

STOLI ALERT

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NAIC & NCOIL: DIFFERENT APPROACHES, SAME GOAL

Although their approaches differ, the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL) are each committed to deterring stranger-originated life insurance (STOLI).

At its Nov. 12-14 meeting in Las Vegas, NCOIL approved an updated Life Insurance Settlements Model Act that strengthens safeguards against STOLI transactions. NCOIL's model offers an alternative to the approach taken by the amendments to NAIC's Viatical Settlements Model Act approved by state regulators earlier this year. The NCOIL model aims to deter STOLI by:

- Defining and prohibiting STOLI transactions;
- Requiring life settlement providers to report data annually to state insurance commissioners that will assist regulators in determining if providers are initiating policies for the purpose of settling them;
- Barring premium finance providers from receiving any proceeds or consideration from the policy or policy owner that are in addition to the amounts required to pay the premium, interest and service charges under the premium finance agreement; and
- Allowing insurers to advise applicants in premium-financed transactions of the possible adverse consequences that might result from the later settlement of the policy, such as a stranger owning an interest in the insured's life, limits on future insurability higher premiums for additional coverage and tax liability.

The NCOIL model attempts to bring within its scope all manifestations of STOLI, whether they involve settlements, trusts or other practices.

The NAIC model addresses the most prevalent form of STOLI, transactions involving policy settlements. It establishes a limited five-year moratorium on the settlement of policies that have the characteristics of STOLI. It also requires life settlement brokers to disclose to policy owners vital information about settlement transactions, such as commissions and other purchase offers. NAIC's Life Insurance

WHERE WE STAND

Lawmakers must act to deter stranger-originated life insurance (STOLI) in all its manifestations. STOLI violates public policies against using life insurance as a vehicle for wagering on human life. It can leave insureds with unknown or undisclosed costs and legal implications. It threatens to undermine the growing legitimate market for life insurance covering senior citizens, STOLI's targeted market.

In that connection, we strongly believe the amendments to the Viatical Settlements Model Act approved in June, 2007 by the National Association of Insurance Commissioners (NAIC) will address the most prevalent form of STOLI, which are transactions involving a policy settlement. The NAIC's limited five-year moratorium on settlements that have the characteristics of STOLI will significantly reduce the economic incentive for abusive transactions while having no impact on policy owners who purchased their policies legitimately and decide to sell them in the secondary market.

We also applaud the National Conference of Insurance Legislators (NCOIL) for developing a model law that seeks to deter all manifestations of STOLI, whether in the form of a settlement, a trust or other scheme. The NCOIL model addresses STOLI by, among other things, defining and prohibiting STOLI transactions and requiring life settlement companies to annually report data to state insurance commissioners.

We will work to the best of our abilities to enact effective legislation in every jurisdiction in the nation.

and Annuities (A) Committee is expected to examine proposals to deter STOLI transactions that do not involve a settlement.

"The model laws approved first by NAIC and now by NCOIL show that our state insurance policymakers recognize the implications of STOLI," said Frank Keating, president and CEO of the American Council of Life Insurers.

"NAIFA is very pleased that NCOIL has joined the NAIC in attempting to take a strong stand against STOLI," said John J. Healy, CEO of the National Association of Insurance and Financial Advisors. "State legislation addressing STOLI will be one of NAIFA's top priorities in 2008."



LARRY KING LAWSUIT POINTS TO DANGERS OF STOLI

A lawsuit filed recently in California by CNN's Larry King describes a series of transactions, some of which have the earmarks of a life insurance arrangement called stranger-originated life insurance (STOLI).

Typically, with STOLI, a broker or speculator approaches a customer and encourages the purchase of a life insurance policy with the intent that the policy be sold to investors who have no insurable interest in the life of the customer. The investors pay the customer an agreed sum for the policy and then expect to profit by collecting the death benefit when the customer dies.

While promising cash upfront, STOLI promoters may fail to disclose the hidden dangers in these transactions. As alleged in the complaint, consumers can end up with the short end of the stick, losing vital insurance protection that could have protected their families from the financial risks associated with an unexpected death.

Moreover, because this is a largely unregulated market, many material facts may be undisclosed by STOLI promoters, such as the tax consequences, the amount received by intermediaries and the fair market value of the policy.

ACLI and NAIFA understand that legitimate policy owners may want to sell their policies in the secondary market when they decide they no longer need or want coverage. However, speculators whose only concern is profit should not be allowed to initiate and purchase life insurance on an individual they do not know and in whom they have no insurable interest.

Life insurance companies and agents are urging state legislators and regulators to adopt stronger laws and regulations that will protect consumers from abusive transactions and maintain the integrity of the life insurance product.

NAIC MODEL'S MORATORIUM PROTECTS PROPERTY RIGHTS

An Analysis of *Grigsby v. Russell*

A five-year moratorium on the settlement of life insurance policies that have the characteristics of STOLI does not violate the property rights of policy owners and does not run afoul of any United States Supreme Court ruling.

STOLI promoters who cite the United States Supreme Court case of *Grigsby v. Russell*, 222 U.S. 149 (1911), as authority against a limited five-year moratorium are wrong both legally and logically. Nothing in *Grigsby* strips the nation's legislators of their constitutional powers to regulate commercial transactions, including determining the rules governing the settlement of life insurance policies. A limited five-year moratorium on the settlement of policies that have the characteristics of STOLI is a major component of the amendments to the Viatical Settlements Model Act recently approved by the National Association of Insurance Commissioners.

Indeed, the opinion in *Grigsby* by Justice Oliver Wendell Holmes, Jr., reinforces the public policy against STOLI and specifically qualifies the property rights of life insurance policy owners. "So far as reasonable safety permits, it is desirable to give to life insurance policies the ordinary characteristics of property," Holmes wrote (emphasis added).

Grigsby essentially restates the opinion in *Connecticut Mutual Life v. Schaefer*, 94 U.S. 457 (1876), which says that a life insurance policy acquired in good faith remains valid even if the beneficiary's insurable interest ends. "Any person has a right to procure an insurance on his own life and assign it to another, provided it be not done by way of cover for a wager policy," the *Connecticut Mutual* case says.

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October, 2007

November, 2007

TIMELINE

RESEARCH: The consulting firm Conning & Co. estimates that the life insurance settlement business grew to some \$6.1 billion in 2006.

STATES:

Connecticut: The General Assembly Insurance and Real Estate Committee conducts a hearing on life settlements and STOLI.

Massachusetts: The Joint Committee on Financial Services conducts a hearing on H. 1052, legislation supported by ACLI and NAIFA that, with minor differences, is based on the amendments to the Viatical Settlements Model Act developed by the National Association of Insurance Commissioners.

Utah: The Department of Insurance seeks input on the NAIC model.

NCOIL: The National Conference of Insurance Legislators approves revisions to the Life Insurance Settlements Model Act, which attempts to deter all forms of STOLI by, among other things, defining and prohibiting STOLI and requiring life settlement providers to disclose data to state insurance departments.

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That is essentially what happened in *Grigsby*. John C. Burchard purchased a life insurance policy and paid the first two premiums. Subsequently, however, Burchard ran short of money while in need of a surgical procedure. To raise funds, he sold the life insurance policy to a physician, A.H. Grigsby, who had no insurable interest in Burchard's life. After Burchard died, a dispute arose between Grigsby and Burchard's estate over who should receive the death benefit. Holmes' opinion upheld Grigsby's claim to the death benefit, while reinforcing the distinction between policies purchased in good faith and those purchased as cover for a wager on human life.

"And cases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith," Holmes wrote.

Holmes' opinion clearly establishes the framework for applying different rules to policies purchased as a means to wager on human life than to policies purchased in good faith. Moreover, Holmes' qualification that life insurance policies should have the ordinary characteristics of property "so far as reasonable safety permits" restates the long-standing legal doctrine that property rights are not absolute.

Federal and state lawmakers place restrictions on property rights in a variety of contexts, such as zoning laws, sales of certain products to minors and sales of pharmaceuticals. It is the legislature's role to identify different—sometimes competing—public interests and then draw the lines between, for example, which property can be developed commercially, and which cannot; which products can be sold to minors, and which cannot; and which pharmaceuticals can be sold with a prescription, without a prescription or not at all.

The same holds true of life insurance policies. In order to deter insurance fraud, state legislators have already decided to place some restrictions on the settlement of life insurance policies through the enactment of two-year "wet ink" laws, which bar the sale of a life insurance policy for two years

after the policy is issued. By the same token, state legislators have the right to decide to deter STOLI by enacting a five-year moratorium on the settlement of policies that have the characteristics of STOLI.

That is the constitutionally-granted authority of the legislative branch of government. And as the *Grigsby* opinion shows, Justice Holmes would approve.

CONGRESS ASKS TREASURY TO WARN SENIORS OF STOLI DANGERS

Two senior members of the House Ways and Means Committee have asked the U.S. Treasury Department to alert elderly taxpayers of the adverse tax consequences of participating in STOLI transactions.

Reps. Richard Neal, D-MA, who chairs the Select Revenue Measures Subcommittee, and Phil English, R-PA, the subcommittee's top Republican, said in a letter to Treasury Secretary Henry M. Paulson that STOLI may have a serious impact on unsuspecting elderly Americans.

"STOLI transactions take advantage of the secondary market in life insurance settlements at the expense of elderly Americans who are left with an unexpected tax liability," Neal and English wrote.

"Our concern with STOLI policies is not intended to inhibit the ability of individuals to legitimately settle life insurance policies. Rather, we seek Treasury's assistance in notifying elderly taxpayers of the adverse tax consequences of investing in a product that is in fact 'too good to be true,'" they wrote. "We recommend that Treasury issue a Notice or other form of public guidance outlining the potential tax consequences of participating in a STOLI transaction."

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COURTS: Television personality Larry King files a multimillion lawsuit against a life settlement broker alleging breach of fiduciary duty in connection with a transaction that has the characteristics of STOLI. King charges that he was approached to purchase a life insurance policy with the intent that it would immediately be sold to

investors. The defendants failed to consider whether the life insurance coverage would be more valuable to King and his family for estate planning purposes, King alleges.

MEDIA: The *Wall Street Journal* features an expansive article on Coventry Financial and the market for life settlements, mentioning life insurer concerns about STOLI (as opposed to the settlement of legitimately-acquired life insurance policies) and noting the litigation involving Larry King.

The *Washington Post* features an article on Larry King and STOLI on the front page of its business section. The article mentions the efforts by NAIC and NCOIL to deter STOLI.

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Neal and English say that depending upon the structure, a STOLI transaction can be classified as a split-dollar life insurance arrangement, which is governed by a Treasury regulation (Treas. Reg. §1.7872-15). The rules concerning cancellation of indebtedness may also come into play on settlement of the policy, they add. In certain cases, the terms for the initial arrangement may not qualify as true indebtedness, thus exposing the insured to income inclusion. The insured may also be taxed on the value of the promotional incentive or cash payment received. STOLI promoters, meanwhile, may be liable for information reporting.

“State legislators, regulators and industry groups have questioned whether STOLI transactions satisfy the fundamental requirement that the owner of the policy have an insurable interest consistent with state law and public policy,” Neal and English say.

STOLI policies are similar to the “wager policies” considered against public policy and rejected by the United States Supreme Court in *Warnock v. Davis*, 104 U.S. 775 (1882), they add.

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

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

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

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