilized in the secondary market occasionally to avoid an unfavorable state statute requiring court approval of the sale of structured settlement payment rights.[49]

Conclusion

The secondary market will continue to create demand for life settlements, which may or may not harm the life insurance industry. As one author observed, "with the 'Silver Tsunami' wave of baby boomers about to crash on our shores with much more life insurance in their hands it's obvious that the stakes in this growing secondary market are very high."[50] Few dispute that where the secondary market goes so far as to play a role in the procurement of the policies themselves, such a role is harmful to the life insurance industry as well as secondary market investors.

With the recent regulation of life settlements and STOLI, it is still uncertain whether that legislation will permit and even encourage the growth of the life

45. *See, e.g.*, Conn. Gen. Stat. § 38a-465(24) (adopting NCOIL model definition of STOLI).

46. *Id.*

47. States that have enacted legislation based on the NCOIL model, or including an NCOIL definition of STOLI, include: Arizona (A.R.S. § 20-443.02), Connecticut (Conn. Gen. Stat. § 38a-465), Hawaii (H.R.S. § 431E-2), Indiana (IN Code § 27-8-19.8-7.8) Kansas (K.S.A. § 40-5002), Kentucky (K.R.S. § 304-15-020), Maine (M.R.S.A. § 6802), and Oklahoma (36 Okl St. Ann. § 4055.2). States that have enacted legislation based on the NAIC model includes North Dakota (NDCC 26.1-33.3-10). Other states have enacted anti-STOLI legislation based on various attributes of both models, or based on similar anti-STOLI concepts: Iowa (I.C.A. § 508E.2), Louisiana (LA R.S. § 22:195), Nebraska (Neb. Rev. St. § 44-1110), Ohio (R.C. § 3916.16), and West Virginia (W.Va. Code § 33-13C-11).

48. *See* Conn. Gen. Stat. 38a-465, et seq.

49. *Cf. In re: Goins*, 2002 Bankr. LEXIS 1736 (E.D. Ky. Bank. 2002) (describing how secondary market finance company encouraged annuity payee to misrepresent state of domicile to avoid application of a Kentucky statute requiring prior court approval of assignment).

50. Christ Orestis, ***Life settlements vs. STOLI: Let's get the debate straight,*** (Dec. 29, 2008), http://www.producersweb.com/r/PARA/p/pweb/articlePrint?adcID=bbd1d596f9e138acb94a9db7c8b4e96e.

settlements market, as was true following the regulation of the secondary market for structured settlement annuity payments.

What is certain is that notwithstanding anti-STOLI legislation, the burden upon life insurance companies to detect and address STOLI will continue to increase. As is true following the enactment of 46 state statutes regulating the transfer of structured settlement annuity payments, legislation does not typically provide complete protection for the insurer from risks and burdens, including the possibility of fraud and risks associated with the lack of statutory compliance. Instead, the only certainty is that the review and processing of petitions and orders concerning such transfers of annuity payments detract from the profitability of the insurance product itself. Far from a panacea to the surreptitious secondary market and related risks, the regulation has not put the insurer in the same position as if the secondary market had not existed. Similarly, too, the regulation of life settlements may turn out to be an imperfect compromise full of its own complications.

On the other hand, should insurers create favorable precedent in favor of rescission of STOLI policies, investment and securitization of life settlements—and STOLI—may decline. In contrast, legal precedent in favor of STOLI, or in favor of low standards to show insurable interest, may result in the continued and perhaps rapid growth of the life settlements market.

Many lessons already have been learned. Insurers should wish to avoid re-learning the same lessons, and develop a smarter way of dealing with similar concerns arising in parallel fields.