SOLI OR IOLI DIES IN VIRGINIA

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Stranger Owned Life Insurance ("SOLI") or Investor Owned/Initiated Life Insurance ("IOLI") are transactions involving structured financing backed by annuities, life insurance policies and certain other insurance policies. Such transactions have obtained a great deal of attention in those states where the laws pertaining to "insurable interest" will allow a consenting individual to "effect" a life insurance policy upon himself or herself for the benefit of this stranger or investor. Virginia was one of only four states (Texas, Tennessee and recently North Carolina) who had laws pertaining to insurable interest that would allow competent consenting individuals to consent to these transactions.[1]

A summary of the typical process of a SOLI or IOLI is as follows:

1. A trust is established and issues securities, e.g. bonds, which provide funding from investors.

2. Trust funds are used to acquire life insurance policies on individuals along with corresponding immediate annuities. An insurable individual consents to the life insurance on his/her life with the prospect of providing a sponsoring charitable organization with a residual interest in the proceeds of the transaction. Insureds are generally high net worth individuals, ages 70 or 75 and over.

3. Assuming favorable pricing, annuity payments should be able not only to fund life insurance premiums but should also cover the interest payments due to bond investors and produce some extra benefit. The trust looks toward arbitrage, i.e. finding pricing inefficiencies – the income from the annuity providing a higher level of income than needed to fund the cost of the life insurance policy. If the annuity can be purchased using a higher mortality assumption (i.e. the annuitant is not expected to live long) and the life insurance is purchased using a lower mortality assumption (i.e. the insured is assumed to be very healthy), then the rate disparity between the annuity and the life product may create a favorable arbitrage opportunity.

4. In the last analysis, the net proceeds from successfully offsetting the pricing disparities in selected life and annuity products should result in covering the cost of financing, transaction and distribution costs, and a residual amount to be paid to the sponsoring charity.

5. When the insured dies, the life insurance proceeds are paid into the trust. Funds are distributed to investors for principal repayment and payment of any interest due. After final payment of expenses, the sponsoring charity receives any remainder.

The above process is representative of the general concept of this transaction, but there can be many different variations of this process. IOLI transactions typically involve multiple insureds.

Licensed insurance agents would identify and solicit a pool of legally competent individuals (the "Consenting Individuals") each of whom will consent to (i) the entity applying for and requiring a life insurance policy on and an annuity measured by his or her life, and (ii) naming the entity as the owner and beneficiary of such life insurance policy and annuity. <u>The Consent would include the entities transfer of such ownership to insurers issuing policies as part of the transaction or as part of a settlement process in the limited circumstances where the life insurer may contest a claim under the life insurance policy</u>. The Consenting Individuals will be legally competent residents and each will designate a charity of her or her choice either located in or outside of Virginia to participate in the transaction.

Each Consenting Individual would enter into a written "consent and acknowledge agreement" in which, among other things, the Consenting Individual will freely and voluntarily and irrevocably consent to the acquisition by the entity of a life insurance policy on his or her life and an annuity measured by his or her life, and acknowledges that he or she, and his or her spouse, heirs, executors and assigns, will have no interest in the life insurance policy or the annuity.

As well, each Charity and the issuing entity will enter into a written consent and acknowledge agreement in which, among other things, the Charity acknowledges certain matters related to its interest and agrees to transfer to the issuing entity any funds or any other entitlement received in connection with the transaction other than as a result of a distribution in accordance with the terms of the transaction. The Charity consent would also include disclosure of material facts and circumstances relevant to the charity in making its decision whether to enter into the Charity consent.

Looking at the summary outlined above simultaneously with the establishment of a trust or issuing entity each Charity would either (a) receive pursuant to a donation from the related consenting individual or his or her spouse or (b) purchase from issuing entity or trust for a nominal amount, a certificate (a "Charity Certificate") representing a beneficial interest in the issuing entity or trust. Each Charity Certificate would be unique and has payment entitlements that are determined in relation to the life of the consenting individual who designated the Charity holding that Charity Certificate.

Another class of certificates, also representing beneficial interest in the issuing entity or trust would be sold to institutional or other qualifying investors either directly in private placements or through an underwriter. This happens simultaneously with the process three shown above. The proceeds received from these investors would be used, among other things, to purchase the life insurance policy and annuities.

Under the old law the key to the transaction was whether or not the consenting individual, consistent with Code Section 38.2-302, had "consented in writing to the insurance contract" and whether or not that consenting individual had "made or effectuated" an insurance contract. In the simplest form, the previous law would have allowed any individual, with his consent and acknowledgement, to have an insurance contract and/or annuity placed on his life with the beneficiary being a trust or entity unrelated to him or the Charity, with an understanding or agreement that the distribution to the trust, after all final payment of expenses principal interest would be paid to the Charity.

As outlined in the process shown above, the consenting insureds are generally very high net worth individuals with ages of 70 or 75 and above.

In its simplest form, the SOLI or IOLI was marketed as a win-win situation for the consenting individual and the Charity. The consenting individual did not have to expend any of his funds or disrupt any of his existing estate planning to participate in a transaction that would benefit his designated Charity. The Charity, likewise, did not have to expend any funds and only had to identify these high net worth older individuals who would be willing to participate. The normal or anticipated return to the Charity varied between two to ten percent of the net proceeds.

The life insurance industry including NAIFA, AALU, ACLI as well as certain prestigious life insurance institutions such as Jefferson Pilot Financial have taken the position that this new approach to selling large amounts of insurance called SOLI or IOLI should be opposed. Basically these institutions and associations feel that underwriting and issuing life insurance where the primary recipient of the life insurance proceeds does not suffer an economic loss at the insured's death strikes at the heart of the typical needs-based selling and underwriting process. They also cite their reinsurers concerns with regard to the lack of financial need, concerns over insurable interest and targeting older customers. [2]

The public policy argument is that profiteering by third party speculators and investors is incompatible with the benefits life insurance provides to loved ones, families, businesses, and charities. Life insurance is about protection, not speculation.

One of the primary concerns was a proposal circulating in Washington, DC that specifically targeted these SOLI and IOLI programs and the target could possibly expand to traditional life insurance transactions. The President's budget for fiscal 2006 and the Treasury Department's proposal included a non-deductible twenty-five percent (25%) excise tax levied on the proceeds of life insurance received by the private investors in transactions ostensibly designed for charitable purposes. There was also talk that tax considerations would be directed at traditional life insurance products in light of the SOLI and IOLI transactions.[3]

Genworth, a recent spin-off affiliate of GE Financial and headquartered in Richmond, Virginia took the lead during this past 2005 General Assembly to change Virginia's insurable interest law to eliminate a provision in the old statute that would allow a person to procure an insurance contract upon another individual when the benefits are payable to a beneficiary designated by the insured if the beneficiary did not have an insurable interest in the insured when the contract was made. Virginia statute has been in existence since 1957 and the Virginia Bureau of Insurance had taken a position that as long as the consenting individual had entered into a written consent and acknowledgement agreement, then the consenting insured could be deemed to have "effected" the life insurance policy upon himself or herself. The Virginia Bureau of Insurance obviously did not speak to the securities matters which are beyond its jurisdiction and they do not endorse these types of transactions.

The strategy during this past Session was to get the majority leaders in both the Senate and House to drop identical bills simultaneously before their committees before any of the patrons of SOLI or IOLI could be awakened to the fact that something was afoot with regard to the insurable interest statutes. It was an effective legislative maneuver and the bill was amended several times to make sure that the Coli provisions were maintained and that certain charities that had already entered into these Charity Certificates prior to December 31, 2004 would not be affected. The bills made a steady progress through both the House and Senate and were passed and signed by the Governor on March 23, 2005 effective July 1, 2005. Attached is a copy of the new statute showing the deletions and amendments.[4]

Conclusion

It is interesting that Virginia's law applicable to life insurance policies will be the law of the state or commonwealth where the policy is delivered or issued for delivery. Since our sister state North Carolina would allow these programs, I anticipate that an agent licensed both in the Commonwealth of Virginia and the State of North Carolina could speak with a resident of the Commonwealth of Virginia, then deliver and execute the appropriate consents and acknowledgement applications, etc. in the State of North Carolina as well as the policy. Under Virginia's statute, the North Carolina law would then apply.

Endnotes

1. Virginia Code §§ 38.2-301 and 38.2-302. North Carolina § 58-58-86. Tennessee Code § 57-7-101. Texas Insurance Code Chapter 1103.

2. Jefferson Pilot Financial Senior Management Announcement, March 18, 2005. Warren May, Executive Vice President - Marketing and Distribution.

3. Ibid.

4. VIRGINIA ACTS OF ASSEMBLY – CHAPTER

An Act to amend and reenact § 38.2-301 of the Code of Virginia, relating to life insurance contracts procured by an individual other than the insured.

[H 2766]
Approved

Be it enacted by the General Assembly of Virginia:

1. That § 38.2-301 of the Code of Virginia is amended and reenacted as follows:

§ 38.2-301. Insurable interest required; life, accident and sickness insurance.

A. Any individual of lawful age may take out an insurance contract upon himself for the benefit of any person. No person shall knowingly procure or cause to be procured any insurance contract upon another individual unless the benefits under the contract are payable to (i) the insured or his personal representative, or (ii) a person having an insurable interest in the insured at the time when the contract was made.

B. As used in this section and § 38.2-302, "insurable interest" means:

1. In the case of individuals related closely by blood or by law, a substantial interest engendered by love and affection;

2. In the case of other persons, a lawful and substantial economic interest in the life, health, and bodily safety of the insured. "Insurable interest" shall not include an interest which arises only or is enhanced by the death, disability or injury of the insured;

3. In the case of employees of corporations, with respect to whom the corporate employer, a trust established by the corporate employer, or an employee benefit trust is the beneficiary under an insurance contract, the lawful and substantial economic interest required in subdivision 2 of this subsection shall be deemed to exist in (i) key employees; and (ii) other employees who have been employed by the corporation for 12 consecutive months, provided that the amount of insurance coverage on such other employees shall be limited to an amount which is commensurate with employer-provided benefits to non-key employees as a group;

4. In the case of a party to a contract or option for the purchase or sale, including a redemption, of an interest in a business proprietorship, partnership or firm or of shares of stock of a corporation or of an interest in such shares, the lawful and substantial economic interest required in subdivision 2 shall be deemed to exist in each individual party to such contract or option and for the purpose of such contract or option only, in addition to any insurable interest that may otherwise exist as to the life of such individual;

5. In the case of a trustee, other than the trustee of a domestic business trust or foreign business trust, as defined in § 13.1-1201, the lawful and substantial economic interest required in subdivision 2 shall be deemed to exist in (i) the individual insured who established the trust, (ii) each individual in whose life the owner of the trust for federal income tax purposes has an insurable interest, and (iii) each individual in whose life a beneficiary of the trust has an insurable interest; and

6. In the case of an organization described in § 501 (c) of the Internal Revenue Code, the lawful and substantial economic interest required in subdivision 2 of this subsection shall be deemed to exist where (i) the insured or proposed insured has either assigned all or part of his ownership rights in a policy or contract to such an organization or has executed a written consent to the issuance of a policy or contract to such organization and (ii) such organization is named in the policy or contract as owner or as beneficiary.

7. That the provisions of this act shall not apply to policies or contracts of life insurance where: (i) a charitable organization headquartered in Virginia executed a nondisclosure and exclusivity agreement prior to December 31, 2004, (ii) such charitable organization was the holder of a charity certificate issued by a business trust prior to December 31, 2004, and (iii) the policies or contracts are written pursuant to such agreement on the lives of individuals who, prior to December 31, 2004, were donors to such charitable organization, or an organization under common control with such organization.