

# **SECURITIZATION OF LIFE INSURANCE POLICIES**

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## **I. SECURITIZATION**

Securitization has been making news for putting the brakes on the economy. Subprime lending was driven by securitization and turned out to be far riskier than either the issuers or the buyers of the securities suspected.

Paul Krugman, Princeton economics professor and columnist, explained how mortgages were turned into investments: “The mortgage was bundled with others and sold to investment banks, who in turn sliced and diced the claims to produce artificial assets.”<sup>1</sup> Ethan Penner, whom the *Wall Street Journal* characterized as a “pioneer” of “the application of securitization technology to real-estate finance,” described securitization of mortgages as “a broad secondary market for mortgage loans through securities backed by the collateral of these mortgages[,] . . . whereby the bond-buying community replaced the S&L’s as the ultimate financiers of mortgages.”<sup>2</sup>

That distancing of the source of the money from its use led to less motivation to protect the investment<sup>3</sup> and less opportunity for remedial work, such as a workout.<sup>4</sup> Consequently, securitization increased the risk of fraud, made failure of nonfraudulent loans more likely, and made correction of failed loans less likely.

Securitization has come to the life insurance industry, too. Interests in life insurance policies are being pooled, and shares are being sold to investors on the secondary market. Investment bankers are offering investment returns by arbitraging the pricing. The securities are also attractive

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<sup>1</sup> Paul Krugman, *Workouts, Not Bailouts*, N.Y. TIMES, Aug. 17, 2007, at A23.

<sup>2</sup> Paul Krugman, *Workouts, Not Bailouts*, WSJ, Aug. 16, 2007, at A11.

<sup>3</sup> “There is an emerging consensus that the ability of mortgage lenders to package their loans as securities that were then sold off to other parties played a key role in allowing borrowing standards to plummet.” Nelson D. Schwartz & Julie Cresswell, *What Created This Monster?*, N.Y. TIMES, Mar. 23, 2008, at BU 1, 8.

<sup>4</sup> Krugman, *supra* notes 1, 2.

to investors because they are “uncorrelated assets,” which means their performance is independent of the performance of other markets.<sup>5</sup>

It remains to be seen whether the investment bankers have again underestimated the risk of securitization. It is already clear, however, that, as with mortgages, the distancing of the source of the money from its use is a threat to the underlying industry.

## II. EXAMPLES OF HOW LIFE INSURANCE POLICIES ARE SECURITIZED

The ways in which life insurance is securitized are numerous but can be grouped into four main categories: life settlements, in which investors buy interests in established policies; investor-originated life insurance (IOLI) (also STOLI, for STranger Originated Life Insurance; or SPINLIFE, for SPeculator INitiated LIFE insurance);<sup>6</sup> charity-owned life insurance (CHOLI), although not all CHOLI involves investors; and premium financing for older insureds, which similarly can operate independently of the secondary market.

Life settlements began as a program of purchasing policies insuring terminally or chronically ill insureds to provide them with cash to help with medical care.<sup>7</sup> They have expanded to include purchasing policies insuring those who are not terminally or chronically ill, although the

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<sup>5</sup> Matthew Goldstein, *Profiting from Mortality*, BUS. WK., July 30, 2007, at 44.

<sup>6</sup> Joseph M. Belth, *The Growing Speculation in Human Lives Through the Secondary Market for Life Insurance Policies*, INS. FORUM, June, 2006, at 53.

<sup>7</sup> See *First Penn-Pac. Life Ins. Co. v. William R. Evans*, 2007 U.S. Dist. Lexis 45112 (D. Md. June 21, 2007).

insureds in which investors are most interested are those with shorter-than-average life expectancies.<sup>8</sup> They were originally called *viatical settlements*, and that term is often still used in contrast to *life settlements* to distinguish between settlements with the terminally or chronically ill and settlements with others.<sup>9</sup>

The term *viatical settlement* is used in the Viatical Settlements Model Act prepared by the National Association of Insurance Commissioners (NAIC) to refer to any purchase of an interest in a life insurance policy, including IOLI.<sup>10</sup> The term *life settlement* is used in the Life Settlements Model Act prepared by the National Conference of Insurance Legislators (NCOIL) to refer to any such purchase, including IOLI.<sup>11</sup> However, apart from those model acts, the term *viatical settlement* is commonly used to refer to settlements with the terminally or chronically ill, and the term *life settlement* is commonly used to refer to settlements with healthier people and that are not arranged at the time of application for the policy. This review of securitization of life insurance will use the latter, more limited, usages for those terms.

Life settlements appeal to insureds because they provide a better deal than surrender value.<sup>12</sup> An insured who is struggling to continue to pay premiums in retirement, or who no longer

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<sup>8</sup> NASD Notice to Members 06-38, at 2 (Aug. 2006).

<sup>9</sup> *Id.*

<sup>10</sup> Viatical Settlements Model Act § 2(N) (2001).

<sup>11</sup> *Id.* § 2(L).

<sup>12</sup> The NCOIL Model Act definition of *life settlement contract* requires that “the minimum value for a Life Settlement Contract shall be greater than a cash surrender value or accelerated death benefit available at the time of an application for a Life Settlement Contract.” National Conference of Insurance Legislators Life Settlements Model Act § 2(L) (2000).

sees a need to pass insurance proceeds on to survivors, can give up the policy and get more out of it than the insurer will provide in surrender value. Just as the insurer can profit by paying the surrender value rather than the much larger death benefit, investors can profit by paying the insured and receiving the much larger death benefit. Also, investors can pay the insured more than the surrender value and still profit by arbitraging the insurer's pricing.<sup>13</sup>

Rather than competing for the limited group of insureds who have existing policies and who are of the right life expectancy, some investment bankers prefer to manage the process from the beginning, inducing a person to acquire a life insurance policy on his life solely for the purpose of transferring it to the investment bankers to be securitized. In many transactions, the insured's irrevocable life insurance trust (ILIT) applies for the policy, but all or most of the premiums are paid by an investor. The ILIT sells the policy to the investor; or the insured, as beneficiary of the ILIT, sells his interest in the ILIT to the investor.<sup>14</sup> The insured's survivors get nothing.

A variation on that practice gives the appearance of providing for the insured's survivors. In that variation, the ILIT sells the policy to an issuer trust, which securitizes the interest, selling shares and giving a share to the ILIT. The ILIT gets a single-digit percentage of the death benefit. Investment bankers sometimes justify the minimal benefit for the insured's family on the basis of their analysis of the net economic benefit of a life policy at life expectancy. They assert that if a person acquires a policy and pays premiums to the time he reaches his life expectancy, the owner's total payments will likely amount to nearly the amount of the death benefit. The argument is thus: Why not go straight to that result and get that small percentage of the death benefit with no out-of-pocket payment? The main problem with that approach is that it eliminates the insurance feature for

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<sup>13</sup> See *infra* text accompanying note 18.

<sup>14</sup> See *Life Prod. Clearing v. Angel*, 530 F. Supp. 2d 646 (S.D.N.Y. 2008).

the insured, which is that if the insured dies prematurely before paying much in premiums, the payoff to his family will be substantial, even net after deducting the amount of the premiums from the death benefit. The effect of eliminating that is that the insured takes no risk, protects against no risk, pays little or nothing, and gets little benefit for beneficiaries. The insured's role is only to consent to the insurance and then die; and the sooner he dies, the better off the investors are.

An insured may be reluctant to consent if intimidated by the thought that some people eagerly await his death. Even if that does not bother the insured, he may not see the point in signing the papers and undergoing a medical examination (or perhaps many examinations)<sup>15</sup> for so little payoff for family members. To deal with that, the investors may offer an additional incentive in the form of an up-front payment.

One way to induce a person to take part in such a transaction in lieu of offering an up-front inducement or a small death benefit to survivors is to offer the chance to help a charity through CHOLI. In that situation, a charity applies for the policy, but the premiums are paid by investors who receive most of the death benefit.

In another variation on IOLI, an insured who is seventy or older borrows to pay the premiums but never plans to repay the loan because repayment is made from the death benefit. Although the insured avoids out-of-pocket costs that way, if the interest is added to the loan, compounding consumes the benefit over time. Therefore, this works best with older people in impaired health who have short life expectancies. Unlike zero-premium IOLI, the insured's beneficiaries will get a significant benefit if the insured dies soon. The financier may refinance by securitizing, with sales of interests to investors, or may be the sole investor.

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<sup>15</sup> See *infra* text accompanying note 23.

### III. POTENTIAL PROBLEMS WITH INVESTORS INITIATING INSURANCE

Congress grants tax preferences to life insurance. In general, income tax on the inside buildup of cash value is deferred.<sup>16</sup> Therefore, no income tax is assessed on the death benefit.<sup>17</sup> Those preferences are granted to encourage people to buy life insurance to care for their families. Congress may reconsider providing tax breaks on life insurance if involvement of investors expands to the point that life insurance helps investors more than the families of insureds. Losing those tax preferences would hurt consumers, and the chilling effect on the business would hurt the industry. Life settlements do not pose the same threat because the family members get substantial protection for a significant period of time before the life settlement occurs.

Insurers are also hurt by the arbitraging of their pricing. Investment bankers will never unintentionally let a policy lapse, except to the extent that occasional mistakes are inevitable, in contrast to individuals, who do let policies lapse. If a policy lapses, the insurer will have received premiums for a number of years without being required to pay the death benefit, and insurers' pricing is based on the assumption, derived from experience, that a percentage of policies will lapse.<sup>18</sup> Similarly, investment bankers will be more efficient than the average person in paying as little as possible into a flexible premium policy, and insurers' pricing is based on assumptions about premium payment amounts. Investment bankers could also monitor the health of their insureds and stop paying premiums on policies insuring healthy insureds rather than paying premiums year after year after year, while keeping up only the policies that will pay off quickly. That adverse (from the

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<sup>16</sup> Cohen v. C.I.R., 39 T.C. 1055 (1963).

<sup>17</sup> I.R.C. § 101(a)(1) (2008).

<sup>18</sup> See *Life Partners v. Morrison*, 404 F. 3d 284, 295 (4th Cir. 2007).

insurers' point of view) selection of risk by the investment bankers would further arbitrage insurers' pricing.

Insurers not only lose financially through arbitraging; they also become the targets of outright fraud.<sup>19</sup> Investor involvement in life insurance is also damaging to the public image of life insurance. A *Business Week* cover story used dramatically negative terms to describe the practice, including *Death Bonds*, *macabre*, *ghoulish gamble*, and *[t]ail wagging the dog* (referring to investors' initiation of insurance).<sup>20</sup>

Insureds may be victims of IOLI. Insureds get little for their beneficiaries and may not be able to get further coverage because insurers will insure a person's life only to a certain limit based on the insured's finances, and changes in health may make individuals uninsurable.<sup>21</sup> If still eligible for insurance, the insured may find replacement coverage far more expensive.<sup>22</sup> The insured may be subjected to periodic medical examinations, losing a degree of privacy by introducing a third party

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<sup>19</sup> First Penn-Pac. Life Ins. Co. v. William R. Evans, 2007 U.S. Dist. Lexis 45112 n.2 (D. Md. June 21, 2007).

<sup>20</sup> Goldstein, *supra* note 5.

<sup>21</sup> The NCOIL Life Settlements Model Act requires the purchaser to disclose to the owner the limit on coverage issued on one life. NCOIL Life Settlements Model Act § 9(A)(18). It provides that the insurer may disclose the limit to an applicant using premium financing. *Id.* § 10(A)(2)(a)(ii).

<sup>22</sup> The NCOIL Life Settlements Model Act provides that the insurer may disclose to an applicant, using premium financing, the potential for higher premiums on replacement coverage. *Id.* § 10(A)(2)(a)(iii).

into the relationship.<sup>23</sup> The insured may suffer unexpected tax consequences.<sup>24</sup> The proceeds may be available to creditors, subject to claims that the insurance policy was protected against.<sup>25</sup> Also, insurers' pricing at a level sufficient to respond to investors' arbitraging practices could make insurance too expensive for many people looking for protection for their families.

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<sup>23</sup> See *Life Partners*, 404 F.3d at 295–96. Exposure to inquiries about health and other personal information must be disclosed by the purchaser under the model acts. NAIC Viatical Settlements Model Act § 8(A)(11); NCOIL Life Settlements Model Act § 9(A)(13).

<sup>24</sup> The *Wall Street Journal* reported that “[t]elevision talk-show host Larry King filed a lawsuit in October against a Maryland insurance brokerage. . . . The complaint alleges that, in 2004, the brokerage advised Mr. King to set up a trust that would buy and then immediately resell a \$10 million policy for \$550,000. Given Mr. King’s age, health and finances, the suit says, he would have been better off keeping the policy to benefit his estate. In part, that’s because the sale of the policy generated income taxes.” Liam Plevin & Rachel Emma Silverman, *An Insurance Man Builds a Lively Business in Death*, WALL ST. J., Nov. 26, 2007, at A1, A17. Exposure to taxes must be disclosed by the purchaser under the model acts. NAIC Viatical Settlements Model Act § 8(A)(3); NCOIL Life Settlements Model Act § 9(A)(2).

<sup>25</sup> Exposure to creditors’ claims must be disclosed by the purchaser under the model acts. See NAIC Viatical Settlements Model Act § 8(A)(4); see also NCOIL Life Settlements Model Act § 9(A)(3).

The potential for fraud can victimize investors, too. The Securities and Exchange Commission is actively pursuing investment firms suspected of defrauding investors in life insurance.<sup>26</sup>

## IV. GENERAL LEGAL RESTRICTIONS APPLICABLE TO IOLI

Investor initiation of life insurance violates existing principles of insurance law. The main issue is that of insurable interest. The Supreme Court stated that as a general rule for insurable interest in life insurance, “there must be a reasonable ground, founded upon the relations of the parties to each other, either pecuniary or of blood or affinity, to expect some benefit or advantage from the continuance of life of the assured.”<sup>27</sup>

Because investors do not have an insurable interest in the insured’s life, they cannot apply for the policy. Their solution is to convince the insured, who clearly has an insurable interest in his

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<sup>26</sup> See, e.g., *S.E.C. v. Lydia Capital*, No. 07-10712-RGS, Fed. Sec. L. Rep. (CCH) ¶ 94,586 (D. Mass. Feb. 21, 2008), which Judge Stearns described as involving “a pooled investment vehicle wagering on life insurance policies issued to older persons with limited life expectancies.” The complaint alleged that Lydia Capital solicited the insureds to purchase the insurance for settlement and that approximately half of the applications misrepresented that the insureds had no intention to sell the policies. It alleged that the private placement memorandum failed to disclose the risk of the insurer rescinding the policies due to those misrepresentations. See *STOLI ALERT 3* (June 2007).

<sup>27</sup> *Warnock v. Davis*, 104 U.S. 775, 779 (1881).

own life, to apply for the policy<sup>28</sup> and then to assign the policy, or an interest in the policy, to an issuer trust or otherwise to investment bankers for securitization. In the case of CHOLI, the charity may apply for the policy because of statutes that declare charities to have an insurable interest in anyone's life, typically subject to the insured's consenting,<sup>29</sup> although consent is not required in all states' statutes.<sup>30</sup> The charity then makes the assignment to the investors. That approach is based on the general rule that an assignee needs no insurable interest.<sup>31</sup>

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<sup>28</sup> See, e.g., *Conn. Mutual Life Ins. Co. v. Schaefer*, 94 U.S. 457 (1877). According to a commentator, “[i]t is more accurate to say that the question of insurable interest is immaterial when the policy is upon the insured’s own life. The presence of an insurable interest is really required only as evidence of the good faith of the parties, and it is contrary to human experience that a person should insure his own life in order to secure payment of money to some other, although instances of such gruesome fraud upon insurers is not wanting. Consequently, it is held that the mere fact that a man of his own motion insures his life for the benefit either of himself or of another is sufficient evidence of good faith to validate the contract.” BUIST M. ANDERSON, *ANDERSON ON LIFE INSURANCE* § 12.3, at 360 (1991). A similar argument can be made to resolve insurable interest questions about the insured’s ILIT.

<sup>29</sup> See, e.g., CAL. INS. CODE § 10110.1(f) (2008); N.Y. INS. LAW § 3205(b)(3), (c) (2008).

<sup>30</sup> See, e.g., OHIO REV. CODE § 3911.09(B) (2008). Ohio H.B. 404, introduced on November 29, 2007, would amend the statute to require consent.

<sup>31</sup> The general rule is that although an insurable interest must exist at issue, there is no legal bar to assigning the policy to an assignee lacking an insurable interest. See, e.g., *Grigsby v. Russell*, 222 U.S. 149 (1911). There are exceptions. See, e.g., UTAH CODE ANN. § 31A-21-104(1)(b); UTAH

However, an assignment made at the inception of the policy can be challenged on the ground that the assignee is in effect the applicant.<sup>32</sup> Some plans try to address that by delaying assignment. In some cases, the assignment is made after expiration of the two-year contestable period. In some cases, an ILIT applies for the policy and remains the owner of the policy, but after a short period the insured assigns his beneficial interest in the ILIT.<sup>33</sup> Nonetheless, there are authorities holding such an arrangement to be ineffective as a mere subterfuge.<sup>34</sup> A federal district

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BULLETIN 2006-3 (*see infra* note 59); *Metcalf v. Montgomery*, 155 So. 2d 582 (Ala. 1934); *Newton v. Hicks*, 138 S.W.2d 329 (Ky. 1940).

<sup>32</sup> In a case in which “[t]he assignment was contemporaneous with the issuance of the policy,” a court found that “the facts disclosed in this record permit a fair inference that it was the intent of the [assignees] to obtain just such a result as the issuance of a wagering contract of insurance permits”; thus, “this court should visit its condemnation upon the assignments.” *Finnie v. Walker*, 257 F. 698 (2d Cir. 1919).

<sup>33</sup> *See Life Prod. Clearing v. Angel*, 530 F. Supp. 2d 646 (S.D.N.Y. 2008).

<sup>34</sup> A federal court in New York has stated that “[i]t is undoubtedly true that, if the policy was taken out by the parties with a view to its immediate assignment, the transaction would be nothing more than a mere subterfuge to avoid the well-settled rule that a party cannot procure insurance upon the life of one in whom he has no insurable interest.” *Travelers v. Reiziz*, 13 F. Supp. 819, 820 (E.D.N.Y. 1935) (dictum). In the case of assignment to a person having no insurable interest who pays the premiums, the Pennsylvania Supreme Court has stated that “[i]f such assignment is merely a subterfuge, planned or contemplated when the policy was issued, to enable the assignee thereby to accomplish what he could not have done directly, namely, to obtain insurance on a life wherein he had no insurable interest, it would not be sustainable.” *Werenzinski v Prudential Ins.*

court narrowed insurers' subterfuge argument somewhat in holding that it is necessary for the insurer to identify a specific assignee to make that argument successfully.<sup>35</sup> Note that the insured is no mere straw man in the case of life settlements.

Another legal issue of which IOLI can run afoul is the statutory prohibition in most states against rebates in life insurance sales, which are defined, in general, as inducements that are not specified in the policy.<sup>36</sup> That prohibition presents problems for both up-front payments to insureds and payment of premiums for insureds.

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Co., 14 A.2d 279, 280 (1940) (dictum). A recent case in the U.S. District Court for the Southern District of New York involved assignment to a person having no insurable interest who paid the premium where the policy was not assigned but rather where the insured assigned his beneficial interest in the ILIT, which was the beneficiary of the policy. The court held that "[i]f there was a pre-assignment agreement to transfer[,] . . . the Policy is an invalid wager policy." *Life Prod. Clearing*, 530 F. Supp. 2d at 646. In the case of assignment to a person having no insurable interest who does not pay any premiums, the Vermont Supreme Court held that "a policy procured by a man on his own life, in which he has an insurable interest, for the benefit of one named therein who has no such interest, and who makes no outlay in the matter, is not a wager; and by parity of reason, such a policy assigned to such a person, though taken out for that purpose, is no wager." *Harrison's Adm'r v. Nw. Mut. Life Ins. Co.*, 63 A. 321 (Vt. 1906).

<sup>35</sup> See *First Penn-Pac. Life Ins. Co. v. William R. Evans*, 2007 U.S. Dist. Lexis 45112 (D. Md. June 21, 2007).

<sup>36</sup> The NAIC Model Unfair Trade Practices Act includes among unfair trade practices in the business of insurance the following: "knowingly permitting or offering to make or making any life insurance . . . or agreement as to such contract other than as plainly expressed in the policy issued

If the applicant attempts to conceal the investor involvement by incorrectly answering questions on the application, the insurer may be able to have the policy declared void.<sup>37</sup> The applicant, and others involved in the settlement, may also be penalized for violating a life settlements act if such an act has been enacted in the applicable state. The NAIC Model Viatical Settlements Act prohibits participating intentionally or with knowledge in presenting false or misleading information in life insurance applications.<sup>38</sup> Moreover, the NAIC Model Viatical Settlements Act prohibits settling a policy that was fraudulently obtained.<sup>39</sup>

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thereon, or paying or allowing, or giving or offering to pay, allow, or give, directly or indirectly, as inducement to such policy, any rebate or premiums payable on the policy, or any special favor or advantage in the dividends or other benefits thereon, or any valuable consideration or inducement whatever not specified in the policy; or giving, or selling, or purchasing or offering to give, sell or purchase as inducement to such policy . . . or in connection therewith, any stocks, bonds or other securities of any . . . corporation, association or partnership, or any dividends or profits accrued thereon, or anything of value whatsoever not specified in the policy.” NAIC Model Unfair Trade Practices Act § 4(H)(1).

<sup>37</sup> See, e.g., WILLIAM F. MEYER, LIFE AND HEALTH INSURANCE LAW §§ 6.1–.10.

<sup>38</sup> Section 2(F) of the NAIC Viatical Settlements Model Act defines *fraudulent viatical settlement act* to include “[a]cts or omissions committed by any person who, knowingly and with intent to defraud, for the purpose of depriving another of property or for pecuniary gain, commits, or permits its employees or its agents to engage in acts including: (1) Presenting, causing to be presented or preparing with knowledge or belief that it will be presented to or by a viatical settlement provider, viatical settlement broker, viatical settlement purchaser, [viatical settlement investment agent], financing entity, insurer, insurance producer or any other person, false material information, or

## V. REGULATORY ACTION DIRECTED AT IOLI

Regulators have begun to take action aimed directly at IOLI. The NAIC amended its Viatical Settlements Model Act to require advance disclosure to the insurer of a plan for originating, renewing, continuing, or financing a policy for the purpose of settling the policy before issuance or within five years after issuance,<sup>40</sup> and to impose a five-year moratorium on the sale of all or part of

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concealing material information, as part of, in support of, or concerning a fact material to one or more of the following: (i) An application for the issuance of a viatical settlement contract or insurance policy; (ii) The underwriting of a viatical settlement contract or insurance policy; . . . (vii) In the solicitation, offer, effectuation or sale of a viatical settlement contract, insurance policy [or viatical settlement purchase agreement].” NAIC Viatical Settlements Model Act § 2(F).

<sup>39</sup> Section 2(F) of the NAIC Viatical Settlements Model Act defines *fraudulent viatical settlement act* to include “[a]cts or omissions committed by any person who, knowingly and with intent to defraud, for the purpose of depriving another of property or for pecuniary gain, commits, or permits its employees or its agents to engage in acts including: (4) Recklessly entering into, brokering, otherwise dealing in a viatical settlement contract, the subject of which is a life insurance policy that was obtained by presenting false information concerning any fact material to the policy or by concealing, for the purpose of misleading another, information concerning any fact material to the policy, where the viator or the viator’s agent intended to defraud the policy’s issuer. “Recklessly” means engaging in the conduct in conscious and clearly unjustifiable disregard of a substantial likelihood of the existence of the relevant facts or risks, such disregard involving a gross deviation from acceptable standards of conduct.” NAIC Viatical Settlements Model Act § 2(F).

<sup>40</sup> Section 9 of the NAIC Viatical Settlements Model Act provides that “[p]rior to the initiation of a plan, transaction or series of transactions, a viatical settlement broker or viatical settlement

a policy.<sup>41</sup> Those provisions would require the insured to pay premiums for five years, which may discourage people from entering into IOLI transactions, unless investment bankers can find a way around that obstacle, such as premium financing. Limiting the transferring of an interest avoids difficult proof problems involved in regulating what is intended at the time of application for a policy, but it provides no regulatory protection following expiration of the limitation period.

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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 any time prior to, or during the first five (5) years after, issuance of the policy.” NAIC Viatical Settlements Model Act § 9.

<sup>41</sup> Section 11(A) of the NAIC Viatical Settlements Model Act provides that “[i]t 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,” subject to certain exceptions. Section 2(N)(1) defines *viatical settlement contract* as, among other things, “a written agreement . . . 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.” NAIC Viatical Settlements Model Act § 2(N)(1).

NCOIL rejected the NAIC's five-year moratorium and included only a two-year moratorium in its Life Settlements Model Act.<sup>42</sup> For a policy settled within five years of issuance, the NCOIL model act requires the provider of the life settlement contract to "file with the Commissioner on or before March 1 of each year an annual statement containing such information as the Commissioner may prescribe by regulation."<sup>43</sup> Instead of adopting the five-year moratorium,

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<sup>42</sup> Section 11(N) of NCOIL's Life Settlements Model Act provides that "[n]o person at any time prior to, or at the time of application for, issuance of, a policy, or during a two-year period commencing with the date of issuance of the policy, shall enter into a Life Settlement regardless of the date the compensation is to be provided and regardless of the date the assignment, transfer, sale, devise, bequest or surrender of the policy is to occur," subject to certain exceptions. NCOIL Life Settlements Model Act § 11(N). Section 2(L) defines *life settlement contract* as, among other things, "a written agreement . . . establishing the terms under which compensation or any thing of value will be paid, which compensation or thing of value is less than the expected death benefit of the insurance policy or certificate, in return for the owner's assignment, transfer, sale, devise or bequest of the death benefit or any portion of an insurance policy or certificate of insurance for compensation, provided, however, that the minimum value for a Life Settlement Contract shall be greater than a cash surrender value or accelerated death benefit available at the time of an application for a Life Settlement Contract. . . . 'Life Settlement Contract' also includes the transfer for compensation or value ownership or beneficial interest in a trust or other entity that owns such policy if the trust or other entity was formed or availed of for the principal purpose of acquiring one or more life insurance contracts, which life insurance contract insures the life of a person residing in this State."

<sup>43</sup> NCOIL Life Settlements Model Act § 6(A).

NCOIL enlarged the list of violations, adding acts that specifically relate to IOLI. It prohibited promoting the purchase of an insurance policy for the purpose of, or with an emphasis on, settling the policy.<sup>44</sup> It added to the list of provisions a prohibition on participating intentionally or with knowledge in presenting false or misleading information in life insurance applications, referring specifically to making misrepresentations about life expectancy evaluations<sup>45</sup> and violating insurable interest laws.<sup>46</sup> In the case of premium financing, it permitted an insurer to require a

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<sup>44</sup> Section 13(A)(4) of the NCOIL Life Settlements Model Act provides that “[i]t is unlawful for any person to . . . issue, solicit, market or otherwise promote the purchase of an insurance policy for the purpose of or with an emphasis on settling the policy.” NCOIL Life Settlements Model Act § 13(A)(4). Section 8(C)(1) provides that “[n]o person or trust shall . . . directly or indirectly, market, advertise, solicit or otherwise promote the purchase of a policy for the sole purpose of or with an emphasis on settling the policy.” NCOIL Life Settlements Model Act § 8(C)(1).

<sup>45</sup> Section 2(H)(1) provides thus: “Fraudulent Life Settlement Act’ includes . . . Acts or omissions committed by any person who, knowingly and with intent to defraud, for the purpose of depriving another of property or for pecuniary gain, commits, or permits its employees or its agents to engage in acts including, but not limited to: . . . (b) Failing to disclose to the insurer where the request for such disclosure has been asked for by the insurer that the prospective insured has undergone a life expectancy evaluation by any person or entity other than the insurer or its authorized representatives in connection with the issuance of the policy.” NCOIL Life Settlements Model Act § 2(H)(1).

<sup>46</sup> According to Section 2(H)(1): “Fraudulent Life Settlement Act’ includes . . . Acts or omissions committed by any person who, knowingly and with intent to defraud, for the purpose of depriving another of property or for pecuniary gain, commits, or permits its employees or its agents to engage

certification from the applicant and the insured that he has “not entered into any agreement or arrangement providing for the future sale of this life insurance policy,”<sup>47</sup> that he has “not entered into any agreement . . . to receive consideration in exchange for procuring [the] policy,”<sup>48</sup> and that “the borrower has an insurable interest in the insured.”<sup>49</sup> It made participating intentionally or with knowledge in presenting false or misleading information in any IOLI transaction a fraudulent life settlement act.<sup>50</sup> It also recommended, in a drafting note, that “states should consider adopting an amendment to their insurable interest laws, if necessary.” That suggested statute is as follows:

In accordance with *Grigsby v. Russell*, 222 U.S. 149, it shall be a violation of insurable interest for any person or entity without insurable interest to provide or

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in acts including, but not limited to: . . . (d) In the solicitation, application or issuance of a life insurance policy, employing any device, scheme or artifice in violation of state insurable interest laws.” NCOIL Life Settlements Model Act § 2(H)(1).

<sup>47</sup> *Id.* § 10(A)(2)(b)(i).

<sup>48</sup> *Id.* § 10(A)(2)(b)(ii).

<sup>49</sup> *Id.* § 10(A)(2)(b)(iii).

<sup>50</sup> Section 2(H)(1)(a)(x) provides thus: “‘Fraudulent Life Settlement Act’ includes . . . Acts or omissions committed by any person who, knowingly and with intent to defraud, for the purpose of depriving another of property or for pecuniary gain, commits, or permits its employees or its agents to engage in acts including, but not limited to: . . . Presenting, causing to be presented or preparing with knowledge and belief that it will be presented to or by a Provider, Premium Finance lender, Broker, insurer, insurance producer or any other person, false material information, or concealing material information, as part of, in support of, or concealing a fact material to one or more of the following: . . . Enter into any practice or plan which involves STOLI.”

arrange for the funding ultimately used to pay premiums, or the majority of premiums, on a life insurance policy, and, at policy inception have an arrangement for such person or entity to have an ownership interest in the majority of the death benefit of that life insurance policy.<sup>51</sup>

NCOIL provided the following definition of STOLI:

“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 prohibitions against wagering on life.<sup>52</sup>

Several state insurance departments have taken action, but that action has been mostly tentative so far, and informal, consisting of bulletins, website alerts, and news releases.

Alabama has issued a bulletin addressed to insurers that imposes filing requirements for issuing “zero premium life insurance,” which that bulletin does not define other than to state that it

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<sup>51</sup> *Id.* drafting note.

<sup>52</sup> *Id.* § 2(Y).

is “also called stranger owned life insurance, investor owned life insurance and/or investor initiated life insurance.” The requirements include, among other things, explaining how the insurable interest and rebate laws will be satisfied, and describing the methods to be used in marketing the arrangements, in recruiting producers to market the arrangements, and in soliciting investors.<sup>53</sup>

Alabama has also issued a bulletin addressed to producers, entitled *Zero Premium Life Insurance*, which states that “producers are cautioned . . . to refrain from entering into any . . . arrangement to market or sell a life insurance product” involving unnamed payers or insurers that are not disclosed up-front or for which the producer is not appointed or “where there is a third person or entity having a remaining beneficial interest in the balance of the coverage beyond that afforded to the insured.”<sup>54</sup> Georgia gives a similar warning to producers on its website under the heading “Zero Cost Insurance Coverage Solicitations.” Vermont issued a similar warning in a May 17, 2007, press release.

Texas and North Carolina also caution producers against zero premium life insurance. Texas has issued an alert stating that

[i]t has come to the attention of the Texas Department of Insurance ("Department") that a nontraditional product is being offered in the Stranger-Owned Life Insurance (STOLI) market. Texas agents are being solicited to assist in the sale of what are frequently called "estate maximization plans," "zero premium life insurance" or "no cost to the insured" policies to consumers, most commonly elderly persons between the ages of 65 and 85. The Department is investigating and gathering details regarding these offerings. This bulletin is

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<sup>53</sup> ALA. BULL. (June 22, 2007).

<sup>54</sup> ALA. BULL. (June 26, 2007).

to alert you as a Texas insurance agent to exercise caution with respect to these transactions.<sup>55</sup>

The North Carolina Department of Insurance has a similar alert on its website concerning “sales of a zero premium life insurance policy,” in which producers are “advised to use caution in considering this program until detailed information is obtained about the product and the product can be thoroughly reviewed.”<sup>56</sup>

Illinois issued a consumer alert on its website, stating that [t]he Illinois Division of Insurance advises consumers to proceed with caution when considering participation in a "Stranger/Investor Originated Life Insurance" (STOLI) arrangement. The Division does not sanction or approve STOLI arrangements. These transactions and parties to these transactions may be subject to the Illinois Insurance Code and other applicable laws of the State of Illinois.<sup>57</sup>

Kansas issued a similar consumer alert on its website, stating that Sandy Praeger, Kansas Insurance Commissioner, and Kathy Greenlee, Secretary of the Kansas Department on Aging, are urging older Kansas consumers to think carefully about purchasing life insurance that could be sold as investments to strangers. . . . The arrangements could allow an outside person or group to purchase insurance on a person’s life in exchange for an immediate lump-sum payment. . . .

These arrangements are considered illegal by the life insurance industry, and sales to

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<sup>55</sup> TEX. INS. DEP'T, AGENT AND COMPANY ALERT (May 29, 2007); *see also* TEX. INS. DEP'T, CONSUMER ALERT (May 29, 2007).

<sup>56</sup> Note to author: please provide citation for this direct quote.

<sup>57</sup> ILL. INS. DIV., CONSUMER ALERT (Jan. 2008).

stranger/investors may void the policy because the new owner has no "insurable interest" in the policyholder.<sup>58</sup>

Ohio has issued a consumer alert on its website warning consumers that [c]onsumers need to be fully aware that, unlike a traditional policy where the insured's loved ones are beneficiaries of the death benefits, in a STOLI arrangement, an investor group—strangers—will likely acquire an interest in the life of a participant. Other possible consequences to consumers participating in STOLI arrangements are limits on future insurability, higher premiums for additional coverage and/or tax liabilities.

The Insurance Department called attention to that alert in a news release.<sup>59</sup>

Idaho has issued a bulletin that says that such transactions may violate insurable interest or rebate laws. It provides that

the Department will review the arrangement in its entirety to determine the underlying intent of the parties and whether the arrangement is designed to circumvent the insurable interest requirement. Factors the Department might consider . . . include: the time elapsed between inception and assignment; all consideration . . ., including incentives for assignment and promises of future compensation; and who ultimately pays the premium. Idaho law also prohibits providing an actual or prospective policyholder rebates or inducements with a value greater than \$50 if they are not a part of the policy terms. . . . Offering to pay

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<sup>58</sup> KAN. INS. DEP'T, CONSUMER ALERT (Feb. 14, 2008).

<sup>59</sup> News Release, Ohio In. Dep't (May 1, 2008).

premiums, forgive premium loans or promising future cash payments to induce a person to purchase an insurance policy may violate this law if the incentive is not included in the terms of the policy filed with the Department of Insurance.<sup>60</sup>

Some state's positions are firm, although informal, consisting of bulletins, a directive, and a general counsel's Opinion.

Utah says such transactions violate insurable interest requirements. It has issued a bulletin that provides as follows:

The Utah Insurance Department has received several inquiries regarding the legality of a life insurance transaction that involves the purchase of a life insurance policy, premium financing through a non-recourse loan, the sale of the policy in the secondary market, and a payment to the applicant.

The department's position regarding these life insurance transactions is that they are not compliant with the insurable interest requirement of this state. As stated in Utah Code Annotated (U.C.A.) 31A-21-104(1)(b), "[a] person may not knowingly procure, directly, by assignment, or otherwise, an interest in the proceeds of an insurance policy unless that person has or expects to have an insurable interest in the subject of the insurance." . . .

To determine if an insurable interest exists, the department will look at the entire transaction and will not limit its review to only that part of the transaction that relates to applying for the life insurance policy. Regarding the transactions that have been described to us, a third party initiates, arranges the transaction, and ultimately expects to receive the proceeds of the

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<sup>60</sup> IDAHO BULL. 07-03 (2007).

insurance policy. The third party has no insurable interest in the person insured because a lawful and substantial interest does not exist in having the life of the insured continue; in fact, there is a substantial interest in *not* having the life of the person continue.<sup>61</sup>

New York also says there is no insurable interest, and there may be a rebate. The Office of General Counsel opined that an

arrangement [which] is intended to facilitate the procurement of policies solely for resale [to investors] . . . does not conform to the requirements of the New York Insurance Law. First, the policies obtained by the Clients herein are arguably not obtained "on [their] own initiative" as required by N.Y. Ins. Law § 3205(b)(1). Secondly, the potential transferees do not appear to have a legitimate "insurable interest" in the lives of the Clients. While it is true that N.Y. Ins. Law § 3205(b)(1) expressly allows an individual to procure and immediately transfer or assign to another a policy on his own life, irrespective of the existence of an insurable interest in the assignee (a position upheld by *Hota v. Camaj*, 750 N.Y.S. 2d 119 (2nd Dept 2002), which the inquirer cites in the inquirer's letter) it is the Department's view that the transaction presented involves the procurement of insurance solely as a speculative investment for the ultimate benefit of a disinterested third party. Such activity is readily distinguishable from the facts underlying *Hota*, and is contrary to the long established public policy against "gaming" through life insurance

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<sup>61</sup> UTAH BULL. 2006-3 (2006).

purchases. In addition, there may exist other potential problems, such as rebating violations, with the proposed transaction.<sup>62</sup>

Arkansas says that insurance benefiting charities but bought “primarily for investment purchases” violates insurable interest requirements. The Arkansas Insurance Department has issued a directive that states that

[t]he Department’s position is that in "investor-owned" life insurance purchases, by trusts or organizations formed by individuals or entities with no relationship with the individual insured, primarily for investment purposes and not solely for the benefit of a participating or sponsoring charity, the life insurance policies are not purchased by one with a substantial economic interest in the continuing life of the individual insured. The trust or business organization establishing "investor-owned" life insurance, even when charitable organizations are partial beneficiaries, have a lesser interest in having the life of the insured individual continue as distinguished from "an interest that would arise only by, or would be enhanced in value by, the death, disablement, or injury of the individual insured."<sup>63</sup>

The Louisiana Insurance Department, on the other hand, has issued a bulletin that limits what insurers can do in response to investor involvement. It provides that “life insurance underwriting may not discriminate against applicants for life insurance based solely on the intention of the insured to subsequently sell the life insurance policy to a life settlement company or on the method of payment utilized by the insured to pay the premium.” It prohibits asking

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<sup>62</sup> Op. N.Y. Off. of General Counsel 05-12-15 (2005).

<sup>63</sup> Ark. Directive 1-2005.

questions that inquire about the intention of the applicant to premium finance the policy; questions that inquire about the intention of the applicant to use the policy as collateral for a loan; questions that inquire about whether the applicant has previously converted a life insurance policy via the life settlement provisions; or questions which inquire about whether the applicant is cognizant that he is vested with a property right to settle a life insurance policy in the future.<sup>64</sup>

However, the NCOIL Life Settlements Model Act provides that [w]ithout limiting the ability of an insurer from assessing the insurability of a policy applicant and determining whether or not to issue the policy[,] . . . insurance carriers may inquire in the application for insurance whether the proposed owner intends to pay premiums with the assistance of financing from a lender that will use the policy as collateral to support the financing.<sup>65</sup>

## VI. POTENTIAL RESPONSES BY INSURERS

If a misrepresentation was made in the application, the insurer may be able to rescind the policy due to that misrepresentation.<sup>66</sup> Typically, such an action must be brought within the two-year contestable period.<sup>67</sup> New Jersey allows a fraud exception to the contestable period.<sup>68</sup> Other states

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<sup>64</sup> LA. BULL. No. 06-05 (2006).

<sup>65</sup> NAIC Life Settlements Act § 10(A).

<sup>66</sup> *See* MEYER, *supra* note 37.

<sup>67</sup> *See id.* §§ 8.1–.14.

could follow New Jersey, especially when presented with a recurring fraudulent scheme perpetrated as a course of business, but current authority in many states does not allow a fraud exception to the contestable period.<sup>69</sup> That two-year limitation enables securitizers to conceal their activity for that period and then enjoy protection against rescission for misrepresentation after the end of the period.

Enactment of a life settlements act, especially with NAIC's moratorium and NCOIL's enhancements,<sup>70</sup> which would impose penalties that are not subject to the two-year contestable period, would address that problem by allowing regulatory enforcement action against securitizers at any time that the securitization is discovered, subject to applicable statutes of limitations. The NAIC Viatical Settlements Model Act provides that "in no event may the prosecution be commenced later than seven years after the act has occurred."<sup>71</sup> Under that limitation, the ability to prosecute does not terminate seven years after the application because violations continue to occur after the application upon payment of premiums,<sup>72</sup> financing,<sup>73</sup> changes of owner or beneficiary,<sup>74</sup> conversion,<sup>75</sup> and submitting a claim<sup>76</sup> while continuing to conceal initiation of the policy by investors.

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<sup>68</sup> *Fioretti v. Mass. Gen. Life Ins. Co.*, 53 F.3d 1228 (11th Cir. 1995) (applying New Jersey law); *Ledley v. William Penn Life Ins. Co.*, 651 A.2d 92 (N.J. 1995).

<sup>69</sup> *See, e.g., Protective Life Ins. Co. v. Sullivan*, 682 N.E.2d 624 (Mass. 1997).

<sup>70</sup> *See supra* notes 44–52.

<sup>71</sup> NAIC Viatical Settlements Model Act § 15.

<sup>72</sup> *Id.* § 2(F)(1)(a)(iv).

<sup>73</sup> *Id.* § 2(F)(1)(a)(ix).

<sup>74</sup> *Id.* § 2(F)(1)(a)(v).

<sup>75</sup> *Id.* § 2(F)(1)(a)(vi).

A potential barrier to an insurer rescinding due to misrepresentation or to a regulator imposing a penalty for misrepresentation is the problem that the insurer may not have asked the right questions on the application, so there may be no misrepresentations upon which to base a rescission or penalty. Another potential barrier to rescission is the possibility that the producer may have been involved in the misrepresentation, raising possible defenses of waiver and estoppel.<sup>77</sup> An insurer may be able to defeat those defenses if it can show that the producer in fact was acting as an agent for the insured or acting as an agent for the securitizer rather than acting as an agent for the insurer.

If rescission cannot be based on a misrepresentation in the application, the insurer may be able to rescind due to lack of insurable interest. That action is not dependent on false statements on the application, and many states allow an insurable interest challenge beyond the contestable period.<sup>78</sup> The NCOIL Life Settlements Model Act would make “employing any device, scheme or

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<sup>76</sup> *Id.* § 2(F)(1)(a)(iii).

<sup>77</sup> *See, e.g.,* MEYER, *supra* note 37, §§ 6.14–.18.

<sup>78</sup> *See, e.g.,* Commonwealth Life Ins. Co. v. George, 28 So. 2d 910 (Ala. 1947), Home Life v. Masterson, 21 S.W.2d 414 (Ark. 1929); Carter v. Cont'l Life Ins. Co., 115 F. 2d 947 (D.C. Cir. 1940); Foreman v. Great United Mut. Benefit Ass'n, 23 N.E. 2d 813 (Ill. App. Ct. 1939); Bromley's Adm'r v. Wash. Life Ins. Co., 92 S.W. 17 (Ky. 1906); Ky. Cent. v. McNabb, 825 F. Supp. 269 (D.C. Kan. 1969); Stevens v. Woodmen of the World, 71 P.2d 898 (Mont. 1937); Wharton v. Home Sec. Life Ins. Co., 173 S.E. 338 (N.C. 1934); Brady v Prudential Life Ins. Co., 5 Kulp 505 (1890); Henderson v. Life Ins. Co. of Va., 179 S.E. 680 (S.C. 1935); Aetna Life Ins. Co. v. Hooker, 62 F.2d 805 (1933). *Contra* New Eng. Mut. Life Ins. Co. v. Caruso, 523 N.Y.S. 2d

artifice in violation of state insurable interest laws” a fraudulent life settlement act.<sup>79</sup> If a state does not allow an insurable interest challenge beyond that period but if it has enacted the NCOIL provision, action can be taken in that state against perpetrators after expiration of the period by means of regulatory enforcement.

Establishing the factual basis for either rescission or penalties for lack of insurable interest will be difficult. The application must be submitted by the insured rather than the securitizer for insurable interest purposes,<sup>80</sup> and the assignment of an interest to the securitizer need not necessarily involve the insurer.<sup>81</sup> When that interest is pooled and sold on the secondary market, the securitization takes place through a private placement.<sup>82</sup> All of those elements of the transaction make the securitization invisible to the insurer. In order to detect it, insurers must investigate carefully. Insurers should look for assignments; an issuer trust or other securitizer; a change in the payer of the premiums; a change in beneficiary to a trust or other entity; and signs that the producer does business with investors, including a new pattern of soliciting very large face-amount policies, a new pattern of soliciting older ages, or activity in life settlements.

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928 (1988) (based on a finding that a lack of insurable interest does not void a policy ab initio in New York).

<sup>79</sup> NCOIL Life Settlements Model Act § 2(H)(1)(d).

<sup>80</sup> See *supra* notes 27, 28, and accompanying text.

<sup>81</sup> In *Life Product Clearing v. Angel*, 530 F. Supp. 2d 646 (S.D.N.Y. 2008), for example, the insured’s trust was beneficiary of the policy; and the insured, as beneficiary of the trust, sold his interest in the trust. The trust remained the beneficiary in the insurer’s records.

<sup>82</sup> See *supra* note 26 and accompanying text.

Insurers may also respond to IOLI through protective actions in their sales and marketing, underwriting, and policy development areas. Sales and marketing actions include establishing a clear company policy, making certain that contracts with producers and selling agreements with broker/dealers require compliance with that policy, and terminating or otherwise disciplining noncompliant producers.

Actions in underwriting start with asking the right questions to enable the insurer to determine whether IOLI is involved.<sup>83</sup> Even if the insurer does not discover IOLI immediately, asking those questions on the application gives the insurer the remedy of rescinding the policy if the involvement of IOLI is discovered following the issuance of the policy.

Louisiana, as previously mentioned, has issued a bulletin imposing limitations on questions in applications. However, the focus of the model acts on intent at the time of application<sup>84</sup> requires insurers to ask questions on the application that are designed to discover the intent. NCOIL recognized that specifically repudiating Louisiana's prohibition against asking about premium finance<sup>85</sup> would express the importance of avoiding "limiting the ability of an insurer from

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<sup>83</sup> The underwriters must also exercise discipline in rejecting applications in which questions are not answered. In *Life Product Clearing*, 530 F. Supp. 2d 646, the insurer issued the policy even though the following question was not answered: "Does the client intend to use the policy for any type of viatical settlement, senior settlement, life settlement or for any other secondary market?"

<sup>84</sup> See *supra* notes 38, 39, 45–52.

<sup>85</sup> Section 10(A) provides that "insurance carriers may inquire in the application for insurance whether the proposed owner intends to pay premiums with the assistance of financing from a lender that will use the policy as collateral to support the financing." NCOIL Life Settlements Model Act § 10(A).

assessing the insurability of a policy applicant and determining whether or not to issue the policy.”<sup>86</sup>

That is not to say that insurers can be indiscriminate in asking questions on the application. They should take care to protect applicants against getting trapped by unclear questions into making inadvertent misrepresentations. For example, instead of asking whether a life settlement is involved, which requires the applicant to define accurately the term *life settlement* and apply that definition to the circumstances, the insurer should ask whether a transfer of an interest in the policy is planned.

Questions that are too subjective to be used as a basis for rescission can still be asked apart from the application in interviews with the applicant and insured. Although a false answer will not enable the insurer to rescind the policy, a truthful answer may provide the information that the insurer needs to determine whether IOLI is involved.

Issues to be investigated by insurers in underwriting include the following:

- Does the policy replace a policy that has been sold?
- Does the premium expense make sense for the insured?
- Is the source of the premium a source other than the insured’s assets (particularly suspect sources include a loan with no security other than the policy, which indicates lack of financial commitment by the insured; and an annuity, which further distances the source of the money and is an additional arbitrage opportunity)?
- Did investment bankers draft the ILIT or provide the trustee?<sup>87</sup>
- Does the ILIT have provisions to accommodate investor involvement?

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<sup>86</sup> *Id.*

<sup>87</sup> *See Life Prod. Clearing*, 530 F. Supp. 2d at 646.

- Is there another trust besides the ILIT, which may be an issuer trust?
- Are there multiple medical information bureau entries, indicating shopping?
- Is the same address on other applications?
- Is another party evaluating life expectancy?<sup>88</sup>
- Are multiple parties sharing the death benefit?
- Has an inducement been offered to the insured?<sup>89</sup>
- Are there signs (as with rescission litigation) that the producer does business with investors?

Policy development to prevent IOLI is also a potential solution. One approach would be to require that a minimum percentage of death benefits must be paid to beneficiaries with insurable interests. That poses the line-drawing question of what percentage of benefits should be required to pass to beneficiaries with insurable interests, a question to which NCOIL has suggested an answer. In the drafting note to its model act, NCOIL proposed amending insurable interest statutes by providing that

it shall be a violation of insurable interest for any person or entity without insurable interest to provide or arrange for the funding ultimately used to pay premiums, or the majority of

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<sup>88</sup> NCOIL supports insurers asking this question. Its Life Settlements Model Act includes among fraudulent life settlement acts “[f]ailing to disclose to the insurer where the request for such disclosure has been asked for by the insurer that the prospective insured has undergone a life expectancy evaluation by any person or entity other than the insurer or its authorized representatives in connection with the issuance of the policy.” NCOIL Life Settlements Model Act § 2(H)(1)(b).

<sup>89</sup> NCOIL supports insurers asking this question, at least in premium finance situations. *See id.* § 10(A)(2)(b)(ii).

premiums, on a life insurance policy, and, at policy inception have an arrangement for such person or entity to have an ownership interest in the majority of the death benefit of that life insurance policy.<sup>90</sup>

Insurers could similarly require in their policies that at least 50 percent of death benefits will be paid to beneficiaries with insurable interests and, for administrative simplicity, should be able to do so without regard to who pays the premiums.

There is a tradition of allowing anyone to be a beneficiary,<sup>91</sup> which such a policy provision would limit but not eliminate. The policy would also have to specify that a trust cannot be named as beneficiary of the policy if more than 50 percent of the beneficial interest in the trust passes to people or entities without an insurable interest.

Another approach in policy drafting is to limit assignments. The general rule is that although life insurance policies are inherently assignable, that assignability may be limited by contract.<sup>92</sup> Assignments could be limited for a period of years. A period of five years would follow the example of the five-year moratorium in the NAIC model act, but five years may not be enough, especially if the premiums are financed. Assignments could be limited to assignees with insurable interests. Objections may be made based on the holding of the U.S. Supreme Court that “[s]o far as reasonable safety permits, it is desirable to give to life policies the ordinary characteristics of property. . . . To deny the right to sell except to persons having such an [insurable] interest is to diminish appreciably the value of the contract in the owner’s hands.”<sup>93</sup> However, the Court was

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<sup>90</sup> *Id.* drafting note.

<sup>91</sup> *See, e.g.,* Metcalf v. Montgomery, 155 So. 2d 582 (Ala. 1934).

<sup>92</sup> *See, e.g.,* Daino v. Atl. Refining Co., 161 A.2d 42 (Pa. 1960).

<sup>93</sup> Grigsby v. Russell, 222 U.S. 149, 156 (1911).

considering what should be prohibited as a matter of public policy, not what may be prohibited as a matter of contract, and the qualifier “so far as reasonable safety permits” establishes that the right to sell the policy is not unlimited.

In limiting assignments, if care is not taken to limit assignment of any interest rather than limiting just a change in ownership of the policy, investors may get around the limitation by leaving the original owner in place and arranging for the owner to assign an interest in the policy or an interest in a trust that is named as beneficiary of the policy.<sup>94</sup>

## VII. CONCLUSION

Some types of securitization threaten the life insurance business more than others. When securitization is the motivating factor in issuing life insurance, it changes the character of the life insurance. It distances the source of the money from its use and eliminates the relationship in which the insurer is the financial protector of the insured’s beneficiaries. It resembles the way securitization made mortgages more precarious by distancing the source of the money from its use and eliminating the relationship in which the lender was the provider of a home for the borrower. Some of the potential results are unique to the insurance industry, such as a change in federal tax policy. Others are shared with the mortgage industry, such as substantially increased fraud.

Whether securitization damages the life insurance industry as it has the mortgage industry depends on many variables. The most pressing concern is, of course, what insurers and regulators

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<sup>94</sup> See *Life Prod. Clearing v. Angel*, 530 F. Supp. 2d 646 (S.D.N.Y. 2008).

do, or fail to do, to preserve the purpose of life insurance to provide financially for designated beneficiaries, and to prevent life insurance from being transformed into an instrument that merely provides investment opportunities for strangers.