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Client Alert

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Betting On Strangers' Lives

A Brief Look at How Different States Are Scoring the Insurable Interest vs. Incontestability Provision Debate

This alert covers the current law on stranger-originated life insurance ("STOLI") policies in 14 different states and includes updates concerning the following developments:

- A 2020 decision applying New York law which suggests that STOLI policies issued post-May 2010 may be invalidated for lack of an insurable interest following the contestability period;
- A 2020 decision applying Georgia law which finds that STOLI policies may be invalidated for lack of an insurable interest following the contestability period;
- A 2019 decision by the Supreme Court of New Jersey finding that STOLI policies may be invalidated for lack of an insurable interest following the contestability period, and anti-STOLI legislation enacted in 2020 which effectively codifies that decision;
- A 2017 decision applying Utah law which finds that STOLI policies may not be invalidated for lack of an insurable interest following the contestability period;
- A 2017 decision applying Tennessee law which finds that STOLI policies may be invalidated for lack of an insurable interest following the contestability period;
- Anti-STOLI legislation enacted in 2017 in Florida, which has yet to be interpreted or applied by any court.

Man walks into a retirement home promising "free" life insurance to residents. All the seniors have to do is sign a blank life insurance application, and in exchange they will get two years of life insurance on which they won't have to pay any premiums and a few thousand dollars in cash at the end of the two-year period.

A few seniors sign the blank applications. The man, an insurance salesman, fills out the applications to make it appear as though the seniors have high net worths; this in turn induces a life insurance company to issue large life insurance policies to the seniors. After issuance, a third-party investor, working with the insurance salesman, pays premiums on the policy for the seniors for exactly two years, which is the amount of time under state law that an insurer typically has to contest a policy as issued under fraudulent pretenses. The investor then buys the policy off the seniors for a few thousand dollars. The transaction is structured such that the third-party investor becomes the beneficiary and policy owner of the large policy, and the senior remains the life insured on the policy.

This is how to bet on a stranger's life. The investor's bet is that the seniors will die shortly after the two-year "contestability" period is over, maximizing his return relative to the "investment" of premium payments.

These schemes, known as STOLI schemes, were all the rage in the mid- to late 2000s. States subsequently cracked down on the schemes, but by the time they did, many STOLI policies were already issued and in circulation. Further, many of these policies remain in force and are coming due now as the seniors—already elderly in the mid- to late 2000s—are reaching the end of their lives today.

So what can an insurer do when it finds itself on the hook today for millions of dollars in death benefits on what it suspects is a STOLI policy? The answer depends on the state in which the policy was issued. This note starts by addressing the varying approaches taken by three different states, Florida, New Jersey, and California, before moving to other states.

THE INSURABLE INTEREST REQUIREMENT

Life insurance policies are required to have an "insurable interest" upon inception. The California Insurance Code provides a standard definition of an "insurable interest," which is "an interest engendered by love and affection in the case of individuals closely related by blood or law" or an "interest based upon a reasonable expectation of pecuniary advantage through the continued life, health, or bodily safety of another person." Cal. Ins. Code § 10110.1(a) (2010); *see also* N.J. Stat. § 17B:24-1(a) (2013); Fla. Stat. § 627.404(2) (2011). Translation: it is a legitimate interest in the insured living a long time. In the usual case, family members have insurable interests in each other, and individuals have insurable interests in themselves. So a husband can take out and own a policy on which his wife is the insured, and you can take out and own a policy on which you are the insured.

A life insurance policy in which the insurable interest requirement is not met is generally void *ab initio*, *i.e.*, it is treated as though it never came into existence. *See, e.g.*, Cal. Ins. Code § 10110.1(g) (2010) ("Any contract of life or disability insurance procured or caused to be procured upon another individual is void unless the person applying for the insurance has an insurable interest in the individual insured at the time of the application.").

Importantly, an insurable interest is only required to exist upon inception of the policy. *See, e.g.*, Cal. Ins. Code § 10110.1(f) (2010) ("An insurable interest shall be required to exist at the time the contract of life or disability insurance becomes effective, but need not exist at the time the loss occurs."). It is not required to exist *after* the policy is issued. Thus, the requirement does not inhibit a policy owner's right to, as with other forms of personal property, sell the policy to a third party. When such a sale takes place, the third-party investor will typically pay the policy owner an up-front amount for less than the death benefit, take over the payment of premiums, and become the owner and beneficiary of the policy while the original insured remains the insured. By the time the transaction is complete, the investor has no interest in the insured living a long time; however, so long as the transaction occurred post-issuance of the policy, it will not run afoul of the insurable interest requirement.

INCONTESTABILITY PROVISIONS

Complicating the insurable interest requirement are incontestability provisions in life insurance policies. State law in almost all 50 states mandates that life insurance policies contain provisions which bar a life insurer from "contesting" a policy as void more than two (or sometimes three) years after issuance. For example, the California Insurance Code provides as follows:

> An individual life insurance policy delivered or issued for delivery in this state shall contain a provision that it is incontestable after it has been in force, during the lifetime of the insured, for a period of not more than two years after its date of issue . . . .

Cal. Ins. Code § 10113.5(a). The purpose of incontestability provisions is to prevent life insurers from, after many years of collecting premiums and potentially even upon an insured's death, attempting to invalidate a policy on the basis of a misrepresentation made in the original application. The misrepresentation may concern, *e.g.*, the insured's net worth, income, health, family history—whatever the case may be, the point is that an insurer must investigate and contest a policy's validity within two years of issuance, otherwise it is forever barred from doing so.

FEIGNED COMPLIANCE WITH THE INSURABLE INTEREST REQUIREMENT

The natural tension between the insurable interest requirement and incontestability provisions comes to a head in the context of STOLI schemes. In the classic STOLI scheme, the original policy owner—either unwittingly as in the example above or knowingly—attempts to steer around the insurable interest requirement and incontestability provision by (i) taking out a policy on himself or a family member, *but with the intention upon inception of selling it to a third-party investor*; and (ii) completing the sale to the investor only after the contestability period is over, stymying any attempt by the insurer to try to invalidate the policy.

So what result when, 15 years after issuance of a STOLI policy, the insured dies and the insurer is on the hook for millions of dollars in death benefits to an investor? Can the insurer challenge the policy as void *ab initio*, or does the incontestability provision block the challenge? Different states have taken different approaches.

Florida

As expressed by the Supreme Court of Florida in 2016, incontestability provisions trump the insurable interest requirement for Florida-issued policies. In *Wells Fargo Bank, N.A. v. Pruco Life Ins. Co.*, 200 So. 3d 1202 (Fla. 2016), the court was faced with a classic STOLI scheme: "In September of 2005, insurance broker Gary Richardson persuaded octogenarian Rosalind Guild to participate in a $10 million STOLI scheme by offering her free life insurance and monetary compensation." *Id.* at 1204 (Fla. 2016). The broker then "submitted a fraudulent financial statement portraying Guild's net worth as $19.2 million," and the insurer issued two $5 million policies to the octogenarian, which she later sold to an investor a little more than two years after issuance. *Id.*

When the life insurer sought to invalidate the policies years later on the basis that they lacked a legitimate insurable interest upon inception, the Supreme Court of Florida rejected the challenge. *Id.* at 1206. Finding that the incontestability provision in the policies essentially trumped the insurable interest requirement, the court ruled that "a policy that has the required insurable interest at its inception, even where that interest is created as the result of a STOLI scheme, is incontestable after two years." *Id.*

Thus, for Florida-issued policies, the law as expressed by the Supreme Court of Florida is that insurers are barred from contesting a policy for lack of an insurable interest after the contestability period is over. The Florida approach is the pro-investor approach.

New Jersey

New Jersey occupies the other extreme, and the insurable interest requirement trumps incontestability provisions. In 2019, the Supreme Court of New Jersey ruled that insurers may seek to void a life insurance policy after the contestability period is over by asserting that the original policy owner lacked a legitimate insurable interest in the life of the insured. *See Sun Life Assurance Co. of Canada v. Wells Fargo Bank, N.A.*, 208 A.3d 839, 851 (N.J. 2019) ("We find that STOLI policies run afoul of New Jersey's insurable interest requirement and are against public policy. It would elevate form over substance to conclude that feigned compliance with the insurable interest statute—as technically exists at the outset of a STOLI transaction—satisfies the law. Such an approach would upend the very protections the statute was designed to confer and would effectively allow strangers to wager on human lives."). The New Jersey legislature effectively codified this holding in October 2020 by passing anti-STOLI legislation. *See* N.J. Stat. § 17B:30B-18 (2020).

In other words, for New Jersey-issued policies, the law is pro-insurer as STOLI policies are subject to invalidation by the insurer for lack of an insurable interest after the contestability period is over.

California

California straddles the line between Florida and New Jersey as a result of a law that went into effect in 2010 targeting STOLI schemes. The law prohibits "[a]ny device, scheme, or artifice designed to give the appearance of an insurable interest where there is no *legitimate* insurable interest violates the insurable interest laws." *See* Cal. Ins. Code § 10110.1(e) (2010) (emphasis added).

Before this provision went into effect, California courts essentially followed the Florida approach and consistently ruled that an original owner's technical, feigned compliance with the insurable interest requirement was sufficient. That is not to say, however, that the courts were enthusiastic in making these rulings and blocking insurers' STOLI challenges. *See, e.g.*, *Lincoln Nat. Life Ins. Co. v. Gordon R.A. Fishman Irrevocable Life Tr.*, 638 F. Supp. 2d 1170, 1179 (C.D. Cal. 2009) (observing that the STOLI conspirators "may have found a loophole in the law barring a STOLI finding, but it is clear to the Court that this whole arrangement with the [original owner and insured] was nothing but a more creative version of the same. Unfortunately for Lincoln, the law as it presently exists allows this kind of insurance arrangement to be valid. In such a circumstance, it is perhaps best to follow the wisdom expressed long ago by President Ulysses S. Grant, who said that 'the best way to get rid of a bad law is to enforce it.'") (internal citations omitted).

The 2010 anti-STOLI legislation corrected the issue and effectively allowed insurers to contest policies after the contestability period was over for lack of an insurable interest. *See, e.g.*, *Transamerica Life Ins. Co. v. Rabadi*, No. CV 15-07623-RSWL-EX, 2017 WL 1405153, at *9-10 (C.D. Cal. Apr. 18, 2017), *aff'd sub nom. Rabadi v. Lysaght Law Grp. LLP*, 753 F. App'x 463 (9th Cir. 2019). However, in interpreting the statue, courts found that it *was not retroactive* and thus only applied where the sale by the original owner to the third party, known as a "life settlement transaction," occurred prior to July 1, 2010. *See Hartford Life & Annuity Ins. Co. v. Doris Barnes Family 2008 Irrevocable Tr.*, No. CV 10-7560 PSG DTBX, 2012 WL 688817, at *5 (C.D. Cal. Feb. 3, 2012), *aff'd*, 552 F. App'x 664 (9th Cir. 2014) ("[T]he California Legislature directed: '[T]his act shall not apply to any life settlement contract entered into on or before July 1, 2010. . . .' While this language is not a model of clarity, it appears to contemplate that the new statutes apply to any new transaction regarding a life insurance policy already in effect. The case before the Court does not turn on any new transactions, but rather only concerns the Policy as it was entered into in 2008.") (internal citations omitted); *Hartford Life & Annuity Ins. Co. v. Doris Barnes Family 2008 Irrevocable Tr.*, 552 F. App'x 664, 665 & n.1 (9th Cir. 2014) (referencing the "pre–2010 version" of the law in affirming the district court's finding that "a pre-existing intent to transfer life insurance policies does not negate the fact that when the trust acquired the policies, they were supported by an insurable interest.") (internal quotations and citations omitted).

In other words, whether an insurer may challenge a California-issued STOLI policy after the contestability period is over depends on whether the original owner's sale to a third party occurred prior to July 1, 2010. If it occurred prior to July 1, 2010, the challenge will be barred; if it occurred post-July 1, 2010, the challenge will not be barred.

OTHER STATES

Beyond Florida, New Jersey, and California, other states have lined up on different sides of the insurable interest vs. incontestability provision debate. For example:

- Courts applying **Illinois**, **Delaware**, **Tennessee**, **Nevada**, **Arizona**, and **Georgia** law have followed the pro-insurer New Jersey approach. *See Ohio Nat. Life Assur. Corp. v. Davis*, 803 F.3d 904, 910 (7th Cir. 2015); *PHL Variable Ins. Co. v. Price Dawe 2006 Ins. Tr., ex rel. Christiana Bank & Tr. Co.*, 28 A.3d 1059, 1065 (Del. 2011); *Sun Life Assurance Co. of Canada v. Conestoga Tr. Servs., LLC*, 263 F. Supp. 3d 695, 703 (E.D. Tenn. 2017), *aff'd*, 717 F. App'x 600 (6th Cir. 2018); *Carton v. B & B Equities Grp., LLC*, 827 F. Supp. 2d 1235, 1243 (D. Nev. 2011); *Sun Life Assur. Co. of Canada v. Moran*, No. 080629-PHX-GMS, 2009 WL 2450443, at *3 (D. Ariz. Aug. 11, 2009); *Jackson Nat'l Life Ins. Co. v. Crum*, No. 17-cv-3857 (N.D. Ga. Mar. 2, 2020) (currently on appeal).
- Courts applying **Pennsylvania** and **Utah** law have followed the pro-investor Florida approach. *Principal Life Ins. Co. v. DeRose*, No. 1:08-CV-2294, 2011 WL 4738114, at *7 (M.D. Pa. Oct. 5, 2011); *Sun Life Assurance Co. of Canada v. Wilmington Tr. Co.*, No. 2:15-CV-00758, 2017 WL 978997, at *6 (D. Utah Mar. 13, 2017).
- A recent decision applying **New York** law suggests that New York, which enacted anti-STOLI legislation in 2010, tracks the composite California approach and is dependent on whether the STOLI policy was issued pre- or post-May 2010. *See Dukes Bridge, LLC v. Sec. Life of Denver Ins. Co.*, No. 10-CV-5491-SJB, 2020 WL 1908557, at *48 (E.D.N.Y. Apr. 17, 2020) (referencing N.Y. Ins. Law § 7815 (2010)). **Wisconsin** and **Minnesota** appear to be similarly situated and are dependent, respectively, on whether the life settlement transaction was entered into pre- or post-November 2010, and whether the policy was issued pre- or post- May 2009. *See U.S. Bank Nat. Ass'n v. Sun Life Assur. Co. of Canada*, No. 14-CV-562-WMC, 2015 WL 3645700, at *5 (W.D. Wis. June 10, 2015), *aff'd sub nom. Sun Life Assurance Co. of Canada v. U.S. Bank Nat'l Ass'n*, 839 F.3d 654 (7th Cir. 2016) (referencing Wis. Stat. § 632.69 (2010)); *PHL Variable Ins. Co. v. Bank of Utah*, 780 F.3d 863, 871 n.7 (8th Cir. 2015), *as corrected* (Mar. 17, 2015) (referencing the bill underlying Minn. Stat. 60A.0784; 60A.0789 (2009)).

This area of the law remains uncertain in many states and continuing to develop even in the states referenced above. Just in Florida, subsequent to the Supreme Court of Florida's decision in 2016, the Florida legislature enacted anti-STOLI legislation. The legislation not only renders STOLI policies "void and unenforceable," *see* Fla. Stat. § 626.99289 (2017), it states that "a life insurer may contest a life insurance policy if the policy was obtained by a stranger-originated life insurance practice." Fla. Stat. § 626.99291 (2017). Neither of these provisions has ever been applied or interpreted by a court. Accordingly, even in Florida, the door remains open for an insurer to argue that the recent anti-STOLI legislation has retroactive effect, and thus a policy issued in Florida during the heyday of STOLI schemes is void for lack of an insurable interest upon inception.

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