

Illicit Life Insurance Settlements

by
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I. PRECIS

The systematic acquisition and transfer of life insurance policies to investors without insurable interest in the insureds' lives is a controversial activity. The systems encourage illicit schemes for originating policies and transferring their benefits to speculators. Authorities are responding in three ways to deter illegitimate activity. They are reasserting insurable interest requirements; expanding the settlement prohibition period and requiring disclosures of settlement plans; and creating new statutory violations for strangers originating life insurance with unlimited time for interested parties to challenge stranger-originated policies.

II. A SHORT HISTORY OF A CONTROVERSIAL ACTIVITY

Officially condoned speculation on the investment value of life insurance policies began in 1993, when the National Association of Insurance Commissioners (NAIC) adopted its first Viatical Settlements Model Act.¹ "Living benefit" providers had been studied by insurance officials for several years. These companies—eventually called viatical settlement providers²—appeared in tandem with individuals experiencing financial difficulties due to their diagnoses of Auto

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¹ Adoption of the Model Act was controversial. Some regulators found the conduct of the viatical settlement companies "uniformly unacceptable" and advocated simple prohibition of viatical settlements. Concern was expressed by numerous insurance regulators that its adoption of the Model Act would "be perceived as legitimizing the practices of viatical settlements. The alternative would be to provide for accelerated death benefits instead of allowing any viatical settlements." 1993 Proceedings of the National Association of Insurance Commissioners (NAIC) 3d Qtr., pp. 29–30; 427–428 [hereafter "*NAIC Proceedings*"]. The Model was adopted in September, 1993 pursuant to a commitment to two groups: "(1) those states who want to ban the viatical settlement industry but cannot get it done, and want to protect consumers, and (2) the states that choose not to limit any financial activity." *Id.*, at 439. The Model Act authorized insurance regulators to promulgate rules including but not limited to regulating "the discount rates used to determine the amount paid in exchange for assignment, transfer, sale, devise or bequest of a benefit under a life insurance policy"; requiring settlement provider licensure; and applying unfair trade practices penalties for violations. NAIC Viatical Settlements Model Act (2003). The regulators immediately began development of model regulations which include minimum values to consumers for settlement of an insurance policy. See NAIC Viatical Settlements Model Regulation (2004). All NAIC Model Acts, Laws, and Regulations are available at www.lexis.com and www.naic.org.

² "A 'viaticum' in ancient Rome was a purse containing money and provisions for a journey. A viatical settlement, by which a dying person is able to acquire provisions for the remainder of his life's journey by selling his life insurance policy, is thus thought to provide a viaticum." *Life Partners v. Morrison*, 484 F.3d 284, 287 (4th Cir.), *cert. denied*, 128 S. Ct. 708 (2007).

Immune Deficiency Syndrome (AIDS).³ The question that arose from this was whether public policy would tolerate the assignment of life insurance benefits by a terminally ill policy owner to an investor for an amount substantially discounted from contract face value though exceeding the cash surrender value offered by the insurer issuing the contract. The legitimization of such activity by states adopting laws based upon the NAIC Viatical Settlements Model Act (NAIC Model Act) created a secondary market for life insurance policies, also known as the viatical settlement market.

By 1997, 20 states had adopted statutes based upon the NAIC Model Act.⁴ The enactments legitimized the transfer of insurance policies for value to persons without insurable interest, who variously held the policies as assets for their own account or moved them or their value into investment commerce. Many unanticipated consequences developed. Substantial new investment capital - both private and institutional - materialized to fund acquisition of policies and transfer their value to investors. Terminal illness as a sole justification for stranger acquisition of life insurance policies eroded. This occurred, first, to recognize a settlement justification for policy owners suffering chronic illnesses. With official recognition of a property value in the contract transferable to persons without insurable interest, however, it was quickly observed that many reasons might justify a sale of an unwanted policy—or that no reason at all was necessary if the property value of the insurance policy was the paramount public concern.⁵ The sale of a policy for a reason other than terminal or chronic illness of the owner became known as a “life settlement.”

In an effort to address burgeoning concerns, insurance regulators amended the NAIC Model Act and the National Conference of Insurance Legislators (NCOIL) adopted a similar Life Insurance Settlements Act (NCOIL Model Act) to

³ AIDS victims organized to plead with regulators “that they be allowed to sell their policies for a direct cash payment for their immediate use . . . [T]o eliminate the option of selling insurance policies would be inconsistent with [the NAIC] desire to protect the terminally ill. The proceeds from selling a policy for a cash payment made the real difference between life with dignity and life with destitution for a person with AIDS.” Testimony of W. Freeman, National Association of People with AIDS (Dec. 1992). *1993 NAIC Proceedings* Vol. 1B, pp. 786–787.

⁴ *1997 NAIC Proceedings* 4th Qtr., Vol. II, p. 763.

⁵ Settlement brokers solicited insurance producers to find policies for settlement. Inadequate policy inventory for investor demand spawned “wet ink” policies (policies obtained and quickly flipped to investor control) and other abuses. Insurers and regulators became alarmed that fundamental safeguards of insurable interest were being breached. Concern arose that unsophisticated investors were being or likely to be bilked. Questions arose whether the sale of policies should require all settlement providers to be licensed by insurance regulators or whether a tertiary market of institutional investors regulated by banking or securities officials might be exempted from insurance regulation. The dual nature of a viatical settlement was recognized as part insurance, part security. Functional regulation issues arose. *See generally 1997 NAIC Proceedings*, 3d Qtr., pp. 1211–1219; *1997 NAIC Proceedings*, 4th Qtr., Vol. II, p. 763; *1998 NAIC Proceedings*, 4th Qtr., Vol. II, pp. 609–610; *1999 NAIC Proceedings*, 2d Qtr., pp. 487–488; *2000 NAIC Proceedings*, 1st Qtr., p. 77; *2000 NAIC Proceedings*, 3d Qtr., pp. 113–114.

recommend improved supervision of insurance policy settlements.⁶ An important common characteristic of the two Model Acts was the prohibition of policy settlement for at least two years from its issue.⁷ The historical record is not clear why two years was determined to be sufficient to deter abusive settlement activity but the time period is the mirror reverse of the standard life insurance policy contestability limitation. Hence the two-year settlement prohibition period appears aligned to increase investor confidence that the propriety of a policy transfer after two years might not be challenged.

Another wave of legislation occurred increasing regulatory authority and attempting to constrain the offensive settlement activity that had arisen following the first wave of enactments. By June 2006, 27 states regulated both life settlements and viatical settlements.⁸

Today leading settlement providers are attempting to redefine insurance by re-interpreting insurance principles.⁹ There is no common ground between those seeking to preserve the values of the business of insurance from those seeking to commute insurance into investment values. The Fourth Circuit explained why:

While obvious, it must first be stated that the subject of every viatical settlement is an insurance policy. Moreover, the viatical settlement is not collateral to the policy. Rather, it modifies it, changing the parties' obligations and benefits, while yet leaving the insurance - i.e., the transfer of the specified risk - in place. At its essence, a viatical settlement is a transaction that fractures the two-part insurance contract between the insurer and the insured and creates a new tripartite arrangement (albeit not a three-party agreement) among the insurer, the insured, and the insured's assignee - the viatical settlement provider. Because of this new tripartite arrangement, each party has, with respect to the preexisting insurance contract, new or different obligations and benefits.

The insurer is faced with the newly divided obligations reflected in the interests of the insured and the viatical settlement provider. While the insured gives up her financial interest in the insurance contract, her life and the risk of her death remain the subject of the insurance contract. But now, the insurer, instead of carrying its obligation to pay on the insurance contract with an insured "who guards against possible loss and disaster to [her] as an individual," see 1 *Appleman on Insurance* § 1 (2d ed. 2006) (defining life insurance), carries its obligation with a viatical settlement provider, who hopes, for financial reasons, for the early death of the insured. The insurer must also now keep track

⁶ See NAIC Model Act (2001) and NCOIL Model Act (2000).

⁷ Cf. NAIC Model Act (2001) § 10 and NCOIL Model Act (2000) § 13.

⁸ Smith, *Acquiring life insurance portfolios: diversifying and minimizing risk*, 12 J. of Structured Finance (June 22, 2006). By April 2007, approximately 38 states had adopted a version of the NAIC Model Act or similar legislation addressing both viatical and life settlements. *Life Partners v. Morrison*, 484 F.3d 284, 288 (4th Cir.), cert. denied, 128 S. Ct. 708 (2007). Most but not all of these states' laws include the two-year settlement prohibition. See note 52 below.

⁹ "Redefining Insurance" is the trademark of Coventry First, a leading settlement provider. See note 55 below.

administratively of both the insured, whose life remains essential to the arrangement, and the viatical provider, who now must pay the insurer the premiums. Moreover, the fact that a new contract - the viatical settlement - introduces a new interested party to the arrangement raises the possibility that the insurer can become involved in legal disputes between the insured and the viatical provider.

The insurer is also faced with changed economic risks that were not factored into its calculation of premiums. Under the two-party arrangement that preexisted the viatical settlement, the insured was in a class of persons that statistically surrendered a portion of its policies or let a portion of them lapse. Insurance companies rely on these surrender and lapse rates to calculate premiums to charge for life insurance policies. The viatical provider distorts these rates, however, because it will always hold onto the policy until the insured dies in order to protect its investment. Thus, as the initial actuarial risk is distorted with each new viatical settlement, the risk-spreading profile of the insurer becomes less reflective of its initial calculations.¹⁰

III. Insurance Principles in the Settlement Mirror

The principle that ostensibly “stands at the core of a modern revolution in the life insurance industry” is that,

A life insurance contract is not one of indemnity, and so it does not require the insurable interest to continue as in the case of fire insurance, but is a mere chose in action, which may be assigned in a *bona fide* transaction as any other chose in action.¹¹

More frequently in their legislative advocacy, settlement representatives point to the holding that:

. . . life insurance has become in our days one of the best recognized forms of investment and self-compelled saving. So far as reasonable safety permits, it is desirable to give to life policies the ordinary characteristics of property.¹²

But:

A contract of insurance upon a life in which the insured has no interest is a pure wager that gives the insured a sinister counter interest in having the life come to an end. And although that counter interest always exists, . . . , the chance that in some cases it may prove a sufficient motive for crime is greatly enhanced if the whole world of the unscrupulous are free to bet on what life they choose. The very meaning of an insurable interest is an interest in having the life continue, and so one that is opposed to crime. And what, perhaps, is more important, the existence of such an interest makes a roughly selected class of persons who, by

¹⁰ *Life Partners v. Morrison*, 484 F.3d 284, 295 (4th Cir.) (applying Virginia law), *cert. denied*, 128 S. Ct. 708 (2007).

¹¹ Coventry First submission to the Maine Bureau of Insurance on July 10, 2008 pursuant to the continuing study of the secondary insurance market required by Maine Public Law ch. 543, § 7 (2008) (quoting *Aetna Life Ins. Co. v. Kimball*, 119 Me. 571, 575, 112 A. 708 (1921)).

¹² *Grigsby v. Russell*, 222 U.S. 149, 156 (1911).

their general relations with the person whose life is insured, are less likely than criminals at large to attempt to compass his death.¹³

In short, the insurance settlement revolution is based upon a gambit that investors can persuade adjudicators of any contest between an insurer and a settlement provider to reinterpret insurance statutes and case law for the benefit of investors. Insurance settlements began as an evasion of insurance laws, provoking enactment of new laws to curtail abuses. The continued growth of settlement activity is itself characterized by attempts to circumvent insurance laws, particularly the new settlement laws. Settlement providers are now attempting to invert insurance principles to justify unencumbered expansion of settlement values. Hence, the question is not whether a life insurance contract provides property value: of course it does. Rather the questions are whether insurable interest existed at the inception of the policy and whether the policy subsequently “may be assigned in a *bona fide* transaction”¹⁴

The discussion above is a good introduction to the phenomena riling the insurance markets because it is the self-proclaimed starting place of judicial authority for the settlement providers’ revolutionary initiatives. The paucity of jurisprudence positively contributing to the settlement revolution is of little deterrence to its undertaking. What the speculators lack in substantive authority for their enterprise is compensated for by their keen arbitrage of the aspirations of the law against the failures of its practical enforcement. The speculators lure transaction participants into “a maze of related entities”¹⁵ by which it becomes unclear how any became involved or who should be held liable when things go wrong. Some observers believe that fraud is intrinsic to all of the revolutionary transactions purported by investment speculators to be legitimate.¹⁶ Others see speculators exploiting vulnerabilities in insurance law, regulation, distribution, products, and pricing as creating a new “gray market” in insurance.¹⁷ The focus

¹³ *Id.*

¹⁴ *Aetna Life Ins. Co. v. Kimball*, 119 Me. 571, 576, 112 A. 708 (1921) (emphasis added).

¹⁵ *See, e.g., American General Life Ins. Co. v. Schoenthal*, 248 F.R.D. 298, 301 (N.D. Ga. 2008).

¹⁶ “There has been substantial criminal and civil litigation arising from the fraudulent activities known to occur in the viatical settlement industry. *See, e.g., Liberte Capital Group, LLC v. Capwill*, 462 F.3d 543 (6th Cir. 2006); *Wuliger v. Kelco, Inc.*, No. 3:02 CV 1348, 2006 U.S. Dist. LEXIS 561 (S.D. Ohio, Jan. 10, 2006). It has been observed that the “risk of fraud” is “somewhat common in the viaticals business.” *People ex rel. Wood v. Innovative Financial Services, Inc.*, No. D045555, 2006 Cal. App. Unpub. LEXIS 1439 (Cal. Ct. App. 4th Dist. Feb. 17, 2006) (unreported); *see also United States v. Sutherland*, 118 Fed. Appx. 911 (6th Cir. 2004) (affirming convictions of viatical schemers and rejecting argument that “the district court should have instructed the jury to consider the alleged fraudulent practices within the viatical insurance industry,” and ruling that “[t]he district court properly rejected the defendants’ ‘viatical industry’ instruction [as] [e]ssentially, the defendants asked the trial court to instruct the jury that fraud may be acceptable so long as others in the business are also committing fraud.”), *cert. denied*, 546 U.S. 877 (2005).” *First Penn-Pacific Life Ins. Co. v. Evans*, Civil No. AMD 05-444, 2007 U.S. Dist. LEXIS 45112, at *12 n.7 (D. Md. June 21, 2007).

¹⁷ *See Hetherington, et al., SPIN Life: Hedging Insurable Interest*, at <http://>

here is upon a common structure of settlement originations argued to be legitimate by the speculators despite its censure by multiple authorities.

IV. The First Official Response to the New Settlement Abuses

A. New York Rejection of the Standard Speculative Scheme

Rumors that settlement providers had developed a new practice to originate insurance policies for settlement were confirmed in 2005. New York State Insurance Department officials received inquiries regarding the validity of a life insurance policy acquired pursuant to a plan involving several agreements among different parties. The parties would include a person who would apply for and obtain ownership of a life insurance policy. The death benefit of the policy would be the key asset supporting the related agreements.¹⁸ A bank would lend funds to a client to purchase a life insurance policy pursuant to an agreement in which the client would elect one of two options after two years.¹⁹

One option would result in the policy being sold to a hedge fund for a pre-determined amount that would cover at least the outstanding debt for the premium loan plus interest. The hedge fund would contract to purchase the policy at the time of the owner's election prior to the acquisition of the policy, i.e., the time of the loan agreement. The contractual promise to the policy owner would be guaranteed by a bank for a fee paid by the hedge fund pursuant to a separate agreement between the bank and the hedge fund. The alternative option would allow the policy owner to keep the policy and repay the outstanding loan amount plus interest. No repayment of loan principal or interest would be required of the policy owner prior to the date of his or her election between the options. Death of the policy owner prior to the date of his election would result in repayment of the loan plus interest from the policy death benefit, the balance of which would be paid to the beneficiary of the policy or the client-owner's estate. The Department

www.bracewellgiuliani.com/dir_docs/news_publication/0ce5fe3a-2c5f-4ef0-8097-1e6eb77705f2_pdfupload.pdf

¹⁸ While the subject matter of the inquiry did not specify that the client obtaining the insurance policy would be elderly, the fact pattern raising general concern among insurance regulators at the time involved senior citizens being induced by third parties lacking insurable interest to originate a life insurance policy for settlement. The fact that the owner was elderly was understood to present investors the likelihood of an earlier—more profitable—payoff for their investment.

¹⁹ In New York, an insurer has two years to contest the validity of an applicant's acquisition of an insurance policy. N.Y. Ins. Law § 3203(a)(3). Virtually every jurisdiction allows a life insurer to rescind a life insurance contract within two years of the policy's issue date under certain circumstances. *See, e.g.*, Cal. Ins. Code § 10113.5 (“An individual life insurance policy delivered or issued for delivery in this state shall contain a provision that it is incontestable after it has been in force, during the lifetime of the insured, for a period of not more than two years after its date of issue”); Fla. Stat. § 627.455 (“[e]very insurance contract shall provide that the policy shall be incontestable after it has been in force during the lifetime of the insured for a period of 2 years from its date of issue”); Tex. Ins. Code § 1101.006 (“Except as provided by Subsection (b), a life insurance policy must provide that a policy in force for two years from its date of issue during the lifetime of the insured is incontestable, except for nonpayment of premiums”).

opined²⁰ that the insurance policy would be invalid for a lack of insurable interest and that the transactions would not be permissible under New York insurance law.²¹

It was realized that nothing in the settlement laws of those states adopting the NAIC Model Act (which did not include New York) would operate more successfully than re-assertion of insurable interest requirements to address the scheme proposed for legitimization. That is, the scheme was based on a policy owner election after the two-year settlement prohibition in the settlement laws. In the wake of the New York Opinion, several state insurance authorities published bulletins or other guidance re-asserting the vitality of insurable interest and other laws to forestall systematic speculator solicitation of their state residents to participate in the new scheme.²²

The Opinion did not deter speculators from replicating the elements of the scheme in numerous efforts to originate insurance policies for settlement. The basic elements of the scheme include a subordination of insurable interest concerns to the alleged superiority of property rights; evasion of the two-year settlement prohibition and the two-year contestability limitation; and the provision of financing leveraged against the death benefit to generate sufficient capital to induce persons of a certain demographic to acquire policies and then sustain premium payments until the death of the insured.²³ The complexity of the scheme was intrinsic to its nature and the necessity of evading constraints arising from insurable interest, contestability and settlement laws. The issues raised by the questions and the New York Opinion set the stage for the ongoing contest between

²⁰ New York State Insurance Department Opinion No. 05-12-15 re life insurance transactions (Dec. 19, 2005).

²¹ Especially N.Y. Ins. Law § 3205(b)(1).

²² See Alabama Insurance Department Bulletin re Zero Premium Life Insurance (6/22/07); Idaho Insurance Department Bulletin 07-03 re Stranger or Investor Owned Life Insurance Arrangements (4/2/07); Illinois Division of Insurance Consumer Alert re Stranger-Originated Life Insurance (1/2008); Louisiana Insurance Department Bulletin No. 06-05 re Authorized and Unauthorized Questions for Use on a Life Insurance Application (9/5/06); Utah Insurance Department Bulletin 2006-3 re Insurable Interest and Life Insurance (7/10/06). See also New York State Insurance Department Opinion No. 06-03-12 re Insurable Interest of an Indian Tribe in its Members (March 16, 2006) and Opinion No. 06-09-20 re Viatical Settlements (Sept. 28, 2006).

²³ For thorough analyses of the many varieties of the basic scheme, see Leimberg, *Investor Initiated Life Insurance: Really a "Free Lunch" or Prelude to Acid Indigestion?*, 41 U. Miami Heckler Inst. On Est. Planning §§ 300; 405-406 (see, especially, § 405.6-7) (2007); Kingma, *Update on Insurable Interests*, 47th Ann. Mich. Prob. & Est. Plan. Inst. 16-1 (2007); and Jensen and Leimberg, *Stranger Owned Life Insurance: A Point/Counterpoint Discussion*, ACTEC J. II (2007). See also Leimberg, *Planners Must Be Aware of the Danger Signals of "Free" Insurance*, 34 ETPL 20 (Feb. 2007); Jones, Leimberg and Rybka, *"Free" Life Insurance: Risks and Costs of Non-Recourse Premium Financing*, 33 ETPL 3 (July 2006); Leimberg, *Stranger-Owned Life Insurance (SOLI): Killing the Goose That Lays Golden Eggs*, 28 Tax Analysts/The Insurance Tax Review No. 5 (May 2005).

those who would defend traditional insurance values and those who would exploit such values to benefit investors.²⁴

B. Insurable Interest Versus Property Rights

In New York law, the term “insurable interest” means:

- (A) in the case of persons closely related by blood or by law, a substantial interest engendered by love and affection;
- (B) in the case of other persons, a lawful and substantial economic interest in the continued life, health or bodily safety of the person insured, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the insured.²⁵

This articulation embodies well-established common law principles against wagering on human life by preserving insurable interest only for those who benefit from the sustained life of the insured. Balanced against this notion is a statutory acknowledgment of a property right in an insurance policy immediately accruing to the policy owner upon policy issuance:

Any person of lawful age may on his own initiative procure or effect a contract of insurance upon his own person for the benefit of any person, firm, association or corporation. Nothing herein shall be deemed to prohibit the immediate transfer or assignment of a contract so procured or effectuated.²⁶

The inquiring New York settlement scheme promoter expressly tested the first sentence of the statute cited above with authority of the second sentence, citing judicial authority upholding the insurable interest of premium financiers. The New York regulators instead adopted the view that the plan in its entirety involved the procurement of insurance solely as a speculative investment for the ultimate benefit of a disinterested third party.²⁷

The tension between the public policy requiring insurable interest based on concern for the protection of life versus the recognition that an insurance policy also has property value that might be immediately assigned to a party lacking insurable interest is a common theme to the public debate arising in all states where settlement legislation is introduced. The property rights argument swings on two hinges, one on either side of the settlement transaction. The hinge on the

²⁴ It was upon this stage that the NAIC would again take action to amend its Model Act to defend the insurance system against the proposed new settlement practice by establishing new bright line tests of transactional legitimacy. *See* Part V.A below. Reaction to the NAIC initiative led to an alternative new NCOIL Model Act that created a third set of criteria for distinguishing illicit settlements, in part by supplementing and expanding existing insurable interest principles. *See* Part V.C below.

²⁵ New York Ins. Law § 3205(a)(1).

²⁶ New York Ins. Law § 3205(b)(1).

²⁷ Rather than being disinterested, the third party in fact would have a financial interest in the early demise of the insured precisely contrary to the public policy against misuse of insurance for wagering on human life.

insurance side is related to premium financing, i.e., whether non-recourse financing of premium in fact imbues a property right to the person with apparent insurable interest even though that person has paid nothing for the property of the insurance policy. The hinge on the settlement side is whether ownership title to the property of the insurance contract is, in fact, “quieted” upon its transfer to persons lacking insurable interest, thus rendering it suitable for investment commerce.

C. Legitimate Versus Predatory Financing of Premium

As support for the legitimacy of the proposed scheme, the New York inquirer pointed to the holding in *Hota v. Camaj*,²⁸ that the complaint was properly dismissed for failing to state a claim in light of the legal assignment of the policy as security from a loan from the defendant to the decedent giving the creditor an insurable interest in the decedent’s life. The *Hota* opinion does not clearly reveal whether the loan was for a purpose other than funding premium or whether it was secured by assets other than the policy. But the regulators distinguished *Hota* from the proposed scheme in an important manner:

In *Hota*, the court noted that the assignee of the policy did in fact possess an insurable interest in the life of the decedent by virtue of the fact that the assignee therein was a creditor of the decedent. In the proposed transaction, the Loan Providers will be the creditors of the Clients, but the indebtedness exists only in connection with the purchase of the insurance. Thus, theirs is “. . . an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the insured” under N.Y. Ins. Law § 3205(a)(1)(B).²⁹

The request to elevate the property interest of creditors fails because the extent of a creditor’s own insurable interest is limited *not* by the amount of the loan but rather by the fundamental insurable interest test of whether the creditor expects his or her interest will be enhanced in value by the death of the insured.³⁰ Further,

²⁸ 299 A.D.2d 453, 750 N.Y.S.2d 119 (2002).

²⁹ New York State Insurance Department opinion re life insurance transactions (Dec. 19, 2005) n.1.

³⁰ See, e.g., *Walker v. Walbridge*, 151 Misc. 329, 271 N.Y.S. 473, 481 (N.Y. Sup. Ct. Erie County 1934) (“It may be stated generally, however, to be such an [insurable] interest, arising from the relations of the party obtaining the insurance, either as a creditor of or surety for the assured . . . as will justify a reasonable expectation of advantage or benefit from the continuance of his life.”) (quoting *Warnock v. Davis*, 104 U.S. 775, 779 (1881)). See generally 69 N.Y. Jur. 2d, *Insurance*, § 898, at 319; see also *New York Life Ins. Co. v. Baum*, 700 F.2d 928, 934–935 (1983) (applying New York law in determining whether a creditor has an insurable interest in a debtor’s life). “The importance of careful examination of the factual bases of the cases that address the issue of a creditor’s insurable interest is illustrated by the development of the rule in New York. In *New York Life Ins. Co. v. Baum*, the Fifth Circuit . . . pushed the law of New York beyond the actual holding of the New York case on which it relied, (*) stating that . . . a creditor whose debt has been paid after the creditor obtained the policy on the life of the debtor may still recover the proceeds from the life insurance contract. The rule announced in *Baum*, that a creditor has an insurable interest in the life of a debtor, as a matter of law, is certainly the law of New York, and probably every other state, but *Baum*’s application of the rule goes beyond this, because a creditor-debtor relationship existed between *Baum* and the debtor at the time the policy was executed, and *Baum* loaned the

the legitimacy of circumstances when a lender, with the consent of a client, applies to an insurer to obtain a life insurance policy on the life of the client to secure the loan to the client is easily distinguished because the transaction itself is transparent to the insurer, which can then successfully underwrite the risk.³¹

It was not long before the New York Department Opinion was judicially validated. In *Life Product Clearing LLC v. Angel*,³² a federal district court applying New York law observed the importance of testing the procurement of a policy for good faith because “Only one who obtains a life insurance policy on himself ‘on his own initiative’ and in good faith—that is, with a genuine intent to obtain insurance protection for a family member, loved one, or business partner, rather than an intent to disguise that would otherwise be a gambling transaction by a stranger on his life—may freely assign the policy to one who does not have an insurable interest in him.”³³ Hence, even for New York and other states statutorily establishing the policy owner’s right to “immediately” transfer or assign a life insurance policy, the *bona fides* of the assignment will be tested against the good faith of the contract as one of *insurance* obtained to protect or benefit those with insurable interest.

It is the transparency of the lender’s application and the nature of security sought from the insurer’s issuance of a life insurance policy that imbues the responsibility for testing insurable interest upon the insurer.³⁴ As discussed below, concerns with current premium financing practices are inspiring legislators to

majority of the funds to the debtor *after the policy went into effect*. None of the New York cases cited dealt with what constitutes an insurable interest in a situation in which the creditor made a loan *after* the policy was issued, yet *Baum* will no doubt be hereafter cited as authority for the proposition that, in New York, the creditor takes all, and that advances subsequent to the issuance of the policy validate it.” 28 *Appleman on Insurance* 2d § 174.07[A], (* footnote omitted).

³¹ *Alperstein v. National City Bank of New York*, 201 Misc. 47, 103 N.Y.S.2d 930 (New York City Mun. Ct. 1951).

³² 530 F. Supp. 2d 646, 653 (S.D.N.Y. 2008).

³³ *Id.* at 653 (citations omitted; emphasis added). The court expressly cited the New York Insurance Department Opinion approvingly, noting that “courts will uphold the interpretations of an agency charged with administration of a statute if the interpretations are not unreasonable or irrational.” (*Id.* at 655 n. 6, citations omitted.) The assignment of the policy contested by the estate in *Angel* included elements of the speculative scheme rejected by the Department, i.e., inducement to the policy applicant to enter into a transaction for the benefit of a stranger lacking insurable interest; policy financed by a stranger lacking insurable interest; misuse of a remote vehicle (in *Angel*, a trust) to guarantee settlement payment to the policy owner and also guaranteeing control of the policy to the investor.

³⁴ The insurer must exercise its responsibility because its negligence or intentional disregard of duty will estop the insurer from raising the lack of insurable interest as a defense to a claim even when insurable interest is, in fact, missing at the inception of policy. *Holmes v. Nationwide Mut. Ins. Co.*, 40 Misc. 2d 894, 244 N.Y.S.2d 148 (N.Y. Sup. Ct. Broome County 1963). There is, however, contrary authority in some states. *See, e.g., Bell v. National Life & Accident Ins. Co.*, 41 Ala. App. 94, 123 So. 2d 598 (1960) (“[T]he doctrine of estoppel will not apply to make enforceable that which is illegal and void in its inception.”).

provide more mechanical tests of the legitimacy of settling insurance policies to strangers.³⁵

D. Quieting Title to Contract Benefits: Incontestability Versus Insurable Interest

An important aspect of the speculative plan proposed to New York insurance officials for legitimization is the omission of whether the insurer was to be apprised of the full scope of the plan itself. The omission goes to the heart of whether the investors might be able to secure ownership of the policy or policy benefits in sufficient time to realize their investment goals. Inasmuch as the schedule of the proposed plan recognized the need for a minimum two-year time frame, the commensurate statutory incontestability limitation was clearly anticipated as an obstacle, with the further implication that the speculators did not likely intend to disclose the full plan to the insurer.

That is, in New York, as in most states, the law requires that a policy be incontestable after it has been in force during the lifetime of the insured for two years from its date of issue.³⁶ In most circumstances and in most states, the incontestability limitation will bar an insurer from rescinding a policy issued to an applicant after two years, even in circumstances where the applicant perpetrates a fraud against the insurer.³⁷ A leading insurance law commentator provided to the Massachusetts Supreme Judicial Court in *Protective Life Ins. Co. v. Sullivan* a historically useful public policy rationale for firm incontestability statutes existing in 1981:

“There are conflicting forces of public policy which affect the matter of contestability. If an applicant chooses to gamble when he seeks a policy of life insurance, he may be guilty of outrageous fraud, and if the insurer fails to uncover such fraud within the contestable period he has been successful. Even if he makes such discovery in time, he receives back his premiums so that he has suffered no loss. On the other hand, only a miniscule percentage of the population ever resorts to such devious conduct, and it is considered desirable to have a cutoff time as to ordinary misrepresentations for two reasons: first, to lighten the burden upon the courts, since litigation otherwise could be increased manifold; second, since most contests would arise after the insured’s death, a beneficiary is in a deplorable condition to wage battle with a large insurer over statements which may have been made years earlier. For these reasons, it is better to countenance the occasional risk of fraud in order to bring an end to the

³⁵ The NAIC approach and NCOIL approach are discussed in Part V below.

³⁶ 29 Appleman on Insurance 2d § 178.03[A]. Forty-three states now have statutes requiring incontestability of life insurance policies. See 29 Appleman on Insurance 2d § 178.03 n. 172 for a list of the states and relevant statutes.

³⁷ *Protective Life Ins. Co. v. Sullivan*, 425 Mass. 615, 682 N.E.2d 624, 628–634 (1997) (AIDS victim successfully manipulated the incontestability doctrine to viaticate a fraudulently obtained life insurance policy on his own life).

controversy.”³⁸ 1A J.A. Appleman & J. Appleman, *Insurance Law and Practice* § 311, at 305–306 (1981).³⁸

While perhaps only a “miniscule percentage” of the population ever resorted to “outrageous fraud” upon insurers in years prior to 1981, by 1997 insurance regulators were alarmed at the amount of fraud being generated by viatical settlement providers and, by 2007, “pervasive fraud” was the concern of the day.³⁹

The firm nature of the incontestability limitation provides investors substantial comfort that the assignment of a policy to them after two years following issuance entitles them to its benefits. The remaining challenge for speculators, then, is whether the lack of insurable interest in the origination of the policy jeopardizes clear title for purposes of securitizing or otherwise selling the policy or its benefits into investment commerce. It is a substantial challenge because “an incontestable clause in an insurance contract does not bar the defense of a lack of insurable interest.”⁴⁰ Because insurable interest concerns arise from public policy condemnation of wagers on life rather than on the insurer’s contract rights, discovery of the lack of insurable interest can invalidate the insurance contract at any time.⁴¹

Speculators attack insurable interest by stepping the evidence of the false origination away from the time of application for the policy. The complexity of the scheme of arrangements and agreements proposed to the New York regulators was not coincidental. Rather, the arrangements of ancillary financing agreements, trusts, guarantees, and cross-indemnifications are designed to elude sound underwriting by the insurer and confound evaluation of the propriety of the related activities.

E. Evidentiary Problems of Relying Upon Insurable Interest to Defend the Insurance System

The official legitimization of some secondary insurance settlements undermines the general efficacy of the insurable interest defense by raising new evidentiary

³⁸ *Id.* at 629, 682 N.E.2d at 629.

³⁹ *See* note 55 below.

⁴⁰ *Beard v. The American Agency Life Ins. Co.*, 314 Md. 235, 259, 550 A.2d 677 (1988). Two states are exceptions to this rule. In New York and Michigan, raising lack of insurable interest as a defense to a claim beyond two years is barred by contestability limits. *See New England Mut. Life Ins. Co. v. Caruso*, 73 N.Y.2d 74, 83, 538 N.Y.S.2d 217, 535 N.E. 2d 270 (1989) (“[I]nequity may be avoided, and the public purpose underlying the insurable interest requirement implemented, by a rule which encourages the insurer to investigate the insurable interest of its policyholders promptly within the two-year [contestable] period.”); *Bogacki v. Great-West Life Assur. Co.*, 253 Mich. 253, 234 N.W. 865 (1931) (defense against policy claim payment grounded in lack of insurable interest cannot be raised after contestable period because the specified exceptions to the incontestability statute did not include insurable interest).

⁴¹ *See* 44 C.J.S. *Insurance* § 352 (2007) (“A policy issued to a person who has no insurable interest is void, from its inception, and is not rendered valid by a clause declaring it incontestable after lapse of a specified period of time.”); 44 Am. Jur. 2d *Insurance* § 767 (2003) (“An insurance policy which is invalid as being violative of public policy cannot be validated by the agreement of the parties that it shall be incontestable after a stated time.”).

requirements for insurers. In *Sun Life Assurance v. Paulson*,⁴² the federal court acknowledged that defendant “Paulson, at the time he obtained the . . . Policy, intended to sell it to a third party after expiration of the contestability period.”⁴³ Paulson, in fact, did sell it to a third party settlement provider shortly after the contestability period expired, and it was only upon the policy transfer did the insurer ascertain Paulson’s intent to settle the policy from its inception. The insurer then acted to rescind the policy on 10 different theories of action, all of them predicated on an initial claim that Paulson did not have an insurable interest and the policies were hence void *ab initio*. In its pleadings, however, the insurer did not identify with specificity the third party. Upon this omission the court found itself confronted with an unresolved issue of state law, namely whether allegation of a defendant’s intent to settle a policy to a third party at inception of the policy is sufficient to sustain a complaint that the policy should be invalidated.

Like the court in *Angel*, the court in *Paulson* acknowledged that assignments must be made in good faith and not intended to circumvent the law to be upheld. But unlike the court in *Angel*, the court in *Paulson* found “[t]he 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.’”⁴⁴ The court dismissed the insurer’s complaint for lack of specificity in failing to allege the identity of the third party or the mutual intent of the third party and the defendant to circumvent the law.⁴⁵ The result is an invitation to persons who lack a genuine interest in obtaining insurance to misuse their apparent insurable interest to obtain an insurance contract for speculation.⁴⁶

In the decades preceding the legitimization of an investment market for insurance contracts it was unlikely for an individual to risk his own capital to fund premiums for a policy in the hope that he might find a buyer willing to pay a value exceeding cash surrender value for the policy. Only if he found an investor prior to application was he assured of a market for the policy—and the finding of that particular investor ran the risk of the invalidation of the policy for a want of

⁴² Civ. No. 07-3877, 2008 U.S. Dist. LEXIS 11719 (D. Minn. Feb. 15, 2008).

⁴³ *Id.*, 2008 U.S. Dist. LEXIS 11719, at *2.

⁴⁴ *Id.*, 2008 U.S. Dist. LEXIS 11719, at *6. In so finding, the court relied on 44 Am. Jur. 2d *Insurance* § 1000 (2003), which stated “[A]ssignments made in bad faith and intended to circumvent the law, as where there was a preconceived agreement that the policy was to be assigned, will not be upheld.”

⁴⁵ The court stated, “[A] court will dismiss a complaint pursuant to Federal Rule of Civil Procedure 12(b)(6) for failing to state a claim upon which relief can be granted if, after taking all facts alleged in the complaint as true, those facts fail ‘to raise a right to relief above the speculative level.’ *Bell Atlantic Corp v. Twombly*, 127 S. Ct. 1955, 1965 (2007).” *Sun Life Assur. Co. v. Paulson*, Civ. No. 07-3877, 2008 U.S. Dist. LEXIS 11719, at *3 (D. Minn. Feb. 15, 2008).

⁴⁶ See *First Penn-Pacific Life Ins. Co. v. Evans*, Civil No. AMD 05-444, 2007 U.S. Dist. LEXIS 45112, at *12 n. 7 (D. Md. June 21, 2007) (insurer motion to dismiss denied in circumstances where “[t]here is no evidence that anyone other than [the insured] was a participant in the scheme at the time [the insured] obtained the First Penn policy”).

insurable interest. But today a ready market of investors exists, relieving a person willing to give a stranger a contract on her life from the need to know up front the identity of the stranger.

F. Practical Problems of Relying Upon Insurable Interest to Defend the Insurance System

There are several practical problems with regard to relying upon insurable interest to defend the integrity of the insurance system from systematic attack by investors, even though the public policy against wagering on life is intact today.⁴⁷

⁴⁷ Almost every state justifies its insurable interest laws as needed to prevent strangers from wagering on the life of the insured. *See, e.g.:*

Alabama: *Brewton v. Ala. Farm Bureau Mut. Cas. Ins. Co.*, 474 So. 2d 1120, 1122 (Ala. 1985); *see also Bell v. National Life & Accident Ins. Co.*, 41 Ala. App. 94, 123 So. 2d 598 (1960) (“[T]he doctrine of estoppel will not apply to make enforceable that which is illegal and void in its inception.”);

Alaska: *State Farm Auto. Ins. Co. v. Raymer*, 977 P.2d 706, 710 (Alaska 1999) (insurable interest prevents insurance contracts from being used as a means of wagering);

Arkansas: *Corning Bank & Trust Co. v. Foster*, 74 S.W.2d 797, 800 (Ark. 1934) (“a wagering contract of insurance is contrary to public policy, and void”);

California: *Jimenez v. Protective Life Ins. Co.*, 8 Cal. App. 4th 528, 536 (1992) (if there is no insurable interest “the policy is a mere wager on the life of the person insured, and . . . void as against public policy”);

D.C.: *Watson v. Mass. Mut. Life Ins. Co.*, 140 F.2d 673, 676 (D.C. Cir. 1943) (purpose of an insurable interest is “to limit [the] speculative business of buying and selling insurance . . . on the lives of others”);

Delaware: *Baltimore Life Ins. Co. v. Floyd*, 91 A. 653, 656 (Del. 1914) (“insurance procured upon a life by one or in favor of one under circumstances of speculation or hazard amounts to a wager contract and is therefore void”);

Florida: *Life Ins. Co. of Georgia v. Lopez*, 443 So. 2d 947, 950 (Fla. 1983) (in “the absence of an insurable interest, the law condemns such policies as mere wagering contracts”);

Georgia: *Burton v. John Hancock Mut. Life Ins. Co.*, 164 Ga. App. 592, 594–595, 298 S.E.2d 575, 578 (1982) (“‘wager’ contracts procured on another by a beneficiary having no ‘insurable interest’ . . . in the life of the insured are void”);

Illinois: *Colgrove v. Lowe*, 343 Ill. 360, 175 N.E. 569 (1931) (“contract of insurance upon a life in which the [owner] has no interest is a pure wager, that gives the [owner] a sinister counter-interest in having the life come to an end”);

Indiana: *Salem Lodge No. 21, F. & A. M. v. Swails*, 209 Ind. 347, 352, 197 N.E. 837, 839 (1935) (a policy . . . taken out by one upon the life of another when [there is] no insurable interest in the life [is] . . . violative of public policy);

Iowa: *Hult v. Home Life Ins. Co.*, 213 Iowa 890, 908–909, 240 N.W. 218, 227 (1932) (a life insurance contract must be based upon an insurable interest, in the absence of which it becomes a wager contract and void);

Kansas: *Geisler v. Mut. Benefit Health & Accident Ass’n*, 163 Kan. 518, 523, 183 P.2d 853, 857 (1947) (contracts are against public policy if (a) “they are . . . wagering in character and (b) . . . afford an incentive to crime”);

Kentucky: *Ficke v. Prudential Ins. Co.*, 305 Ky. 172, 175, 202 S.W.2d 429, 431 (Ky. 1947) (“the

First, the ostensible bright line that only those with an interest “engendered by love and affection” in the continued life of the insured rather than “. . . an interest

lack of an insurable interest creates . . . wager policies, which are invalid”);

Louisiana: *Adam Miguez Funeral Home, Inc. v. First Nat'l Life Ins. Co.*, 234 So. 2d 496, 499 (La. Ct. App. 3d Cir. 1970) (“the public policy purpose of requiring an insurable interest is to prevent wagering contracts on insurance risks”);

Maine: *Getchell v. Mercantile & Mfrs.' Mut. Fire Ins. Co.*, 109 Me. 274, 277, 83 A. 801, 802 (1912) (“Wagering policies are forbidden as against public policy”);

Maryland: *Hopkins v. Hopkins*, 328 Md. 263, 271, 614 A.2d 96, 100 (Ct. App. 1992) (the “requirement of insurable interest was intended to prevent wagering on human lives”);

Michigan: *Hicks v. Cary*, 332 Mich. 606, 609, 52 N.W.2d 351, 354 (1952) (“a life insurance policy naming as beneficiary one who has no insurable interest in the life of the assured is a wagering contract, void as against public policy”);

Missouri: *Estate of Bean v. Hazel*, 972 S.W.2d 290, 292 (Mo. 1998) (“one must have an insurable interest in a person’s life in order to take out a valid policy of insurance on that person’s life”);

New Hampshire: *Mechanics' Nat'l Bank v. Comins*, 72 N.H. 12, 15, 55 A. 191, 193 (1903) (“insurance procured by one person upon the life of another, the former having no insurable interest in the latter, was void as a wager contract”);

New York: *Scarola v. Ins. Co. of N. Am.*, 67 Misc. 2d 437, 438, 323 N.Y.S.2d 1001 (N.Y. App. Term 1971) (the “vice sought to be avoided by requiring insurable interest is to prevent the insurance policy from becoming a wagering contract”);

North Carolina: *Wharton v. Home Sec. Life Ins. Co.*, 206 N.C. 254, 256, 173 S.E. 338, 339 (1934) (“a person cannot take out a . . . policy of insurance for his own benefit on the life of a person in which he has no insurable interest”);

Ohio: *Westfall v. Am. States Ins. Co.*, 43 Ohio App. 2d 176, 178, 334 N.E.2d 523, 525 (1974) (a “wager policy” is one in which the insured has interest only in the loss or destruction of the property” or thing insured);

Oklahoma: *Delk v. Markel Am. Ins. Co.*, 81 P.3d 629, 634 (Okla. 2003) (the “insurable interest requirement was to prohibit wagering contracts in the guise of insurance”);

Oregon: *Brett v. Warnick*, 44 Or. 511, 519, 75 P. 1061, 1063–64 (1904) (“before one can be permitted to take out a policy of insurance upon the life of another for the former’s benefit he must have an insurable interest in the life of the latter”);

Pennsylvania: *Van Cure v. Hartford Fire Ins. Co.*, 435 Pa. 163, 166, 253 A.2d 663, 664 (1969) (“insurable interest is founded upon the public policy against wagering”);

South Carolina: *Warren v. Pilgrim Health & Life Ins. Co.*, 217 S.C. 453, 456, 60 S.E.2d 891, 893 (1950) (“one cannot obtain valid insurance upon the life of another in whom he has no insurable interest”);

Tennessee: *Duncan v. State Farm Fire & Cas. Co.*, 587 S.W.2d 375, 376 (Tenn. 1979) (finding an insurable interest “essential” or “the contract amounts to no more than a wager and is void”);

Texas: *Cheeves v. Anders*, 28 S.W. 274, 276, 87 Tex. 287, 291 (Tex. 1894) (it “is against public policy for one to be interested in the death of another when he has no interest in the continuance of his life”);

Virginia: *Green v. Southwestern Voluntary Ass'n*, 179 Va. 779, 785, 20 S.E.2d 694, 696 (1942) (“it has long been held that in the absence of an insurable interest, a policy on the life of another is contrary to public policy and cannot be enforced”);

Washington: *Buckner v. Ridgely Protective Ass'n*, 131 Wash. 174, 181–182, 229 P. 313, 316 (1924).

which would arise only by, or would be enhanced in value by, the death, disablement or injury of the insured” is fact-specific, especially in light of the ready assignability of the policy pursuant to its collateral property value. That is, some party—regulator, insurer, natural beneficiary, or estate of the deceased insured—must stand ready to press the principle of insurable interest to defend the principal of the death benefit from being paid to an assignee-claimant lacking insurable interest. As a leading commentator observed:

“[T]he predominant common law rule is that only the insurer may raise the issue of lack of an insurable interest, even to the exclusion of the estate of the insured. (Footnote omitted). Barring any one other than the insurer from enforcing the insurable interest requirement seems to be inconsistent with the concept of requiring some interest in the continued existence of the insured. Since the insurer issued the policy in the first place, it would seem ill-positioned to be the one to raise the defense, although most jurisdictions hold that, because of the public policy involved, the insurer may not be deprived of this defense by waiver or estoppel.”⁴⁸

The paradox of the insurable interest laws relying upon the insurer for enforcement—despite the laws being recognized as protecting *public* policy against wagers on life—makes sense to the degree the insurer carefully underwrites the risk, and also to the degree the insurer will know for sure who presents the policy for payment of its benefits upon the death of the insured. Even then, the insurer may hesitate to risk a bad-faith action for resisting the claims payment.⁴⁹

The insurable interest laws have not relied upon regulators for enforcement but, as will be seen, the settlement laws are changing to expand regulation of policy transfers in a manner inviting regulatory determinations of insurable interest. Similarly, even though natural beneficiaries of the insured may not even be aware of the insured’s acquisition of an insurance policy and its subsequent transfer or assignment of benefits, there is a growing recognition of the standing of such parties to help police insurable interest.⁵⁰

Moreover, insurers have little incentive to resist paying the death benefit to any claimant when invalidation of the policy for the want of insurable interest results

⁴⁸ 28 Appleman on Insurance 2d § 174.02[F]; *see also* 28 Appleman on Insurance 2d § 174.10[A].

⁴⁹ *See generally* 30 Appleman on Insurance 2d § 183.02 (Life Insurer’s Liability for Bad Faith in Payment or Settlement of Claims).

⁵⁰ A minority of jurisdictions hold that any “interested parties . . . [may] question the lack of an insurable interest.” P.N. Swisher, *Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, Drake Law Review 536 (Winter 2005). Even in states which historically have followed the majority rule, “it is . . . [no longer] uncommon for a court to consider . . . [insurable interest] regardless of the party who raises the issue.” Cohen & Gerber, *Understanding Insurance Law* § 34.02 in Martinez, Mayerson & Richmond, *New Appleman Insurance Law Practice Guide*. *See also* *Willingham v. United Ins. Co.*, 628 So. 2d 328 (Ala. 1970); *Cundiff v. Cain*, 707 So. 2d 187 (Miss. 1998).

not in its rescission but merely payment to a substituted party.⁵¹ There may even be diminished inclination to rescind a policy for lack of insurable interest if the rescission permits a return of the *status quo ante* since the *status quo ante* typically requires repayment of premium plus interest, thereby failing to return the insurer the costs of its marketing, production and contract administration.

Then there are the hazards arising from the temptations of the gray market. Wrongfully induced policy applications may offer a prospect of several years of large premium payments, creating moral hazard for producers and insurers in the primary market. Insurers may be enticed to issue policies predestined to investors to inflate quarterly financial returns to enhance stock market performance, sell a block of business or an entire company, or otherwise game the insurance system by securitizing or reinsuring problematic policies. Producers may be enticed by the extraordinary commissions paid to settlement brokers to settle perfectly good policies for the settlement commission, and tempted again to replace settled policies with new policies.

Finally, modern financiers have calculated the discount rate for ignoring insurable interest, and it is sufficiently cheap as to encourage violation of the laws. That is, failure to respect insurable interest generally results in rescission of insurance policy with repayment of the premium plus interest to the policy owner. There is no criminal penalty imposed for intentional violation of insurable interest law; there are no damages recoverable by the insurer or society itself. The downside of a detected scheme and rescinded policy is merely receipt of returned premium plus interest. Such a deal for violating the law is hard to beat; indeed, the downside operates as a hedge or guarantee for investors. The economics of insurable interest violation are win-win for investors, contributing greatly to systematic attack of the insurance system by investors employing a mercenary army of individuals willing to trade upon their apparent personal insurable interest.

New York in 2005 responded to the attempt to legitimize a system of investor acquisition of insurance value applying existing statutes, insurable interest precedents and a traditional lexicon to describe the parties and the transactions. The consensus of most insurance regulators was that existing laws were inadequate to address the new system of speculation proposed for legitimization.

V. The Second Official Response to the New Settlement Abuses

A. The NAIC Model Act (2007) Generally

Even while New York was reasserting the vitality of insurable interest laws to

⁵¹ For example, “If the beneficiary, assignee or other payee under any contract made in violation of this subsection [“Insurable interest in the person; consent required; exception”] receives from the insurer any benefits thereunder accruing upon the death, disablement or injury of the person insured, the person insured or his executor or administrator may maintain an action to recover such benefits from the person receiving them.” New York Ins. Law § 3205(b)(4). *See also, e.g.,* Fla. Stat. § 627.404(4).

defend against speculator attempts to originate life insurance policies, the National Association of Insurance Commissioners undertook a fourth effort to regulate life insurance settlements faced with evidence that previous attempts had proven ineffective.⁵² Some life settlement providers were resisting multi-state

⁵² The first attempt was in 1993; the second in 1998; and the third was in 2000. See *Proceedings of the NAIC* for 1993, 3d Quarter 435–439; 1998, 1st Quarter 701–706; and 2000 4th Quarter 103. The NAIC catalogs the following states as having statutes based upon one or another version of the NAIC Model:

Alaska: Alaska Admin. Code tit. 3 §§ 31.300 to 31.449; Alaska Stat. § 21.89.155;

Arizona: Ariz. Rev. Stat. § 20-443.02;

Arkansas: Ark. Code Ann. §§ 23-81-501 to 23-81-512; *see also* Arkansas Bulletin 13-97 (1997);

California: Cal. Ins. Code §§ 10113.1 to 10113.2;

Colorado: Colo. Rev. Stat. §§ 10-7-601 to 10-7-620, 11-51-201 (Investments);

Connecticut: Conn. Gen. Stat. §§ 38a-465 to 38a-465m;

Delaware: Del. Code Ann. tit. 18 §§ 5701 to 5711; 2005 D.C.L.B. 953 (2006);

Florida: Fla. Stat. §§ 626.991 to 626.99295, § 517.021 (Investments);

Georgia: Ga. Code. Ann. §§ 33-59-1 to 33-59-18, 10-5-2, 10-5-12 (Investments);

Hawaii: Haw. Public Act 177 (2008);

Idaho: Idaho Bulletin 2007-3 (2007);

Illinois: 215 Ill. Comp. Stat. 158/1 to 158/99;

Indiana: Ind. Code §§ 27-8-19.8-1 to 27-8-19.8-26, 27-1-12-44;

Iowa: Iowa Ins. Code § 508E.2; Iowa Admin. Code §§ 191-48.1 to 191.48.13;

Kansas: Kan. Stat. Ann. §§ 40-5001 to 40-5016;

Kentucky: Ky. Rev. Stat. §§ 304.15-020, 304.15-700 to 304.15-725;

Louisiana: La. Rev. Stat. Ann. §§ 22:191 to 22:200;

Maine: Me. Rev. Stat. Ann. tit. 24-A §§ 6801 to 6819; *see also* Me. Rev. Stat. Ann. tit. 32 § 10501 to 10504, § 10607-A (Related to viatical investments);

Maryland: Md. Ann. Code Ins. §§ 8-601 to 8-611;

Massachusetts: Mass. Gen. Laws ch. 175 §§ 212 to 223; 940 Mass. Code Regs. §§ 18:01 to 18:08;

Michigan: Mich. Comp. Laws §§ 550.521 to 550.528;

Minnesota: Minn. Stat. §§ 60A.961 to 60A.974;

Mississippi: Miss. Code Ann. §§ 83-7-201 to 83-7-223;

Montana: Mont. Code Ann. §§ 33-20-1301 to 33-20-1317;

Nebraska: Neb. Rev. Stat. §§ 44-1101 to 44-1116;

Nevada: Nev. Rev. Stat. §§ 688C.010 to 688C.510; *see* Nev. Bulletin 2006–007;

New Jersey: N.J. Rev. Stat. § 17B:30B-1;

New Mexico: N.M. Stat. Ann. §§ 59A-20A-1 to 59A-20A-11;

New York: N.Y. Ins. Law § 3220(6)(A), §§ 7801 to 7810; *see also* New York Admin. Code tit. 11 §§ 380.1 to 380.10 (Regulation 148); New York Op. Gen. Counsel 11-6-2006;

North Carolina: N.C. Gen. Stat. §§ 58-58-200 to 58-58-310 (Insurance law), 78A-2, 78A-13 to

licensing and other requirements such as providing minimum settlement value to sellers of insurance policies in states where the seller resided.⁵³ Others were resisting functional regulation by insurance authorities.⁵⁴ The New York Attorney General had commenced an investigation which would produce a complaint alleging that the entire life settlements business exhibited “pervasive fraud.”⁵⁵ It was clear that efforts by insurance regulators and legislators had not disciplined secondary life insurance market activity despite enactment of laws similar to the existing NAIC Model Act in 38 states.⁵⁶ Galvanized by the settlement activity

78A-14 (2002) (Securities law); *see also* N.C. Gen. Stat. §§ 78A-17, 78A-27, 78A-49, 78A-56 (1925/2002) (Investments);

North Dakota: N.D. Cent. Code §§ 26.1-33.3-01 to 26.1-33.3-17;

Ohio: Ohio Rev. Code Ann. §§ 3916.01 to 3916.2;

Oklahoma: Okla. Stat. tit. 36 §§ 625.1, tit. 36 §§ 4041 to 4096;

Oregon: Or. Rev. Stat. §§ 744.321 to 744.358;

Pennsylvania: Pa. Stat. Ann. §§ 40-38-201 to 40-38-214;

South Dakota: S.D. Codified Laws §§ 47-31A-401 to 47-31A-402 (Regulated as a security);

Tennessee: Tenn. Code Ann. §§ 56-50-101 to 56-50-111;

Texas: Tex. Ins. Code §§ 1111.001 to 1111.06; Tex. Bulletin B-0026-07 (2007);

Utah: Utah Code Ann. §§ 31A-36-101 to 31A-36-119, 31A-21-104 (Insurable interest), 31A-23-221 (Licensing requirement);

Vermont: Vt. Stat. Ann. tit. 8, §§ 3826 to 3834;

Virginia: Va. Code §§ 38.2-6000 to 38.2-6016, 38.2-1865.1 (Licensing of brokers);

Washington: Wash. Rev. Code Ann. §§ 48.102.005 to 48.102.901;

West Virginia: W. Va. Code §§ 33-13C-1 to 33-13C-18;

Wisconsin: Wis. Stat. § 632.68; Viatical Settlement Model Act, NAIC Model Laws, Regulations and Guidelines, vol. 4, p. 697-1 (2008) (updated by author with enactments subsequent to April 2008).

⁵³ *See, e.g.,* Life Partners, Inc. v. Morrison, 484 F.3d 284 (4th Cir.), *cert. denied*, 128 S. Ct. 708 (2007).

⁵⁴ *See, e.g.,* National Viatical v. Oxendine, No. 1:05-CV-3059-TWT, 2006 U.S. Dist. LEXIS 25851 (N.D. Ga. Apr. 20, 2006) (applying Georgia law), *aff'd*, 221 Fed. Appx. 899 (11th Cir. 2007).

⁵⁵ *See* People of the State of New York v. Coventry (New York Supreme Court No. 404620/06 filed Oct. 2006; denial of motion to dismiss and reinstatement of action for common-law fraud Ordered by Supreme Court Appellate Division at 2008 N.Y. Slip Op. 05548 (June 17, 2008)). The New York findings were corroborated by similar findings by insurance officials in Florida Office of Insurance Regulation v. Coventry (Order Show Cause No. 88270-06, resolved October 2007) (Order requires Coventry pay Florida \$1.5m plus submit to special compliance audits until 2009 as well as specially report all Florida resident transactions quarterly and more).

⁵⁶ A few weeks before the insurance commissioners made their final decisions on the NAIC Model Act, the Fourth Circuit observed that: “Not only are the parties to insurance contracts affected by viatical settlements, 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.” *Life Partners v. Morrison*, 484 F.3d 284, 296

threatening fundamental principles of insurance, the regulators again undertook the task of modernizing the NAIC Model Act. This time the effort was coupled with a new commitment that approval of the amended Model Act would be accompanied by special effort to advance it legislatively in the states.⁵⁷

The result was approval in 2007 of extensive amendments to the NAIC Model Act.⁵⁸ The amendments reassert insurance regulators' functional authority over life settlements; establish clear fiduciary duties for settlement brokers and providers; expand a policy owner's right to rescind a settlement from 15 to 60 days; provide new bonding requirements for viatical settlement brokers and providers; and require settlement entity compensation disclosure to assure consumers received fair value for their insurance policies.⁵⁹ The amendments also included new provisions designed to address investor speculation against insurance values, two of which are discussed below.⁶⁰

B. Subprime Life Insurance Settlements

The words "insurable interest" do not appear in the NAIC Model Act. Rather, the NAIC innovated guidance to delay an insurance policy settlement for five years depending on whether the policy acquisition included elements of the standard scheme proposed to be legitimized by speculators.⁶¹ The insurance regulators recognized that the nature of investor speculation against insurance was to actively evade, or work around, static regulation. Consequently, the regulators devised a dynamic set of three transactional tests by which to separate *prima facie* legitimate settlements from *prima facie* suspicious settlements, while not declaring any of the elements illegal *per se*.

In investment parlance, the suspicious settlements would be subprime compared to settlements indisputably legitimate thanks to the certainty of their

(4th Cir. 2007), *cert. denied*, 128 S. Ct. 708 (2007).

⁵⁷ The NAIC adopted new "Procedures for Model Law Development" wherein "Upon NAIC adoption of the Model Law, it will be a priority of the NAIC, through the collective efforts of the Members, to uniformly adopt the Model Law in a majority of states within three years after its adoption by the NAIC membership. The NAIC Members will devote significant regulator and NAIC resources to communicate, educate and support the Model Law. The NAIC staff will provide briefing materials, testimony, make state visits and answer questions. The Executive Committee shall provide quarterly updates to the NAIC Plenary on the status of adoption by states of the Model Law. The NAIC will post information on its website and issue public releases when a state adopts a Model Law." See NAIC Procedures at: http://www.naic.org/documents/committees_models_procedures.pdf.

⁵⁸ America's insurance regulators voted 47-0 in June 2007 to approve strengthening amendments to the NAIC Model Act and advocate adoption of the Model Act to legislators in their 47 states. 2007 NAIC Proceedings, 2d Qtr., Vol. I, pp. 38-105.

⁵⁹ See NAIC Viatical Settlement Model Act (2007). This Model Act contains 19 sections totaling 53 pages of text. Every section of the Model Act was amended in 2007.

⁶⁰ See Kingma and Leimberg, *Deterring STOLI: Two New Model Life Settlements Acts*, Estate Planning, Vol. 35, No. 7 (July 2008).

⁶¹ NAIC Model Act § 11 (2007).

provenance and maturity. By requiring five rather than two years before the policy can be settled to strangers lacking insurable interest, investors might be discouraged from funding schemes to originate subprime settlements. The practical effect of the five-year wait removes the statutory presumption of illegality but it does not alter the necessity of insurable interest to make certain the payment of the death claim. The presumptive tests in the NAIC Model Act are whether, at all times up to two years after policy issue:

1. Premiums were paid with non-recourse financing (i.e., the only collateral for the loan is the insurance policy itself);
2. There is a guarantee to purchase the policy from the original policy-owner, including through forgiveness of premium loan debt; or
3. Either the policy or the insured was evaluated for policy settlement.⁶²

The effectiveness of the five-year settlement testing delay is attributable to mortality. Perpetrators of illicit arrangements to obtain insurance values for investors target affluent senior citizens. The perpetrators react to legal obstacles with hypertechnical work-arounds, i.e., they work to circumvent all attempts at regulation. Hence the NAIC Model Act addresses the complexity of the scheme's variations with a catch-and-release dragnet that itself is complex. That is, the Model Act is structured to: define every relevant transaction as a "viatical settlement contract";⁶³ exclude from the definition all traditional insurance

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- A. It is a violation of this Act for any person to enter into a viatical settlement contract at any time prior to the application or issuance of a policy which is the subject of viatical settlement contract or within a five-year period commencing with the date of issuance of the insurance policy or certificate unless the viator certifies to the viatical settlement provider that one or more of the following conditions have been met within the five-year period:
- (3) The viator enters into a viatical settlement contract more than two (2) years after the date of issuance of a policy and, with respect to the policy, at all times prior to the date that is two (2) years after policy issuance, the following conditions are met:
 - (a) Policy premiums have been funded exclusively with unencumbered assets, including an interest in the life insurance policy being financed only to the extent of its net cash surrender value, provided by, or fully recourse liability incurred by, the insured or a person described in Section 2N(3)(e);⁶¹
 - (b) There is no agreement or understanding with any other person to guarantee any such liability or to purchase, or stand ready to purchase, the policy, including through an assumption or forgiveness of the loan; and
 - (c) Neither the insured nor the policy has been evaluated for settlement.

NAIC Viatical Settlements Model Act, § 11 Prohibited Practices (2007).

⁶³ (1) "Viatical settlement contract" means a written agreement between a viator and a viatical settlement provider or any affiliate of the viatical settlement provider establishing the terms under which compensation or anything of value is or will be paid, which compensation or value is less than the expected death benefits of the policy, in return for the viator's present or future assignment, transfer, sale, devise or bequest of the death benefit or ownership of any portion of the insurance policy or certificate of insurance. (2) "Viatical settlement contract" includes a premium finance loan made for a life insurance policy by a lender to viator on, before or after the date of issuance of the

transactions;⁶⁴ and exclude from the definition all traditional financing used solely for premiums plus loan costs or to secure a bank loan.⁶⁵

The result is that only settlement transactions including financings based on death benefit values remain covered by the definition of “viatical settlement contract”. The NAIC Model Act then prohibits settlements of such contracts for five years but protects property rights by permitting certain *any time* settlements. These include exceptions for: chronic or terminal illness (classic viatical settlements); death of the spouse; divorce; retirement; physical or mental disability; or personal insolvency.⁶⁶

The NAIC Model Act then further protects consumer property interests - including latitude even for non-recourse financing of premium - by barring settlement of a policy for only two years if:

1. The policy owner posts cash or collateral for a loan against the policy or limits the loan to the net cash surrender value of the policy;
2. There is no agreement evidencing intent to settle the policy prior to two years from policy issuance; and
3. There has been no evaluation of the insured or the policy for settlement prior to two years from policy issuance.

The transactions left to be prohibited for five years are speculative originations involving non-recourse financing, guarantees of settlement, and premature life expectancy evaluations—the chief elements of the standard speculative scheme being attempted to be legitimized. All “natural” settlements are protected by one or more of the exceptions, some permitting “any time” settlement and the others permitting settlement after two years. Even the five-year settlement prohibition of the NAIC Model Act might not stop all abusive transactions because of the intrinsically evasive nature of speculative activity. It is the economic implications that follow from the NAIC Model provision that become the effective deterrent to speculation.

That is, the targets of investor speculations are typically affluent seniors. Investment promoters demonstrate a willingness to risk their capital and wait two years to capture the death benefit before realizing a return on their investment. Bluntly, the premise of the effectiveness of the NAIC Model Act provision is that investors are willing to bet a 75-year-old will live for two years but not much longer. The odds that the 75-year-old will live to 80 is too long a risk for investors, especially when they must continue to pay the premiums for the elderly policy

policy where: (a) The viator or the insured receives on the date of the premium finance loan a guarantee of a future viatical settlement value of the policy; or (b) the viator or the insured agrees on the date of the premium finance loan to sell the policy or any portion of its death benefit on any date following the issuance of the policy. NAIC Model Act § 2N (2007).

⁶⁴ See NAIC Model Act § 2N(3)(e)-(i) (2007).

⁶⁵ See NAIC Model Act § 2N(3)(a)-(d) (2007).

⁶⁶ NAIC Model Act § 11A(2) (2007).

owner. Investors need a quicker return lest their planned investment asset transform into a genuine insurance policy. This would be the result of the death of the policy owner prior to the settlement trigger date, which would deny investors a return beyond their investment because the death benefit is paid to the estate or the policy owner's natural beneficiaries.⁶⁷ By this means, the NAIC Model Act effectively deters capital formation for settlement marketing and illicit originations.

C. Transparency of Transactions Under the NAIC Model Act

The NAIC Model Act also addresses that aspect of the speculators' standard scheme in which evidence of evasion of insurable interest and contestability laws are stepped away from discovery. It does so by requiring full disclosure of any plan of policy origination, including policy financing:

Prior to the initiation of a plan, transaction or series of transactions, a viatical settlement broker or viatical settlement provider shall fully disclose to an insurer a plan, transaction or series of transactions, to which the viatical settlement broker or viatical settlement provider is a party, to originate, renew, continue or finance a life insurance policy with the insurer for the purpose of engaging in the business of viatical settlements at anytime prior to, or during the first five (5) years after, issuance of the policy.⁶⁸

This provision, where enacted, should help to balance the interests of insurers and settlement entities. By requiring secondary market entities to disclose policy origination plans, insurers will be encouraged to approve a plan for general use or, alternatively, reject applications based on a plan determined too risky for proper insurance underwriting and pricing. Insurer approved plans, of course, will estop insurers from contesting the policies subsequently issued, thereby quieting title of policies transferred for value and providing confidence to all parties—including tertiary market investors—that the contracts are reliable. This development should, in turn, relieve the judiciary of litigation both on the insurance and investor side of the settlement transaction.

North Dakota, Nebraska, West Virginia and Ohio enacted most provisions of the NAIC Model Act, including the five-year settlement prohibition for subprime policy originations.⁶⁹ The new Ohio settlement law provision relevant to the five-year settlement moratorium uniquely ties the legitimacy of suspicious transactions to their disclosure and approval by the insurer. The law provides:

(B) It is a violation of this chapter for any person to enter into a viatical settlement contract within a five-year period commencing with the date of

⁶⁷ Though in circumstances of rapidly deflating asset values, a guaranteed return of the premium itself might be an attractive hedge.

⁶⁸ NAIC Model Act § 9 (Disclosure to Insurer).

⁶⁹ See N.D. Century Code ch. 26.1-33.3-10 (Prohibited Practices); Neb. Rev. Stat. § 44-1110 (1)(a) *et seq.*; Code of West Virginia § 33-13C-11 (Prohibited Practices); Ohio Rev. Code § 3916.16(A)(1) *et seq.*

issuance of the policy unless the viator certifies to the viatical settlement provider that one or more of the following conditions have been met within five years after the issuance of the policy: . . .

(4) The viator enters into a viatical settlement contract more than two years after the date of issuance of a policy and certifies that all of the following are true:

(a) The viator has funded the policy using personal assets, which may include an interest in the life insurance policy being viaticated up to the cash surrender value of the policy *or any financing agreement to fund the policy premiums entered into prior to policy issuance or within two years of policy issuance was provided to the insurer within thirty days of the date the agreement was executed and the financing agreement was secured with personal assets.*

(b) The viator had no agreement or understanding with any other person to viaticate the policy or transfer the benefits of the policy, including through an assumption or forgiveness of a premium finance loan at any time prior to issuance of the policy or during the two years after the date of issuance of the policy.

(c) *If requested by the insurer, the viator both disclosed to the insurer whether a person other than the insurer obtained a life expectancy evaluation for settlement purposes in connection with the application, underwriting, and issuance of the policy and provided a copy of any such life expectancy evaluation to the insurer at the time of application.*

(d) *The viator disclosed any financial arrangement, trust, or other arrangement, transaction, or device that conceals the ownership or beneficial interest of the policy to the insurer prior to the issuance of the policy.*⁷⁰

The Ohio statute expressly imposes upon the insurer a responsibility to underwrite those elements of the policy origination that give rise to suspicions of impropriety. Carrier rejection of any element, of course, likely makes moot any potential violation of the statute. Carrier approval of the financing and structural arrangement of the proposed transaction likely estops the insurer from raising either statutory or insurable interest objections to it as a defense to a claim.⁷¹

The National Conference of Insurance Legislators (NCOIL) tacked away from the NAIC approach in addressing the speculative activity of concern. Whereas previous versions of the NCOIL Model Act tracked concurrent versions of the NAIC Model Act, NCOIL elected to modernize its Life Insurance Settlements Act in a manner sustaining the two-year settlement prohibition common to most settlement laws enacted as of the end of 2007. The NCOIL Model Act establishes a new public policy, creates a new statutory offense, imposes new limits on premium financing, and levies stronger penalties for speculative originations of life insurance.

⁷⁰ Ohio Rev. Code § 3916.16(B) (emphasis added).

⁷¹ See *Holmes v. Nationwide Mut. Ins. Co.*, 40 Misc. 2d 894, 244 N.Y.S.2d 148 (N.Y. Sup. Ct. Broome County 1963).

VI. The Third Official Response to the New Settlement Abuses

A. New Laws Prohibiting Stranger-Originated Life Insurance

The new arrangements whereby individuals apply for insurance policies destined for settlement to strangers lacking insurable interest was not clearly understood at first due to the confusing variety of schemes and the difficulty of distinguishing legitimate from illegitimate applications. New York, lacking a specific law regulating life settlements *per se*, had created the first bright line against illegitimate settlements without using special terminology. The NAIC had invented the lexicon of “viatical settlements” but it did not especially label illicit viatical settlements or create a new model offense warranting special legislative redress.

By the time NCOIL resolved its legislative modeling approach, the repetitive reference in public discourse to “stranger-originated life insurance” had named the problem. NCOIL decided to address the problem head-on: first, by defining “stranger-originated life insurance” and then prohibiting it as a fraudulent life settlement act.⁷² The definition is:

“Stranger-Originated Life Insurance” or “STOLI” is 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. 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. Trusts, that are created to give the appearance of insurable interest, and are used to initiate policies for investors, violate insurable interest laws and the prohibition against wagering on life.⁷³

Eleven states have enacted new laws recognizing stranger-originated life insurance as a fraudulent act.⁷⁴ Several characteristics of these laws represent substantial new approaches to curtailing illicit life insurance settlements.

⁷² The National Conference of Insurance Legislators voted unanimously in November 2007 to amend the NCOIL Model Act with important provisions to address stranger-originated life insurance.

⁷³ NCOIL Life Settlement Model Act § 2Y.

⁷⁴ **Arizona:** Intentionally practicing or planning to initiate a life insurance policy for the benefit of a person or entity that lacks an insurable interest and that, at the time of policy origination, has no insurable interest in the insured, is a violation of [Ariz. Rev. Stat.] § 20-1104. Stranger originated life insurance practices include situations in which life insurance is purchased with resources or guarantees from or through a person or entity that, at the time of policy inception, could not lawfully initiate the policy himself or itself, and if, at the time of policy inception, there is an agreement to directly or indirectly transfer the ownership of the policy or the policy benefits to a person or entity that lacks an insurable interest. Trusts that are created to give the appearance of insurable interest and that are used to initiate policies for the benefit of investors with no insurable interest violate [Ariz. Rev. Stat.] § 20-1104 and the prohibition against wagering on life. Intentionally practicing or

The new laws imbue regulators with new authority to examine settlement

planning does not include a policy holder's lawful assignment of the insured's life insurance policy. Arizona Revised Statutes (A.R.S.) § 20-443.02.

Connecticut: ["Stranger-originated life insurance" or "STOLI" is an] act, practice or arrangement 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. Such 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 or the policy benefits to a third-party. Trusts created to give the appearance of insurable interest and used to initiate policies for investors violate insurable interest laws and the prohibition against wagering on life. Conn. Gen. Stat. § 38a-465.

Hawaii: "Stranger-originated life insurance" or "STOLI" means a practice or plan to initiate a policy for the benefit of a third party investor who, at the time of policy origination, has no insurable interest in the insured, and includes:

- (1) Arrangements 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 by oneself 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, the policy benefits, or both, to a third party; and
- (2) Trusts created to give the appearance of insurable interest and used to initiate policies for investors. "STOLI" does not include those practices set forth in subsection (b) of the definition of "life settlement contract." Hawaii Public Act 177 (2008).

Indiana: ["Stranger-originated life insurance" or "STOLI" is a] practice or plan to initiate a life insurance policy for the benefit of a third party investor who, at the time the life insurance policy is originated, has no insurable interest in the insured. The term includes the following:

- (1) An arrangement under which, at the time of life insurance policy inception:
 - (A) a life insurance policy is purchased with resources or guarantees from or through a person that is not legally permitted to initiate the life insurance policy; and
 - (B) a written or verbal arrangement or agreement is made to transfer the ownership of the life insurance policy or policy benefits to a third party.
- (2) A trust that is:
 - (A) created to give an appearance of the existence of an insurable interest; and
 - (B) used to initiate a life insurance policy for an investor. Ind. Code § 27-8-19.8-7.8.

Iowa: ["Stranger-originated life insurance" or "STOLI" is a] practice or an act 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. Iowa Ins. Code § 508E.2.

Kansas: ["Stranger-originated life insurance" or "STOLI" is an] act, practice or arrangement 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 under [Kan. Stat. Ann.] § 40-450 and amendments thereto. Stranger-originated life insurance 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, and where, at the time of policy inception, there is an arrangement or agreement to directly or indirectly transfer the ownership of the policy or the policy benefits, or both, to a third party. Any trust that is created to give the appearance of insurable interest, and is used to initiate one or more policies for investors, violates [Kan. Stat. Ann.] § 40-450, and amendments thereto, and the prohibition against wagering on human life. Kan. Stat. Ann. § 40-5002(1).

Kentucky: "Stranger-originated life insurance" or "STOLI" means the procurement of new life

activity and, upon the discovery of stranger-originated life insurance, invalidate relevant transactions and otherwise sanction the perpetrators originating policies

insurance by persons or entities that lack insurable interest on the insured and, at policy inception, such person or entity owns or controls, or has an arrangement or agreement to own or control, the policy or the majority of the death benefit in the policy and the insured or insured's beneficiaries receive little or none of the proceeds of the death benefits of the policy. Trusts that are created to give the appearance of insurable interest and are used to initiate policies for investors violate insurable interest laws and the prohibition against wagering on life. STOLI arrangements do not include those practices set forth in paragraph (b) of subsection (17) of this section. Ky. Rev. Stat. § 304.15-020.15.

Maine: ["Stranger-originated life insurance" or "STOLI" is an] act or practice to initiate a life insurance policy for the benefit of a person who, at the time of the origination of the policy, has no insurable interest in the insured. "Stranger-originated life insurance" includes, but is not limited to, cases in which life insurance is purchased with resources or guarantees from or through a person who, at the time of the inception of the policy, could not lawfully initiate the policy and when, at the time of policy inception, there is an arrangement or agreement to directly or indirectly transfer the ownership of the policy or the policy benefits to another person. A trust that is created to give the appearance of insurable interest and is used to initiate policies for investors violates insurable interest laws and the prohibition against wagering on life. Me. Rev. Stat. Ann. tit. 24A, § 6802.

Ohio: "Stranger-originated life insurance," or "STOLI," means a practice, arrangement, or agreement initiated at or prior to the issuance of a policy that includes both of the following:

- (a) The purchase or acquisition of a policy primarily benefiting one or more persons who, at the time of issuance of the policy, lack insurable interest in the person insured under the policy;
 - (b) The transfer at any time of the legal or beneficial ownership of the policy or benefits of the policy or both, in whole or in part, including through an assumption or forgiveness of a loan to fund premiums.
- (2) "Stranger-originated life insurance" also includes trusts or other persons that are created to give the appearance of insurable interest and are used to initiate one or more policies for investors but violate insurable interest laws and the prohibition against wagering on life. Ohio Rev. Code Ann. § 3916.01.

Oklahoma: 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. Stranger-originated life insurance 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, and where, at the time of policy inception, there is an arrangement or agreement, whether verbal or written, to directly or indirectly transfer the ownership of the policy or the policy benefits to a third party. Trusts that are created to give the appearance of insurable interest and are used to initiate policies for investors violate Section 3604 of Title 36 of the Oklahoma Statutes and the prohibition against wagering on human life. Stranger-originated life insurance arrangements do not include the practices provided in subparagraph b of paragraph 15 of this section. Okla. Stat. tit. 36 § 625.1.

West Virginia: "Stranger-originated life insurance" or "STOLI" means a plan or agreement that provides for both of the following at the time of the origination of a life insurance policy:

- (A) The purchase of a life insurance policy by an applicant primarily for the benefit of a third-party investor that lacks insurable interest in the insured person; and
- (B) The subsequent accrual, directly or indirectly, to that third-party investor of the legal or beneficial ownership of the policy or the benefits of the policy. W. Va. Ins. Code § 33-13C2.18.

for illicit settlement.⁷⁵ In several states, criminal penalties may be imposed for commission of a fraudulent life settlement act, including stranger origination of life insurance.⁷⁶

The authority to act against stranger-originated life insurance is not limited to insurance regulators but invests any interested party with an opportunity to challenge the validity of an illegitimately originated policy.⁷⁷ This would naturally include the insurer. It also will include the representatives of the estate of the deceased insured and the natural beneficiaries of the insured. Tertiary market investors will also have standing to challenge the validity of policy originated by a stranger. This might occur in circumstances where the investors are the target of a speculative scheme leading to investigation into the origination of the insurance contracts constituting the investment asset.⁷⁸

Most of the new laws also address the threat of unilateral misuse of apparent insurable interest which are the fact patterns in *First Penn-Pacific v. Evans* and *Sun Life Assurance v. Paulson* (discussed above). That is, the definition of “stranger-originated life insurance” removes the necessity that a complainant particularly allege there is an agreement with a specific third party to settle the policy. The definitions in the new laws “include *but are not limited to cases in which . . . there is an arrangement or agreement . . . to . . . transfer the ownership of the policy and/or the policy benefits to a third party.*”⁷⁹ While it most likely will be the insurer to challenge the validity of the origination of the policy, a challenge might even arise from a settlement provider which, subsequent to the settlement transaction, discovers the policy owner unilaterally “initiate[d] 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.”

Further, the authority to invalidate stranger-originated life insurance is not limited in time. This is certainly true for regulators and interested parties not

⁷⁵ The new laws at minimum provide regulators with enforcement authority under their respective unfair trade practices acts. See generally 30 Appleman on Insurance 2d § 183.02[D][1-2].

⁷⁶ See, e.g., Okla. Enrolled Bill No. 1980, § 14F (new) (eff. Nov. 1, 2008).

⁷⁷ See, e.g., IA Viatical Settlements Act, Ins. Code § 508E.16(2) (new 2008).

⁷⁸ See, e.g., Securities and Exchange Commission v. Mutual Benefits Corp., Litigation Release No. 18698 (May 6, 2004); cf. *Liberte Capital Group v. Capwill*, 229 F. Supp. 2d 799, 800 (N.D. Ohio 2002); *Wuliger v. C.M. Life Insurance Co.*, No. 3:05 CV 2717 (N.D. Ohio June 6, 2006); *Wuliger v. Manufacturers Life Ins. Co.*, No. 3:03 CV 07457 DAK (N.D. Ohio 2008).

⁷⁹ See Ariz. Rev. Stat. § 20-443.02; Conn. Ins. Code § 38a-465; Ind. Ins. Code § 27-8-19.8-7.8; Iowa Ins. Code § 508E.2; Kan. Stat. Ann. § 40-500-2(1); Me. Rev. Stat. Ann. tit. 24A, § 6802 (2008); Ohio Ins. Code § 3916.01; Okla. Stat. tit. 36, § 625.1. Ohio includes an additional strengthening provision wherein: “Any contract, agreement, arrangement, or transaction including, but not limited to, any financing agreement or arrangement identified in section 1321.72 of the Revised Code entered into for the furtherance or aid of a stranger-originated life insurance *act*, practice, arrangement, or agreement is void and unenforceable.” Ohio Ins. Code § Sec. 3916.172 (italicized and underlined emphasis to the specific word that reaches to unilateral acts to originate insurance for settlement).

limited by incontestability laws constraining insurers. However, even insurers are enfranchised by nine of the new statutes to rescind a policy as stranger originated inasmuch as the enactments represent new public policy arguably superseding contractual limits of contestability.⁸⁰ This important statutory override of contestability limitation furthers the new public policy against stranger originations. It also restores the balance between the public policies against wagers on life and stranger originations of life insurance vis-à-vis incontestability limitations, in awareness of settlement plans intentionally evading the latter.

B. New Laws Addressing Premium Financing of Speculative Transactions

Another especially important provision of the NCOIL Model act likely to deter insurance origination by strangers is that addressing premium financing. Among nine specific practices enumerated by NCOIL as Prohibited Practices, is the following:

A. IT IS UNLAWFUL FOR ANY PERSON TO: . . .

4. enter into a premium finance agreement with any person or agency, or any person affiliated with such person or agency, pursuant to which such person shall receive any proceeds, fees or other consideration, directly or indirectly, from the policy or owner of the policy or any other person with respect to the premium finance agreement or any settlement contract or other transaction related to such policy that are in addition to the amounts required to pay the principal, interest and service charges related to policy premiums pursuant to the premium finance agreement or subsequent sale of such agreement; provided, further, that any payments, charges, fees or other amounts in addition to the amounts required to pay the principal, interest and service charges related to policy premiums paid under the premium finance agreement shall be remitted to the original owner of the policy or to his or her estate if he or she is not living at the time of the determination of the overpayment; . . .⁸¹

Whereas the NAIC Model Act relies upon the cost of sustaining policies for five years before the possibility of investor recoupment of capital, the NCOIL Model Act in the provision above limits the legitimate return on premium financing to repayment of the loan plus interest and reasonable expenses. The NCOIL Model Act thus deprives speculative financiers of the windfall profit of the policy death

⁸⁰ Indiana is an exception: "Notwithstanding any other law, an insurer shall not, after a life insurance policy has been in force for two (2) years after the life insurance policy's date of issue, allege that the life insurance policy was issued in connection with stranger originated life insurance (as defined in [Ind. Code] § 27-8-19.8-7.8) as a basis to deny payment of the proceeds of the life insurance policy. However, an insurer may seek to void a life insurance policy at any time for lack of insurable interest at the time the life insurance policy was issued." Ind. Ins. Code § 27-1-12-44 (effective July 1, 2008).

⁸¹ NCOIL Model Act § 13 (2007).

benefit. Five states enacted this provision.⁸² These states by statute now join at least five other states with similar rules limiting creditors to the amount of the debt.⁸³

Two sections of the new Ohio law are of special interest. They provide that:

- (D) Notwithstanding divisions (C) and (D) of section 1321.72 of the Revised Code, in the case of a life insurance policy, any premium finance company shall give notice of its financing to the insurer either prior to the issuance of the life insurance policy if the financing agreement is accepted prior to the issuance of the policy or prior to the completion of the premium financing transaction if the financing agreement is accepted after the issuance of the policy.
- (E) If premium financing is used in connection with a life insurance policy, and the premium finance company fails to provide notice of its financing to the insurer pursuant to division (D) of this section, the premium financing agreement is unenforceable as a matter of public policy.⁸⁴

These provisions are in addition to Ohio Ins. Code § 916.171(B)(10), which establishes a fraudulent settlement act for any premium financing agreement requiring a borrower to repay any amount in excess of the principal, interest, costs and expenses related to the policy premiums. The provisions functionally invalidate schemes by which insurance values might be drained into investment commerce via predatory financing. As a statutorily expressed public policy, Ohio Ins. Code § 1321.78(D) (set forth above) likely supersedes the contestability limitation on the insurer, adding another timeless defense, along with lack of insurable interest, by which to challenge transactions.

⁸² See:

Connecticut: Conn. Ins. Code § 38a-465i(a)(5);

Iowa: Iowa Ins. Code § 508E.13.6;

Kansas: Kan. Senate Substitute H.B. 2110 New Section 3(a)(6) (2008);

Ohio: Ohio Ins. Code § 3916.171(B)(10);

Oklahoma: Okla. Enrolled S.B. 1980 § 11F (2008).

⁸³ They are:

California: see *Jimenez v. Protective Life Ins. Co.*, 8 Cal. App. 4th 528, 10 Cal. Rptr. 2d 326 (1992);

Missouri: see *Strode v. Meyer Bros. Drug Co.*, 101 Mo. App. 627, 74 S.W. 379 (1903);

South Dakota: see *Froiland v. Tritle*, 484 N.W.2d 310 (S.D. 1992); see also S.D. Codified Laws §§ 58-10-3, 58-10-4(3);

Texas: *Stillwagoner v. Travelers Ins. Co.*, 979 S.W.2d 354, 359 (Tex. App. 1998);

Washington: Wash. Rev. Code § 48.34.090(2); see also *Abbott v. CUNA Mut. Ins. Soc'y*, 102 Wash. App. 519, 7 P.3d 852 (2000).

⁸⁴ Ohio Ins. Code § 1321.78.

VII. CONCLUSION

The legitimization of life insurance settlements created an opportunity for investors to profit from insurance policies on a scale never anticipated by insurers or their regulators. Investors' willingness to fund solicitations to individuals to acquire insurance; compensate individuals for use of their apparent, personal insurable interest; and fund premium for two years in return for control of the insurance policy and its death benefit is of a qualitative nature far different from historical precedents of speculation against insurance. The willingness and concerted activity of settlement entities, hedge funds, investment banks, commercial banks, accredited investors and other financial speculators attempting to originate insurance for settlement is changing the dynamics of insurance underwriting, financing and regulation. One can expect more legislative activity to curtail speculative activities and substantially more litigation over settled insurance policies. The litigation will refresh the vitality of long-standing insurance principles; reexamine judicial perspectives about insurable interest, contestability and premium financing; and become increasingly responsive to legislative efforts to balance the interests of the primary, secondary and tertiary insurance markets.