FEDERATION OF REGULATORY COUNSEL, INC.

ANTI-STOLI LEGISLATION: A STATUS REPORT

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Do you remember where you were when you first learned that "STOLI" isn't always an adult beverage? For many involved in the life insurance industry, it was a moment to remember. And life hasn't been the same since.

Some life insurance companies see their business and pricing models being undermined, and the federal tax preferences of the products threatened by STOLI. Some life settlement companies see STOLI as undermining the credibility of their business and undermining a stable statutory and regulatory climate. Elected officials, regulators, and representatives of the settlement and insurance industries have faced enormous challenges during recent debates about STOLI. Those debates have occurred at the National Association of Insurance Commissioners ("NAIC"), the National Conference of Insurance Legislators ("NCOIL"), and in many state legislatures. State activity related to STOLI is expected to continue in 2009. This article provides an overview of state anti-STOLI laws enacted to date.

Background. While there is discussion about the best, most accurate, most legally defensible definition of STOLI, there is general agreement about the concept. A STOLI transaction involves a person who intends, at the time of original purchase of a life insurance policy, that the policy will benefit a third person who has no interest in the continued life of the insured. STOLI is a technique or design that involves these elements. STOLI isn't a type of insurance product. STOLI transactions can take many different forms and, to avoid detection by insurance companies, STOLI often involves complex arrangements designed to conceal the true nature and purpose of the transaction. Some insurers tell of instances where STOLI involves simple misrepresentation, but they also report about sophisticated STOLI transactions using trusts and other business entities that conceal the identity of parties with ownership or beneficial interest.[1]

When the growth of STOLI activity was first identified 3 or so years ago, questions arose about what effects STOLI would have on the life insurance and life settlement markets. While there's not much that life insurers and life settlement companies agree on in this debate, it may be accurate to say that both industries would be better off if no one had cooked up STOLI!

But we know that the concept that underlies STOLI has been tried before--at least as far back as the 1880s. *Warnock v. Davis*, 104 U.S. 775 (1881), involved a contract between an individual and the Scioto Trust Association. The contract provided that the individual, who was himself a partner in the Association, would apply for an insurance policy on his own life, and then unconditionally assigned the policy to the Association. In exchange, the Association paid all premiums, and agreed to pay the insured's wife one-tenth of the policy proceeds upon the death of the insured. There is no suggestion that the insured's death would create a pecuniary loss for the Association. If that had been the case, this might have been a forerunner of today's key-man insurance. This case is referenced here not because of the significance of the holding,[2] but to illustrate that there is nothing new about the concept of an individual and a disinterested third party agreeing that the individual -- for a fee -- will buy insurance on his own life, with the intent of benefitting a third party. By owning the policy at issuance, the insured and intended third-party beneficiary circumvent insurable

interest laws.

NAIC and NCOIL Respond. At the urging of the life insurance industry, both the NAIC and NCOIL recently appproved new model laws intended in part to help eliminate STOLI. The NAIC acted first, adopting a new version of its Viatical Settlement Model Act (the "NAIC Model Act") in December 2006.[3] NCOIL followed by adopting its Life Settlements Model Act (the "NCOIL Model Act") in December 2007.[4]

There are many similarities between the Model Acts approved by the NAIC and NCOIL. While the specifics differ, the two Models have the following major provisions in common:[5]

- Settlement Providers (investors who purchase life insurance policies in the initial settlement transaction) and Settlement Brokers (intermediaries who arrange the sale of a life insurance policy from an individual to investors/Settlement Providers) must be licensed by the state insurance regulator.
- A policy owner must give written consent to the settlement contract and have a "full and complete" understanding of the contract.
- A policy owner must receive disclosures regarding possible tax issues, possible effect on eligibility for certain public assistance programs, and exposure of settlement proceeds to claims of creditors.
- Contacts with the insured to determine health status, subsequent to the settlement, are limited to once every three months when life expectancy is one year or more, and limited to once each month when life expectancy is less than one year.
- Settlement Providers must report certain data regarding their settlement activity to the state insurance regulator.
- Settlement Providers and Brokers must adopt and implement anti-fraud programs.
- Advertising by Settlement Providers is subject to state regulation; the use of certain phrases, such as those stating or implying that insurance is "free," are prohibited.

The NAIC and NCOIL Model Acts take very different approaches to address STOLI. The NCOIL Model Act uses a very direct approach to STOLI. Under the NCOIL Model Act, it is a "fraudulent life settlement act" to enter into any practice or plan which involves STOLI. STOLI is defined as "a practice or a plan to initiate a life insurance policy for the benefit of a third party investor who, at the time the life insurance policy is originated, has no insurable interest in the insured."[6] The NCOIL Model Act also provides that it is unlawful for any person to "issue, solicit, market or otherwise promote" the purchase of a life insurance policy "for the purpose of or with an emphasis on settling the policy."[7] The NCOIL Model includes a two-year moratorium on the settlement of life insurance policies.

In contrast, the NAIC Model Act has as the centerpiece of its anti-STOLI provisions a five-year moratorium -- or waiting period -- on the settlement of a policy.[8] Sometimes referred to as a "catch and release" approach, the NAIC Model Act prohibits the settlement of all life insurance policies until five years after original issuance by the insurer, then identifies categories of policies that are carved out of the five-year moratorium. Most importantly, the NAIC Model Act provides that policies that do not have any of the characteristics of a STOLI transaction are subject to only a two-year waiting period prior to being eligible for settlement. A policy may be settled after two years when: policy premiums have been funded exclusively by the insured; there is no agreement or understanding that a policy would be settled at the inception of the contract; and neither the insured nor the policy has been evaluated for settlement.

Finally, if any of several specified hardship situations occur, a life insurance policy can be settled at any time. A policy may be settled at any time if the policy owner experiences any of the following: retirement from full-time employment; divorce or death of a spouse; physical or mental disability that prevents full-time employment; bankruptcy or insolvency; or the terminal or chronic illness of either the policy owner or the insured.

One of the challenges facing state legislatures and regulators is that neither Model Act is unconditionally supported in unaltered form by either the settlement companies or the life insurance companies.[9] The life settlement industry generally opposes key elements of the NAIC Model, particularly the 5-year moratorium on settlement. The life insurance industry supports the NAIC Model.

The approach taken in the NCOIL Model is generally supported by both the settlement and insurance industries and has been endorsed by the two major trade associations representing those industries.[10] But during debate on state legislation, both industries have sought modifications of key provisions of the NCOIL Model -- such as the definition of "STOLI." As a result, very few of the state anti-STOLI laws enacted so far faithfully track either Model Act.

State Activity To Date. Although many state legislators have never heard of a viatical or life settlement, in about half the states they've been thrust into the complex and sometimes fractious debate on Stranger-Originated Life Insurance. And in twelve states, they've approved anti-STOLI legislation that was then signed by their governors.[11]

In most states, either the NAIC Model Act or the NCOIL Model Act was used as a basis for drafting legislation. However, most state legislatures have developed their own variations on a Model, rather than enact it as approved by either the NAIC or NCOIL. Some of the state variations are minor, while others are substantively significant.

In 2008, laws generally based on the NCOIL Model Act were enacted in Connecticut, Hawaii, Kansas, and Oklahoma. In Arizona, Indiana, Kentucky, and Maine, "slimmed down" versions of the NCOIL Model Act were enacted. The NAIC Model Act was the basis for statutes enacted in Nebraska and North Dakota.

Three states -- Iowa, Ohio, and West Virginia -- enacted "hybrid" laws that combine the anti-STOLI features of both the NAIC and NCOIL Models. These hybrid laws define and prohibit STOLI transactions and impose a 5-year moratorium on settlement of policies with STOLI characteristics.

During 2008, several other states considered anti-STOLI legislation. The Rhode Island legislature passed anti-STOLI legislation, but it was vetoed by the Governor. Notably, bills are pending in both California and New York.

Several state insurance regulators have issued bulletins and less formal "alerts" to consumers and producers regarding STOLI.[12]

Ohio Law includes Unique Provisions. The most recent anti-STOLI bill was enacted in Ohio.[13] In addition to including most of the major elements of the NCOIL and NAIC Model Acts, the Ohio law includes some unique provisions. First, rather than using the NAIC Model Act's language describing the STOLI characteristics that trigger imposition of the 5-year moratorium, the Ohio law re-words the triggers. Ohio legislators were concerned that the NAIC Model Act would require a policy owner to "prove a negative" before being allowed to settle a policy after two years. For example, the NAIC Model Act requires that to avoid the 5-year moratorium, a policy owner must certify that the insured has not been evaluated for settlement. To address this concern, the Ohio law requires that at the time of application, the policy owner truthfully respond to the insurer's inquiry about whether a life expectancy evaluation was obtained and, if one was obtained, a copy of it must have been provided to the insurer.[14] Similar changes were made to related provisions.

Ohio law also imposes new requirements on insurers. Each insurer issuing life insurance policies in Ohio must annually provide to the Ohio Department of Insurance a description of its anti-STOLI measures.[15] The information must be provided electronically in a format prescribed by the Department.[16] It is likely that the first report will be due some time in 2009. Perhaps more importantly, insurers issuing life insurance policies in Ohio will be required to include on their applications questions "reasonably structured to identify and prevent" STOLI.[17] The Department of Insurance is charged with adopting rules to implement this requirement. Compliance by insurers will be required 12 months after the rules are adopted. At this writing, the rules remain under development by the Ohio Department of Insurance.

The Ohio law also includes unique provisions designed to facilitate an insurer's detection of STOLI transactions. To motivate compliance with these "transparency" requirements, the Ohio law states that contracts and agreements related to STOLI, including premium financing agreements that are not disclosed to the insurer, are unenforceable as a matter of law. Specifically,

- If a premium finance company fails to provide notice to the insurer within 30 days of entering into an agreement, the agreement is unenforceable.
- A contract, agreement, arrangement or transaction entered into "for the furtherance or aid of a STOLI act, practice, arrangement, or agreement" is void and unenforceable.
- Trusts, LLCs, LLPs or other entities created as part of a STOLI transaction violate Ohio's insurable interest laws and the prohibition against wagering on life.[18]

Case Law. A discussion of case law and pending litigation related to STOLI is beyond the scope of this article. Among the cases of interest are: *American General Life Ins. Co. v. Schoenthal Family, LLC*, 248 F.R.D. 298 (N.D. Ga. 2008); *Life Product Clearing LLC v. Angel*, 530 F.Supp. 2d 646 (S.D.N.Y. 2008); *Kramer v. Lockwood Pension*, No 98-2499 (S.D.N.Y. 2008); *Sun Life Assurance Co. of Canada v. Paulson*, 2008 U.S. Dist. LEXIS 11719 (D. Minn. Feb. 15, 2008); and *Wuliger v. Manufacturers Life Ins. Co*., 2008 U.S. Dist. LEXIS 9809 (N.D. Oh 2008). To our knowledge, no litigation has yet ensued under the new state anti-STOLI laws. But this is sure to come.

What's Ahead? On the legislative front, it's likely that additional states will consider anti-STOLI initiatives in 2009. States to watch -- as always -- include California and New York, where bills are pending.

It seems inevitable that litigation related to STOLI will continue. It may result from insurance company rescission actions, or from an insurer's refusal to honor requests for change of ownership -- pursuant to the

insurer's understanding of a new state anti-STOLI statute, or on other grounds. And certainly we can expect that actions will continue to be brought by survivors and estates of individuals insured under policies subsequently sold to third party investors.

It's unclear how investors who fund the life settlement industry will respond to state anti-STOLI laws. If we assume that these investors have every reason to avoid being involved in STOLI transactions, we must assume that they will demand an increasingly high level of due diligence by settlement providers. But will laws like the new Ohio statute that voids any contract related to STOLI make investors unwilling to fund settlements in Ohio? And, of course, economic developments unrelated to the laws and regulations governing STOLI will affect investors.

Finally, insurers are likely to continue to look for innovative ways to compete against the life settlement industry. In the 1980s, insurers developed accelerated death benefits in response to the viatical settlement industry. Similarly, the life settlement industry may prompt the next wave of innovation by life insurers.

One major question remains: will there continue to be sufficient investor funding for STOLI? Many observers of the settlement marketplace suggest that investors have tightened their standards for this market. It's too early to know what effect, if any, the 12 new state anti-STOLI laws will have on those who fund the settlement industry generally, and STOLI transactions in particular. Will these laws give investors more confidence in policies sold in the secondary life insurance market? Or will these new laws create further uncertainty -- at least in the near term?

We make no predictions, other than to say that this will continue to be an interesting and important area of the life insurance marketplace.

Endnotes

1. For background on STOLI, see "Stranger-Owned Life Insurance: A Point/Counterpoint Discussion," Jensen and Leimberg, ACTEC Journal, Fall, 2007.

2. After the death of the insured, the administrator of his estate sued to recover all proceeds paid by the insurer. The Court ruled that the Association was entitled only to recover the amounts it had advanced to the insured to pay policy premiums; the estate was entitled to all remaining policy proceeds. The Court effectively held that a policy could be assigned to one without insurable interest only as security for the loan made by the Association. *Warnock v. Davis*, 104 U.S. 775 (1881). This holding effectively has been overturned: today most states permit a life insurance policy, if legitimately purchased, to be assigned to one without an insurable interest. E.g., *Grigsby v. Russell*, 222 U.S. 149 (1911) (holding that life insurance policies may be assigned to persons without an insurable interest in the insured, but not in a situation where a person with an insurable interest "lends himself" to one without any insurable interest "as a cloak to what is in its inception a wager."

3. Earlier versions of the NAIC Viatical Settlement Model Act were prepared in response to the development of viatical settlements (the sale of a life insurance policy by a policy owner who has a chronic or terminal illness).

4. The NAIC Model Act uses the term "viatical settlement," while the NCOIL Model Act uses "life settlement." Throughout this article, the term "settlement" is used to refer to the sale of a life insurance policy on the secondary market.

5. Some of these provisions were included in versions of the NAIC Model Act approved prior to 2007.

6. The NCOIL Model Act, Sec. 2.Y.

7. *Id.*, at Sec. 13.A.4.

8. NAIC Model Act, Sec. 11.

9. This article does not attempt to articulate the positions of either the life settlement industry or the life insurance industry. There are often different views among the companies within each industry. This article reflects the positions expressed by some settlement and insurance companies and their trade associations that have been actively involved in state legislative debates.

10. The Life Insurance Settlement Association (LISA) and the American Counsel of Life Insurers (ACLI) both endorsed the NCOIL Model shortly after its adoption.

11. The following states have enacted legislation to address STOLI: Arizona, Connecticut, Hawaii, Indiana, Iowa, Kansas, Kentucky, Maine, North Dakota, Ohio, Oklahoma, and West Virginia. The Rhode Island legislature also approved anti-STOLI legislation, but the legislation was vetoed by Governor Carcieri on July 3, 2008.

12. Bulletins and other advisories are available on the websites of insurance regulators in Arkansas, California, Idaho, Illinois, Kansas, Louisiana, North Carolina, Ohio, Pennsylvania, and Utah.

13. Ohio House Bill 404 was signed into law in June and is effective September 11, 2008.

14. Ohio Revised Code Sec. 3916.16(B)(4)(c).

15. Ohio Revised Code Sec. 3911.021.

16. The Ohio Department of Insurance has not yet released information regarding the format to be used by insurers.

17. Ohio Revised Code Sec. 3916.05(B).

18. Ohio Rev. Code Secs. 3916.172 and 3916.173. There is no "prohibition against wagering on life" elsewhere in Ohio statutes.