King & Spalding

Client Alert

Providing Strategic Legal Guidance to the Global Financial Services Industry

FINANCIAL SERVICES

MARCH 14, 2023

For more information, contact:

Matthew Biben
+1 212 556 2163
mbiben@kslaw.com

Damien Marshall
+1 212 790 5357
dmarshall@kslaw.com

Brian Donovan
+1 212 556 2162
bdonovan@kslaw.com

King & Spalding

New York
1185 Avenue of the Americas
New York, New York 10036-4003
Tel: +1 212 556 2100

STOLI Policy? Don't Count on the Return of Premiums

Two Recent Decisions Throw Cold Water on Investors' Ability to Get Their Premiums Back on Policies Deemed Void *Ab Initio*

In the latter half of 2022, the Seventh Circuit Court of Appeals and the Delaware Supreme Court—two courts on the forefront of crafting STOLI law in this country—issued decisions making it difficult for investors to recover their premium payments on life insurance policies deemed void *ab initio*. Courts in other jurisdictions may use the decisions as a roadmap.

STRANGER-ORIGINATED LIFE INSURANCE

Stranger-originated life insurance ("STOLI") refers to the practice of an individual taking out a life insurance policy on his or her own life for the very purpose of selling it to an investor. Once sold to the investor, the investor becomes the policy beneficiary and takes over the payment of premiums to the insurer. The investment pays off if the death benefit is greater than the price the investor paid for the policy plus the investor's premium outlay. This is how to bet on a stranger's life, which we have written about comprehensively here.

Life insurance policies are freely transferable, but STOLI policies—that is, policies in which the insured intends upon inception to sell the policy to a third-party investor—are void *ab initio*. Challenges to the validity of a policy can come from the insurer, which may sue the investor for a declaratory judgment to try to avoid paying the death benefit on the policy, or from original insured (or estate of the insured), which in some jurisdictions (*e.g.*, Delaware) may sue the investor for the death benefit paid out by the insurer to the investor. If the STOLI challenge is successful, the policy is void, and the investor loses the death benefit. Along with the insurer raising cost of insurance ("COI") rates on universal life policies, the possible presence of STOLI policies in a block of life insurance policies on the secondary market is a key risk factor for investors.

THE RETURN OF PREMIUM PAYMENTS

But what about the premium payments paid by the investor? Assume a life insurance policy with a death benefit of $20 million was issued during the heyday of STOLI schemes in 2005, and when the insured dies 15 or 20 years later, the insurer successfully sues for a declaratory judgment invalidating the policy. By that point, millions of dollars in premium payments have been paid to the insurer. If the insurer gets to keep those payments after the policy is invalidated, it is a win on all counts for the life insurer. If, on the other hand, a court treats the invalidated policy as rescinded, it may return the parties to their pre-contractual states and refund the premium payments to the investor.

In the latter half of 2022, two courts that have been on the vanguard of crafting STOLI (and COI) case law in this country, the Seventh Circuit Court of Appeals and the Supreme Court of Delaware, issued decisions in quick succession that may set the tone for other courts on whether the insurer gets to keep those premium payments.

In *Sun Life Assurance Co. of Canada v. Wells Fargo Bank*, N.A., 44 F.4th 1024 (7th Cir. 2022), after affirming the district court's invalidation of a STOLI policy, the Seventh Circuit determined that the secondary market investor could not recover its premium payments. In analyzing the investor's unjust enrichment counterclaim against the life insurer, the court denied the claim on grounds that the secondary market investor in the case was far from a "naïve innocent" or "innocent purchaser." *See id.* at 1040-41 ("Vida is a multibillion-dollar company in the business of purchasing life insurance policies. Its representatives and attorneys conduct an in-depth due-diligence process before purchasing any insurance policy, including the Corwell policy. That process includes reviewing the policy, determining whether it was supported by an insurable interest, and figuring out the net worth of the policyholder. A Vida representative testified that Vida would give a policy a 'moderate' risk designation if there might be questions about net worth or insurable interest.") (internal quotations omitted). In other words, because the investor was a sophisticated party which made a "well-informed calculation of risks and potential rewards" in purchasing a block of life insurance policies on the secondary market, its bid to recover premium payments failed. *Id.* at 1041.

In *Geronta Funding v. Brighthouse Life Ins. Co.*, 284 A.3d 47 (Del. 2022), the Delaware Supreme Court was faced with a policy that the trial court had already determined was void *ab initio* and thus the question of whether to refund the premiums paid by the investors. Again, the answer was no. The Delaware Supreme Court squarely rejected that the investor was entitled to an automatic return of premiums under a rescission theory. *Id.* at 61-63, 72 ("[T]he automatic return of premiums encourages investors to continue purchasing life insurance policies without investigation into whether those policies are unenforceable policies due to lack of an insurable interest"). Instead, the court followed in the footsteps of the Seventh Circuit and determined that a "fault-based analysis" was necessary to examine whether there would be a "disproportionate forfeiture if the premiums are not returned," whether the investor is "excusably ignorant," whether "the parties are not equally at fault," or whether either party engaged in "serious misconduct." *Id.* at 72. The court remanded the case to the trial court to conduct this analysis, though notably, in light of the presence of facts in the case that "could support a finding that Brighthouse [the insurer] was on inquiry notice of facts tending to suggest that the Policy was void"—*e.g.*, an insurance fraud conviction approximately ten years prior by the insured—the court appeared to signal that the investor's unjust enrichment claim had merit. *Id.* at 74-75.

KEY TAKEAWAYS

Together these decisions are a win for life insurers in the latest round of the STOLI wars. To recover premiums on a policy deemed void *ab initio*, an investor should not expect to rely on a rescission remedy entitling it to an automatic refund of premiums (though the law will vary by state) and should instead expect to have to justify the return of premiums as a matter of unjust enrichment. That is a fact-intensive showing unlikely to be resolved by courts in advance of trial. It also may be a difficult showing to make by sophisticated investors in the secondary life insurance market, which will have to prove injustice after their calculated bet on somebody's life didn't quite pay off.

But it is a qualified win. As the *Geronta Funding* decision makes clear, life insurers cannot simply close their eyes to suspicious circumstances surrounding a potential STOLI policy and continue to collect premium payments for years, only to seek to invalidate the policy when it comes time to pay the death benefit. And the suspicious circumstances concerning STOLI policies are by this point no secret to insurers—large life insurance policies funded by the original policyowner through non-recourse loans and which are sold on the secondary market right after the two-year incontestability period is over may warrant a raised eyebrow (or two) by insurers. At some point, ignoring these circumstances may result in a return of premiums.