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GUEST COMMENTARY

PURCHASE WITH INTENT TO RESELL

Property Right or Wager on Human Life?

by Nat Shapo

The proper meaning and application of the ancient and seemingly dull insurable interest requirement will substantially affect the future marketing, sale, and disposition of life policies in the United States.

The use and very purpose of life insurance is being weighed today by courts and legislatures in a protracted struggle which pits insurers against policy owners, insurance agents, and secondary market companies.

The essence of these contests: Is an insured's purchase of a policy on her own life with an intent to later resell it for market value the exercise of a property right, or an illegal wager on human life?

The stakes: Doubts about a policy's insurable interest can mar clean title, thus reducing the asset's marketability and value.

Established law holds that, as with other property, an insured may procure a life policy with intent to resell. Only a pre-arranged settlement is illegal. But insurers seek to change this doctrine based on their contention that today's secondary market facilitates abuse.

The potential seeds for such a shift can be found in recent law, including a preliminary U.S. District Court decision now subject to an important appellate review. Issued earlier this month, this opinion known as *Kramer* seems to suggest that insurable interest is determined by the insured's subjective "good faith ... intent" to benefit her loved ones or business.

Background on The Market

The secondary market developed in reaction to a perceived market defect in a relatively new product: universal life insurance. Until the 1980s, consumers chose term life for pure death benefit coverage or (far more expensive) whole life for permanent coverage with an investment component. Then universal policies were introduced as a cheaper, permanent/investment alternative to whole life.

Universal life is affordable and flexible, but, particularly for seniors with larger policies and some level of health impairment, cash surrender value frequently lags behind actual value. This gap creates the secondary market: Investors pay consumers (often far) more than the insurers' surrender offer, with enough remaining value to cover transaction costs and turn a profit.

The resulting interest group clash revolves around which measuring stick controls policy valuation: carriers' cash surrender offers or settlement providers' bids.

Established Legal Framework

Although the settlement industry is relatively new, its intellectual and legal roots date back to the 1800s. Scores of courts have since validated a policy owner's fundamental property right to sell her asset to any willing buyer for market price.

Summing up this consensus, the U.S. Supreme Court held in 1911 that, because "life policies [have] the ordinary characteristics of property," then "to deny the right to sell ... is to diminish appreciably the value of the contract in the owner's hands." (*Grigsby v. Russell*).

But, since policies must be procured either by the insured or someone with insurable interest, investors cannot use insureds as straw purchasers. The Court thus condemned "cases in which a person having an [insurable] interest lends himself to one without any, as a cloak to what is, in its inception, a wager."

It elaborated that such a wager occurs when the "policy [is] taken out for the purpose of allowing a stranger association to pay the premiums and receive the greater part of the benefit, and having been assigned to it at once."

The cases establish a dividing line: Did the insured procure the policy pursuant to a concrete, pre-arranged agreement to sell? The Minnesota U.S. District Court explained last December that it had "identified no cases in which a life insurance policy was declared void ... because the insured intended at the time he procured the policy to assign it to an unidentified individual on an unspecified date." (*Sun Life v. Paulson*).

This simple formulation defines today's struggle: Policy owners and secondary market companies are defending insureds' power to procure a policy with an intent (but no agreement) to resell from insurers' attempts to modify the established rule.

Ironically, then, in fending off the secondary market's challenge to the business status quo, life insurers are challenging the legal status quo, as follows.

An Agenda for Change

Carriers argue that today's market requires new rules pertaining to insurable interest (and the related doctrine

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of incontestability). Their strategy is detailed by American Council of Life Insurers senior attorney Michael Lovendusky in his 2008 LexisNexis scholarly article entitled *"Illicit Life Insurance Settlements."*

Mr. Lovendusky focuses on the legal rules which ensure life policies' marketable title: courts' refusal to rescind for insurable interest absent an agreement to sell at policy inception; and incontestability statutes which prohibit fraud challenges after two years.

Mr. Lovendusky laments that consumers' exercise of the very property rights that buttress the secondary market may attract capital sources which seek to manufacture policies. He argues that "the legitimization of an investment market for insurance contracts" has rendered traditional laws unable to "defend the integrity of the insurance system from systemic attack by investors." He thus concludes that judges and lawmakers must "refresh the vitality of long-standing insurance principles."

Insurable Interest

Mr. Lovendusky states that, in *Life Product Clearing v. Angel*, a New York U.S. District Court "observed the importance of testing the procurement of a policy for good faith because 'Only one who obtains a life insurance policy on himself "on his own initiative" and in good faith – that is, with a genuine intent to obtain insurance protection for a family member, loved one, or business partner ... may freely assign the policy to one who does not have an insurable interest in him.'"

Angel was not an intent standard case (the insured had been induced by a prior and flagrant agreement to resell) but it is now apparent that this 2008 opinion's non-controlling language (known as dicta) regarding "good faith ... intent" may have dealt insurable interest litigation a wild card.

For instance, on Sept. 1, in a complicated case in part involving an insurable interest question, another U.S. court in New York rejected a preliminary challenge to a carrier's lawsuit. This opinion (*Kramer v. Lockwood*) relied upon *Angel*'s language regarding an insured's "good faith" and "genuine intent to obtain insurance protection for a family member, loved one, or business partner."

A "good faith ... intent" standard for insureds would represent a new development. Insurable interest statutes and cases fundamentally distinguish between a policy procured by an insured on her own life as compared to a purchaser other than the insured. This doctrine holds that (absent a prior agreement to sell) the insured has an unlimited interest to take out a policy on her own life for any reason or beneficiary – whereas the question of why and for whom a policy is procured is only relevant when the purchaser is not the insured.

This distinction significantly affects commerce. In rejecting the intent standard, the U.S. 4th Circuit Court of Appeals explained: "[E]valuating insurable interest on the basis of the subjective intent of the insured at the time the policy issues ... would be unworkable and would inject uncertainty into the secondary market for insurers." (*First Penn v. Evans*, a 2009 case I briefed and argued for life settlement interests.)

Settlement providers depend on the simple, objective rule of an agreement standard for insurable interest to perform due diligence and make purchasing decisions. This is essential because, in many jurisdictions, even incontestable policies can be subject to an insurable interest challenge.

The *Angel* and *Kramer* courts' language regarding the insured's intent could muddle this rule. The judge in *Kramer* – acknowledging "substantial ground for difference of opinion" while explaining that the case's "determination will have a significant impact on estate planning decisions made by New Yorkers" – therefore certified her opinion for an expedited review by the 2nd Circuit Court of Appeals.

Kramer's facts are complex (its immediate policy assignments suggest that it may really be an agreement standard case), and parts of New York's insurable interest and contestability laws are unusual – perhaps limiting the opinion's reach. But – particularly because insurers are now citing *Angel* in many jurisdictions – any federal appellate court's consideration of a "good faith ... intent" standard for insureds poses a potentially important test for property rights and life settlements.

Incontestability

Incontestability statutes bar fraud challenges after two years. Since secondary market investors rely on the expiration of contestability to clear title, incontestability protects the value of the asset for policy owners.

Mr. Lovendusky, though, argues that incontestability is outdated. Before the advent of the secondary market, "only a 'miniscule percentage' of the population ever resorted to 'outrageous fraud,'" whereas he claims that "by 2007, 'pervasive fraud' was the concern of the day."

Touting recent legislative activity, Mr. Lovendusky asserts that a definition of "stranger originated life insurance" (STOLI) derived from a National Conference of Insurance Legislators (NCOIL) Model Law in "nine ... new statutes ... represent[s] new public policy arguably superseding contractual limits of contestability."

This untested claim was necessarily qualified. The new STOLI laws do not reference incontestability – a cornerstone of the insurance code. In fact, while this Model was being drafted, NCOIL's spokesperson stated that attempts to restrict incontestability "would be a non-starter."

The Future and Meaning of These Debates

To date, the legal framework which supports the secondary market remains intact.

The central legal truism of insurable interest – no opinion is known to have invalidated a policy based solely on an insured's intent at policy inception to later resell – has not changed. In fact, in July, a California U.S. District Court adopted the defendant's argument that an insurer "may not avoid its obligations ... merely because [the insured] or the Trust ... intended to exercise the right to sell or transfer [the policies] at some point in the future." (*Lincoln National v. Fishman*.)

And in the legislative arena, Illinois' new settlement statute authorizes agents selling life insurance to "inform consumers of their rights with respect to a life insurance policy, including the option of entering into a lawful viatical settlement contract." This constitutes statutory acknowledgment that resale potential constitutes a fundamental part of a policy's original value.

This lawyer's analysis, however, does not settle the matter.

Challengers to the status quo of insurable interest and incontestability will press courts and legislatures to expand perceived toeholds – such as case law referencing insureds' "good faith ... intent" – toward their stated goal of "refresh[ing] the vitality of long-standing insurance principles."

And the uncertainty created by challenges (whether successful or not) to the marketable title of life insurance may affect investors' valuation of, or even willingness to purchase, policies.

Lawyers' and lobbyists' debates over the nuances of the seemingly esoteric issues surrounding the subjective intent of insureds at policy inception are thus of significant consequence to all participants in the life insurance marketplace. LSR

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