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Insurance

Legislation designed to eliminate stranger-originated life insurance has its positives, negatives



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Should it be a crime to purchase a life insurance policy and then sell it to an investor within the first five years of its issuance? The legislators in at least four states think so.

Last month, West Virginia made it possible for consumers to go to prison for up to 20 years if they violate this new law. Three other states — Oklahoma, Illinois and New York — have pending bills that would mandate similar punishment.

The impetus for this is that life insurance companies and legislators alike are attempting to eradicate a controversial transaction known as stranger-originated life insurance (STOLI).

This practice involves individuals age 72-85 obtaining "free" life insurance and either upfront payments of cash or the potential of revenue from sales of their policies at some specified time in the future. The coverage is "free" because the premiums are financed on a non-recourse basis.

In essence, these are preconceived plans to originate life insurance policies that would not have otherwise been purchased if consumers had to pay premiums out of their own pockets.

There are legitimate reasons to bring an end to STOLI. However, newly enacted laws, like West Virginia's, as well as other pending bills around the country go too far and infringe important consumer rights.

So, what's wrong with STOLI in the first place?

It can be problematic because it may cause unintended consequences for uninformed consumers and their families.

Consumers may be liable if no death benefit is paid

One of the major concerns with STOLI is that the insured or the insured's estate may be liable if the life insurance company rescinds the policy and fails to pay a death benefit. There are two situations where this is possible — when insurable interest laws are violated and when fraud is committed on the insurance application.

STOLI appears to violate insurable interest laws. An insurable interest is a pre-existing relationship between the insured and beneficiary of a life insurance policy, such as husband and wife, business partners, or parents and heirs.

Under state law, if an insurable interest exists at the moment a life insurance policy is issued, then an insurable interest always exists despite potential, future transfers of ownership.

In a STOLI transaction, the policy is purchased with the intent to sell it to an investor, not to protect a beneficiary of the insured. Hence, there is a strong argument that no insurable interest ever existed.

Most STOLI contracts provide the investor the right to collect from the insured or the insured's estate if a death benefit is not paid. If a carrier challenged a death claim on the grounds that no insurable interest existed, an investor could then seek to recover loss of its anticipated profit from the insured's estate, i.e., the insured's spouse or children.

There may be similar liability if consumers commit fraud on in their applications. Most life insurance companies dislike STOLI and therefore include questions in their applications to help determine whether policies will be financed and/or sold. In order to consummate STOLI sales, applicants may be coached by agents to answer "no" to these questions. The failure to accurately answer these questions may be deemed fraud and justify a carrier's denial of a death benefit.

Consumers may be unable to obtain additional coverage

Each individual who applies for life insurance has a maximum threshold of coverage that will be issued based on their financial capacity, and the industry capacity for an individual risk. This is known as insurable capacity.

In order to maximize everyone's gain in a STOLI sale, the parties want the largest possible policy to be issued. This has the effect of using up all or substantially all of the insured's insurable capacity if future coverage is needed.

Uninformed consumers enticed with "getting something for nothing" may not understand that there are alternative ways to utilize their insurable capacities. Simply put, if Wall Street views an insurance policy as worthwhile asset, it is worth understanding the value of the asset and how to maximize this value.

Detrimental changes in the law

In 2007, the National Association of Insurance Commissioners (NAIC) issued amendments to its Viatical Settlements Model Act (the "NAIC Model"), which addressed STOLI for the first time. If enacted, the NAIC Model offers needed regulation governing the sales of existing policies. However, NAIC included the following four provisions that are detrimental to consumers and the viability of a legitimate life settlement market:

1. A prohibition on the sale of an existing life insurance policy for five years from its date of issuance unless certain exceptions exist.

Because the majority of STOLI programs involve sales of life insurance policies within 27 months of their issuance, the imposition of a five-year ban is intended to eliminate these programs altogether. But policies originated by the insured for legitimate reasons should not be subject to such a lengthy ban.

A life settlement can be a more lucrative exit strategy for owners of unneeded or unwanted (and legitimately purchased) policies, because these policies can be sold for amounts greater than their cash surrender values. Life settlements can take place as early as 25 months after the policies are issued, i.e., once they come out of their two-year contestable periods.

NAIC carves out a poorly conceived exception to address this issue. The NAIC Model provides in relevant part that a policy may be sold any time after its two-year anniversary if the premiums are not financed on a non-recourse basis, if there is no agreement or understanding that the policy will be sold to a third party, and if neither the insured nor the policy was evaluated for settlement prior to the policy's issuance.

The first two elements of this exception hit STOLI squarely on the head. However, the third element unnecessarily impacts consumer rights.

Where insurance is purchased for family, business or estate planning purposes, it is advisable for agents to disclose the existence of the life settlement market to their clients in accordance with the advisors' fiduciary duties.

Moreover, should consumers wish to learn what the anticipated value of their policies would be on the secondary market, certain information, including the consumers' life expectancies, would be ascertained. Such analyses would likely be interpreted as "evaluations" of the insureds for settlement.

It would then follow that these consumers would be prohibited from selling their policies for five years. Consumers should have the right to fully evaluate assets that they are purchasing for their own account without undue restriction on their right to sell their assets in the future.

2. Any broker or investor engaging in these transactions must purchase a \$250,000 bond; and

3. A 60-day rescission period.

states will have to spend \$5 million before engaging in its first transaction. Such an expense may be prohibitive and cause firms to invest elsewhere.

The 60-day rescission period appears to be a consumer-friendly provision. However, if in every transaction investors will not know whether their purchases are complete for 60 days after the proceeds are paid, investors may seek to purchase policies in other states where the sales will be finalized much sooner.

The value of a viable life settlement market is dependent on open competition and full disclosure. If these overly burdensome laws deter investors from remaining in the market, competition will be stifled and prices will decrease. This benefits insurance carriers but not consumers because more policies will lapse or be surrendered.

4. Consumers who violate the law may be criminally prosecuted and convicted of a felony.

The NAIC Model does not have unanimous support among the states

To date, only North Dakota, West Virginia and Iowa have enacted versions of the NAIC Model. Illinois, Louisiana, Massachusetts, Nebraska, Ohio and Oklahoma are the other supporters of the NAIC Model where legislation is pending.

The National Conference of Insurance Legislators recently passed a competing Model Act (the "NCOIL Model"). While the NCOIL Model also aims to eliminate STOLI, it does so without infringing consumers' rights like the NAIC Model.

The NCOIL Model provides for a two-year ban on selling existing policies and clearly defines the various machinations of STOLI that are impermissible. There also are no criminal penalties or bond requirements like the NAIC Model. The NCOIL Model currently is being considered by eight states

Several more states, including Michigan, are expected to introduce bills in 2008. Only time will tell whether these states will follow the NAIC or NCOIL Models.

In closing

The secondary market for life insurance has developed a less than stellar reputation because of the existence of STOLI. The issues with STOLI are real and include serious risks for consumers, including liability to investors if policies are rescinded and no death benefits are paid.

STOLI also limits the consumers' access to future coverage thereby causing unintended transfers of a valuable asset — one's insurable capacity — to third parties.

Legislators are justified in eradicating STOLI. The NAIC Model, however, hurts consumers by trying to undermine a legitimate secondary market that has for the first time allowed consumers to benefit

from insurance they no longer need or can afford. The effect of the NAIC Model could be to force consumers to once again accept surrender or policy lapse as their only alternatives.

The NCOIL Model recognizes this tension between stopping abuse and preserving the rights of life insurance policy holders to freely sell an asset to which the market attaches significant value.

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**Investors should consult with their own professional advisor regarding the potential tax, estate, and legal considerations that may arise in connection with entering into a life settlements transaction. Proceeds from a life settlement transaction may be taxable under federal or state law to the extent the proceeds exceed the cost basis. The proceeds from a life settlement transaction may be subject to claims of creditors. The receipt of proceeds from a life settlement transaction may adversely impact eligibility for government benefits and entitlements. The amount received for the sale of the Policy may be impacted by the circumstances of the particular purchaser of the Policy, the insured's life expectancy, future premiums, the death benefit, the terms of the Policy, and the current market for insurance policies, among other factors. The amount received for the sale of the Policy may be more or less than what others might receive for the sale of a similar policy. There may be high fees associated with the sell of a Life settlement.*

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