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Long Live Life Settlements: The Current Status and Proposed Direction of the Life Settlement Market

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LONG LIVE LIFE SETTLEMENTS: THE CURRENT STATUS AND PROPOSED DIRECTION OF THE LIFE SETTLEMENT MARKET

The payment of life insurance policy benefits to the insured's surviving spouse or child is something with which most people are both familiar and comfortable. However, when those benefits are instead paid to a third party investor who has no interest in the insured's life, some people cry foul. Yet this is the basic premise of the secondary market for life insurance. In this market, insured individuals assign their policy benefits to an investor who agrees to pay the insured a lump sum of money in addition to assuming responsibility for the policy's premiums.

While the underlying concepts that support the secondary market for life insurance policies are not new, the young and imperfectly regulated market has been strained by an increase in supply and demand for these products. Because of the limited guidance within the market, fraud and uncertainty have pervaded many transactions. As a result, many validly settled policies may face challenges in the courts.

In an effort to help stabilize and legitimize the secondary market, this Comment recommends coupling a strict judicial interpretation of the incontestability periods contained in many life insurance policies with a five year holding period on newly issued life insurance policies. This framework will help deter fraudulent transactions while promoting certainty among investors.

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I. INTRODUCTION

Most Americans have some familiarity with life insurance policies.¹ Countless beneficiaries have relied on the critical safety net that a life insurance policy provides to guide their families through not only the loss of a loved one but also the loss of the family's breadwinner. To illustrate, a recently married couple expecting its first baby may consider purchasing life insurance policies. These policies will help ensure that, even if something tragic occurs to one parent, the surviving family members will be left with some support.

If, however, the family is able to avoid tragedy, the parents may at some point in the future be left with a policy into which they no longer wish to pay premiums. Until relatively recently, most owners of unwanted life insurance policies had two options.² First, the owner could stop paying premiums and simply allow the policy to lapse.³ Second, the policy owner could cancel the policy and recover any cash surrender value that exists on the policy.⁴

Policy owners now have a third option: a life settlement.⁵ In its most basic form, a life settlement is a transaction where the policy owner sells the policy to a third party for an amount greater than the policy's cash surrender value but less than the expected payout to the beneficiary upon the policy owner's death.⁶ Therefore, a life settlement creates a secondary market that exploits an inefficiency to achieve a mutual economic benefit. On one hand, a policy owner with an unwanted policy can get more than the policy's cash surrender value; on the other hand, a third party can make a sizable gain.⁷

1. Leslie Scism, *More Go Without Life Insurance*, WALL ST. J., Aug. 30, 2010, at C1 (stating that only one-third of U.S. households do not have some form of life insurance).

2. PAUL J. WINN, VIATICAL AND LIFE SETTLEMENTS: THE LIFE INSURANCE SECONDARY MARKET 1 (2008–2010).

3. *Id.*

4. *Id.*

5. *See infra* Part II.

6. STAFF REP. TO U.S. SEC. & EXCH. COMM'N, LIFE SETTLEMENTS TASK FORCE 3 (2010) [hereinafter TASK FORCE]. The payment will vary depending on a variety of factors. *See infra* notes 54–56 and accompanying text. A study by the U.S. Government Accountability Office found that individuals who settle a life insurance policy on the secondary market receive nearly eight times the cash settlement value. *See* Press Release, Life Settlement Institute, GAO Study Finds that Life Settlements Deliver Almost 8 times Surrender Value to Seniors (July 28, 2010), *available at* <http://lifesettlementinstitute.org/articles/article16.html>.

7. *See generally* Michael K. Stanley, *Boomers Ready for Life Settlement Option*, LIFEHEALTHPRO (Jan. 26, 2012), <http://www.lifehealthpro.com/2012/01/26/boomers-ready->

This Comment provides an effective approach to promote the development of both an efficient and legal secondary marketplace for life insurance policies. Specifically, this Comment will discuss how to rid the life settlement market of stranger-originated life insurance (STOLI) policies so that legitimate and beneficial life settlements between competent parties can occur in an environment free of fraud and legal uncertainty.⁸ Such an effort cannot be accomplished without an understanding of the life settlement market and the areas of law that are relevant to that market.

To provide this background, Part II of this Comment will discuss the life settlement industry in greater detail, beginning with a review of participants on both the sell side and the buy side as well as the process by which a life insurance policy progresses through the secondary market. Part II also includes an examination of the relationship between the primary insurance market and the secondary market.

Part III examines the case law that is relevant to the examination of the life settlement market. The analysis begins with the case law surrounding STOLI policies and provides insight into the concerns that courts have raised regarding STOLI policies. The analysis then moves into life settlements by examining some of the important cases that serve as the foundation for the life settlement market. After laying this foundation, the discussion advances into the current legal atmosphere in Delaware, with special emphasis placed on two recent Delaware Supreme Court cases. These Delaware cases are then contrasted with the view taken by New York courts. An examination of proposals by members of the insurance industry to establish a legitimate secondary market follows the judicial analysis. This discussion focuses mostly on the model acts proposed by two industry groups: the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL).

Part IV applies the different holdings and regulatory proposals to the secondary marketplace and determines that the New York rule

for-life-settlement-option; Deidre Wengen, *More Boomers Selling Life Insurance Plans to Fund Retirement*, PHILLYBURBS.COM (Jan. 25, 2012), http://www.phillyburbs.com/lifestyle/young_heart/more-boomers-selling-life-insurance-plans-to-fund-retirement/article_d9dd4676-4784-11e1-98eb-0019bb30f31a.html.

8. See Mary Ann Mancini & Caitlin L. Murphy, *The Elusive Insurable Interest Requirement: Are You Sure the Insured Is Insured?*, 46 REAL PROP. TR. & EST. L.J. 409, 441–43 (2012) (providing an overview of the concerns arising out of the increasing prevalence of STOLI transactions).

helps provides a more desirable, market-driven outcome. The discussion then advances by articulating the benefits of coupling the New York view on incontestability clauses with state adoption of a five-year period where an insured, subject to certain “life events,” is barred from assigning a policy to a third party. This approach would help rid STOLI policies from the secondary market and bring with it the certainty and legitimacy that the market desperately needs. Finally, Part V offers a brief summary of this Comment’s discussion.

II. LIFE SETTLEMENTS IN CONTEXT

A. *How Life Settlements Fit into the Broader Insurance Market*

The life insurance industry in the United States is massive. Nearly \$2.9 trillion worth of new life insurance coverage was purchased in 2011.⁹ The total amount of life insurance in force totaled \$19.2 trillion, representing a 4% increase from 2010.¹⁰ Of the \$19.2 trillion total, individual life insurance coverage contributed nearly \$11 trillion.¹¹ The industry has an enormous impact on employment as well, with 807.9 million people employed by life, health, and medical insurance companies in 2012.¹² To provide some context, all components of the insurance industry, including agencies and brokerages, employed 2.3 billion people.¹³

Beyond just life insurance, the broader insurance market is composed of several different categories that are in turn comprised of a variety of sub-categories. To illustrate the difference between two major kinds of insurance¹⁴—property/casualty and life/health insurance—imagine a car crash involving Alex, a fully insured person. The damage to Alex’s car and any other property would be covered by

9. See AM. COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 2012, at 63 (2012).

10. *Id.*

11. *Id.* The secondary market for individual life insurance policies is the focus of this Comment.

12. *Careers and Employment*, INS. INFO. INST., http://www.iii.org/facts_statistics/careers-and-employment.html (last visited Mar. 25, 2013).

13. *Id.*

14. Not discussed here or elsewhere in this Comment are various public insurance programs, like Medicare and Medicaid. Furthermore, this Comment does not incorporate a discussion of group or commercial insurance. For a discussion on these subjects, see 1 STEVEN PLITT ET AL., COUCH ON INSURANCE 3D § 1:2 (rev. ed. 2009). Instead, this Comment focuses on the secondary market for individual, personal life insurance. See *infra* notes 37–41 and accompanying text.

his property and casualty insurance.¹⁵ Any injuries sustained by Alex during the accident would be covered by his health insurance.¹⁶ If Alex died during the car accident, his beneficiaries would receive the proceeds of his life insurance policy.¹⁷

Because life settlements develop from life insurance policies, further understanding of the kinds of life insurance is important. For the purposes of this Comment, three basic kinds of life insurance: term, endowment, and ordinary.¹⁸

Term life insurance provides coverage for a specific term of time.¹⁹ Premiums paid typically increase with the policyholder's age, and if the policyholder survives past the policy's term, the premiums paid are irretrievable.²⁰

Endowment life insurance strikes a balance between term life insurance and a savings account.²¹ Under this arrangement, a term of years is selected and periodic premium payments are made.²² If the policyholder dies before the term's completion, the beneficiary receives the policy's face value.²³ Should the policyholder survive until the end of the term, however, the policyholder would receive the policy's face

15. See *What is Property/Casualty Insurance?*, ISO, <http://www.iso.com/About-ISO/ISO-Services-for-Property-Casualty-Insurance/What-Is-Property/Casualty-Insurance.html> (last visited Mar. 25, 2013) (defining property/casualty insurance as "insurance on homes, cars, and businesses").

16. See 1 BERTRAM HARNETT & IRVING I. LESNICK, *THE LAW OF LIFE AND HEALTH INSURANCE* § 1.01 (Matthew Bender rev. ed. 2012) (defining health insurance as "a broad panoply of coverages for payments on account of accident, sickness, hospitalization, and disability").

17. See *id.* § 1.03. Though referred to as being under the same umbrella, life and health insurance are typically memorialized in different policies. *Id.* § 1.01.

18. See *id.* § 1.03. The treatise refers to four basic types of life insurance, but because limited payment life insurance is a type of whole-life insurance, there are, for the purposes of this Comment, only three.

19. BLACK'S LAW DICTIONARY 1010–11 (9th ed. 2009); see also HARNETT & LESNICK, *supra* note 16, § 1.03 ("Term insurance . . . covers death during a limited term of years.")

20. HARNETT & LESNICK, *supra* note 16, § 1.03 ("[I]n term life insurance the insured's economic rights are exhausted and the premiums irretrievably paid out unless the insured dies during the policy term."); *Increasing Term Life Insurance—Useful for Some*, LIFEINSURANCEHUB.NET, <http://www.lifeinsurancehub.net/increasingpremiumtermlifeinsurance.html> (last visited Mar. 25, 2013).

21. Amy Fontinelle, *The Pros of an Endowment Life Insurance Policy*, YAHOO! FIN. (Jul. 19, 2012), <http://finance.yahoo.com/news/pros-endowment-life-insurance-policy-213847789.html>; see also HARNETT & LESNICK, *supra* note 16, at § 1.03 ("Endowment forms mark the transition from death protection to retirement protection.").

22. Fontinelle, *supra* note 21.

23. HARNETT & LESNICK, *supra* note 16, at § 1.03; Fontinelle, *supra* note 21.

value.²⁴ These policies are common components in a college-savings plan that a parent establishes for a child.²⁵

Whole-life insurance policies are ordinary life insurance policies.²⁶ As opposed to a term life policy, a whole-life policy covers the insured until death and couples life insurance with a cash value account and annual dividend.²⁷ In exchange, the policyholder makes premium payments²⁸ during his entire lifetime.²⁹ Limited payment life insurance policies offer a variation of whole-life policies by compressing premium payments into an abbreviated payment window.³⁰ Under a limited payment life insurance policy, an insured may pay all premiums, for example, in one lump sum.³¹

Furthermore, whole-life policies possess a cash surrender value,³² which is defined as “[t]he amount of money payable when an insurance policy having cash value, such as a whole-life policy, is redeemed before maturity or death.”³³ Surrendering the policy offers a way for the policyholder to cancel the policy while recovering a portion of the total premiums paid to the insurance company.³⁴ Furthermore, most insurers impose a surrender charge that further erodes the discounted rate

24. HARNETT & LESNICK, *supra* note 16, at § 1.03. For example,

[I]n a \$125,000 endowment policy, taken out at age thirty-five and payable at age sixty-five, the insured, if still alive at sixty-five, gets his \$125,000 as endowment proceeds and the policy terminates. On the other hand, if the insured had died at age forty-three, for instance, his beneficiary would have collected the \$125,000 face amount as death benefit proceeds.

Id.

25. See Fontinelle, *supra* note 21.

26. Howard J. Saks, *Flexibility and Tax Advantages of Whole Life Insurance Are Valuable Features*, EST. PLAN., Nov. 2009, at 23; see also BLACK’S LAW DICTIONARY 1010 (9th ed. 2009) (defining ordinary life insurance as “[l]ife insurance having an investment-sensitive cash value, such as a whole life insurance or universal life insurance”); *id.* at 1011 (defining whole life insurance). But cf. *id.* at 873 (defining group insurance); *id.* at 1010 (defining industrial life insurance). For additional information, see *supra* note 14 and accompanying text.

27. Leslie Scism, *Life Policies: The Whole Truth*, WALL ST. J., June 9, 2012, at B8.

28. These payments, along with broker costs, are often much higher for whole-life insurance than term life insurance. See *id.*

29. HARNETT & LESNICK, *supra* note 16, at § 1.03; see also BLACK’S LAW DICTIONARY 1011 (defining whole life insurance).

30. HARNETT & LESNICK, *supra* note 16, at § 1.03.

31. *Id.*

32. *Id.*

33. BLACK’S LAW DICTIONARY 1691 (9th ed. 2009).

34. HARNETT & LESNICK, *supra* note 16, § 1.03; PLITT ET AL., *supra* note 14, § 32:83.

received by the policyholder.³⁵ Because of the relatively paltry cash surrender value, likely imposition of a surrender charge, and the potential tax implications associated with surrendering a policy, the eventual sum received will be minimal. As a result, a window of mutual economic benefit exists for a policyholder and investor between the final cash settlement value of the policy and the face value of the policy.

So what does this mean to someone looking to settle a life insurance policy? Assume that Alex, our car accident victim from earlier, survives the car crash but several years later is diagnosed with a rare and aggressive form of leukemia. Alex carries two life insurance policies, one valued at \$1.5 million and the other valued at \$1 million. An experimental treatment exists for his leukemia, but due to its experimental nature, Alex's health insurance does not cover the treatment.³⁶ Willing to try anything to beat the leukemia, Alex talks to his wife (the policy's listed beneficiary) and they decide to dispose of one policy to get the cash needed to afford the experimental treatment.

Unfortunately, neither of Alex's policies have a cash surrender value that is high enough to pay for the treatment. Wary of surrendering both policies for a treatment that is not guaranteed to work, Alex enters the life settlement market to find an investor who will pay more than the cash surrender value of his policy but less than the policy's benefits.

B. The Life Settlement Participants and Process

The underlying concept of the life insurance secondary market is simple: transfer a policy from the owner to an investor.³⁷ The secondary

35. HARNETT & LESNICK, *supra* note 16, at § 1.03. Surrender charges are not, in themselves, "void as an unreasonable penalty, [or] against public policy." *Jefferson Standard Life Ins. Co. v. Adams*, 129 F.2d 431, 435 (6th Cir. 1942). Some states, however, statutorily cap the percentage that insurance companies can charge through surrender charges. *See, e.g.*, N.Y. INS. LAW § 4220(a)(2)(B) (Consol. 2000) (fixing the limit on a surrender charge at two and a half percent of the policy's face value).

36. *See* Matt Stroud, *U.S. Consumers Tell Insurers to Cover Experimental Drugs*, REUTERS (Jan. 23, 2012), <http://www.reuters.com/article/2012/01/23/us-drugs-idUSTRE80M16520120123> (recounting a case where an insurer would not pay for the insured's experimental treatment).

37. The earlier described circumstance regarding the need for liquidity to treat a disease is only one of many potential reasons for seeking to settle a policy. *See* Sam Rosenfeld, *Life Settlements: Signposts to a Principal Asset Class* 11–12 (Univ. of Pa. Wharton Sch. Fin. Insts. Ctr., Working Paper No. 09–20, 2009), available at <http://fic.wharton.upenn.edu/fic/papers/09/0920.pdf> (other possibilities for settling a policy include the policy no longer being necessary and the premiums becoming unaffordable); A.M. BEST CO., CRITERIA—INSURANCE-LINKED SECURITIES 1 (2012), available at

life insurance market has been analogized to the real estate market where,³⁸ though direct sales from seller to buyer sometimes occur,³⁹ the process more commonly involves intermediaries serving as a conduit between the seller and buyer.⁴⁰ In the secondary life insurance market, the common intermediaries include life settlement agents and brokers, life settlement providers, and life expectancy underwriters.⁴¹

1. The Sell Side

Policy owners will often be represented by a broker or an agent (and in some instances both) who will help the owner navigate the secondary insurance market.⁴² Because of the cloudy, and sometimes conflicting, regulations⁴³ in the life settlement industry, the definition of who can serve as a broker may vary.⁴⁴ For example, in states that regulate life settlements, a licensed life insurance agent can act as a life settlement broker, but financial planners, accountants, and lawyers cannot.⁴⁵

One of the tasks for life settlement brokers and agents—who are typically working for a fee or commission⁴⁶—is to help the policy owner prepare the information necessary to sell a life insurance policy on the secondary market and to find potential purchasers.⁴⁷ The life settlement application is an important piece in this puzzle. The application requires

<http://www.ambest.com/debt/lifeselement.pdf> (listing reasons similar to Rosenfeld's and including the need for cash following a bankruptcy or to fund new annuities, life insurance, or investments).

38. See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-775, LIFE INSURANCE SETTLEMENTS: REGULATORY INCONSISTENCIES MAY POSE A NUMBER OF CHALLENGES 19–29 (2010) [hereinafter REGULATORY INCONSISTENCIES] (providing an overview of the life settlement broker's role); Sachin Kohli, Comment, *Pricing Death: Analyzing the Secondary Market for Life Insurance Policies and its Regulatory Environment*, 54 BUFF. L. REV. 279, 282 (2006); Glenn S. Daily, *What Is a Reasonable Broker's Commission?*, GLENN S. DAILY (June 28, 2006), <http://www.glenndaily.com/wmpwrb5a.htm> (relying on typical real estate broker's commission to offer advice on reasonable life settlement broker's commission).

39. See REGULATORY INCONSISTENCIES, *supra* note 38, at 26.

40. *Id.*; see also TASK FORCE, *supra* note 6, at 7–8 (discussing the various market intermediaries used).

41. See REGULATORY INCONSISTENCIES, *supra* note 38, at 26.

42. *Id.* at 28–29; Rosenfeld, *supra* note 37, at 12.

43. See *infra* Part III.

44. See REGULATORY INCONSISTENCIES, *supra* note 38, at 28.

45. *Id.*

46. The fee or commission is a negotiated term between the policy owner and the broker or agent. *Id.* at 29.

47. *Id.* at 28–29.

the compilation of information regarding the life insurance policy, the policy owner, the insured's primary physicians, and the insured's medical records for the past several years.⁴⁸

Critically, the agent or broker also serves as the policy owner's liaison to the buy side of the life settlement process.⁴⁹ The agent or broker reaches out to multiple life settlement providers⁵⁰ in an effort to find an ideal purchaser of the owner's policy.⁵¹ The expertise of a broker is especially valuable here, since the broker will have a better idea of which life settlement providers have portfolios or demand for the type of policy that the owner is looking to settle.⁵²

2. The Buy Side

Just as policy owners typically rely on brokers to help navigate the secondary market for life insurance, investors and financial institutions in the life settlement marketplace generally use life settlement providers to locate and bid on attractive life insurance policies.⁵³ The provider will examine many factors that impact the size of the payout from the policy. These concerns can range from the financial stability of the insurance company that issued the policy,⁵⁴ to the probability that the issuing insurance company will challenge the validity of the policy following a settlement,⁵⁵ and, of course, to the size of the policy's face value.⁵⁶ Additionally, the longer the settling individual lives, the more premiums

48. WINN, *supra* note 2, at 15–16; *see also* LIFE INS. SETTLEMENT ASS'N, *THE BASICS OF LIFE SETTLEMENTS: AN EDUCATIONAL GUIDE FOR CONSUMERS* (2012) (discussing the application process).

49. *See* Rosenfeld, *supra* note 37, at 12.

50. *Id.*; *see* A.M. BEST CO., *supra* note 37, at 2.

51. *See* Rosenfeld, *supra* note 37, at 12; *see also* TASK FORCE, *supra* note 6, at 7 (“Once the application materials are complete, the settlement broker will offer or ‘bid’ the contract to a number of providers to obtain a range of provider offers.”).

52. *See* TASK FORCE, *supra* note 6, at 7 (“[T]he settlement broker in some instances may be the same insurance agent who sold the policy to the policy owner. In other cases, a broker may work with a variety of insurance agents or other financial professional to solicit interest from policy owners.”).

53. *See* A.M. BEST CO., *supra* note 37, at 2.

54. TASK FORCE, *supra* note 6, at 8; *see also* WINN, *supra* note 2, at 19 (explaining that the expected percentage of the policy's death benefit offered as a settlement amount “would generally be reduced if the insurer on the policy is lower rated”).

55. TASK FORCE, *supra* note 6, at 8. Challenging the validity of the contract following a settlement typically rests on a lack of insurable interest argument. *Id.*; *see also infra* Part III. The lack of standardized regulation presents further opportunities for legal challenges to what may be valid settlements. *See infra* Part III.

56. REGULATORY INCONSISTENCIES, *supra* note 38, at 33.

the investor will have to pay. These additional premiums further erode the investor's eventual payout and tie up capital. Therefore, given its direct impact on the size of the payout, the individual's life expectancy serves as the most critical variable in valuing a life insurance policy on the secondary market.⁵⁷

Life expectancy underwriters play a critical role in the life settlement process by helping to ameliorate the possibility that an investor will be required to pay more premiums than anticipated.⁵⁸ To accomplish this important task, underwriters gather information from multiple, and in some cases specialized, sources. For example, underwriters will generally solicit a physician to review the medical history of the policy owner and make a recommendation.⁵⁹ To ensure accuracy, the underwriter may employ another physician to review the first physician's recommendation.⁶⁰

Furthermore, when determining the life expectancy, underwriters also use special methods that are less formulaic than what the life insurance industry uses because the pool used in life insurance underwriting is typically much younger and healthier than those in the secondary life insurance market.⁶¹ By using these techniques, life settlement underwriters are able to compensate for diseases that move faster in older populations and impairments that, given an individual's age, will not have time to become life threatening.⁶² All of these techniques are used to determine a mean life expectancy for the insured, which allows providers to assign the policy its proper value.⁶³

Once the underwriter finishes its examination, the provider will review the information and either reject the policy or make an offer.⁶⁴ If

57. See A.M. BEST CO., *supra* note 37, at 1 ("The higher the medical impairment of an insured . . . the higher the price paid for the insurance policy.").

58. TASK FORCE, *supra* note 6, at 8.

59. *Id.* at 9.

60. See *id.*

61. *Id.* at 8 ("Different methodologies are used because life insurance underwriting is generally limited to a younger population with limited medical impairments whereas life expectancy underwriting is used with an older population who may have multiple significant impairments.").

62. See *id.* at 9 (listing three common adjustments to align the life insurance debit methodology with the life settlement demographic).

63. Rosenfeld, *supra* note 37, at 13. The multiple sources and techniques utilized also result in estimates varying from provider to provider, making the broker's task of generating multiple bids an important one. See WINN, *supra* note 2, at 18.

64. TASK FORCE, *supra* note 6, at 9.

the life expectancy of the policy owner is relatively short, the provider will be willing to pay more for the policy for numerous reasons: the number of premiums that the investor will have to pay is fewer, the investor will receive payment sooner, and the risk is theoretically less.⁶⁵ As a result, a lower life expectancy results in a higher cash settlement, which benefits each intermediary in the market.

3. Finalizing the Deal

If the insured accepts the provider's offer, the insurer changes the ownership of the policy and transfers it to an escrow agent who pays the seller.⁶⁶ Once the seller is paid, most states require a rescission period whereby the seller can pull out of the deal.⁶⁷ Upon completion of the transfer, the investor takes control of the premium payments.⁶⁸ To help with this process, a specialized tracking agency ensures that the individual who settled his policy is still alive before the payment of each premium.⁶⁹ Once the policy matures (that is, the individual who settled the policy dies) the investor receives the benefit of the policy.⁷⁰

C. Development of the Secondary Life Insurance Market—Booms

The United States Supreme Court laid the foundation for the life insurance secondary market over a century ago with its decision in

65. See WINN, *supra* note 2, at 19. For a life expectancy of less than six months, an expected percentage of the policy's death benefit offered as a bid may be around 80%. *Id.* For a life expectancy of two years or greater, the expected bid drops to 50% of the policy's death benefit. *Id.*

66. Rosenfeld, *supra* note 37, at 13.

67. See, e.g., KY. REV. STAT. ANN. § 304.15-715(5) (LexisNexis 2011) ("All life settlement contracts entered into in this state shall contain an unconditional right to rescind a life settlement contract before the earlier of thirty (30) calendar days after the date it is executed or fifteen (15) calendar days after the date of receipt of the proceeds of the life settlement contract by the owner."); N.Y. INS. LAW § 7813(g)(1) (Consol. Supp. 2012) ("Every life settlement contract shall provide that the owner has an unconditional right to rescind the life settlement contract from the time of execution of the contract until fifteen days after the receipt of the life settlement proceeds . . ."); WIS. STAT. § 632.69(8)(f) (2009–2010) ("[T]he owner has a right to rescind a life settlement contract before the earlier of 30 calendar days after the date upon which the life settlement contract is executed by all parties or 15 calendar days after the life settlement proceeds have been paid to the owner . . .").

68. See Rosenfeld, *supra* note 37, at 13.

69. *Id.*; see, e.g., Services, TRACK-LIFE, <http://www.track-life.com/index.php> (last visited Mar. 25, 2013) (explaining that Track-Life "give[s] life settlement providers and other policy owners an alternative means to manage" the effective tracking, managing, and monitoring of a portfolio of policies).

70. Rosenfeld, *supra* note 37, at 13.

Grigsby v. Russell.⁷¹ In *Grigsby*, a man named John Bruchard took out a life insurance policy.⁷² In year three of his policy, while in desperate need of money, Bruchard sold his life insurance policy to Grigsby.⁷³ In consideration of the deal, Grigsby purchased the policy for \$100 and the duty to pay the future premiums.⁷⁴

The Court discussed that Grigsby had no insurable interest in Bruchard's life, defining insurable interest as having "an interest in having the life [of the insured] continue[,] and so one that is opposed to crime."⁷⁵ The Court suggested that the holder of a valid life insurance policy should be able to transfer the policy to "one whom [the insured], the party most concerned, is not afraid to trust."⁷⁶ In other words, the Court determined that a policyholder has the right to assign the policy to whomever the policyholder so chooses and that an assignee does not need to have an insurable interest in the assignor.⁷⁷ Furthermore, the Court categorized life insurance policies as property.⁷⁸ By providing that individuals can assign life insurance policies to third parties that do not have an insurable interest in the insured, and by categorizing life insurance policies as property, the Supreme Court provided important principles to the future life settlement market.

The *Grigsby* decision paved the way for the development of the viatical settlement market during the AIDS crisis in the 1980s.⁷⁹ Viatical

71. *Grigsby v. Russell*, 222 U.S. 149 (1911).

72. *Id.* at 154.

73. *Id.*

74. *Id.*

75. *Id.* at 155.

76. *Id.*

77. *See id.* at 157. One of the first instances of the court addressing the assignment of a life insurance policy occurred in *Warnock v. Davis*. 104 U.S. 775 (1881). *Warnock* involved the assignment of a life insurance policy to an individual with no insurable interest who agreed to pay the premiums. *See id.* at 779. The Court considered this agreement to be a wager policy and held it invalid. *Id.* Importantly, the Court went even further and stated that "[t]he assignment of a policy to a party not having an insurable interest is as objectionable as the taking out of a policy in his name." *Id.* *Grigsby* back-tracked on the *Warnock* decision and added to the foundation for the eventual creation of the life settlement market. *See Grigsby*, 222 U.S. at 157. For a more thorough discussion and context on these cases, see *supra* Part III.A.1.

78. *Grigsby*, 222 U.S. at 156.

79. *See, e.g.,* Susan Lorde Martin, *Betting on the Lives of Strangers: Life Settlements, STOLI, and Securitization*, 13 U. PA. J. BUS. L. 173, 174 (2010); Eli Martin Lazarus, Note, *Viatical and Life Settlement Securitization: Risks and Proposed Regulation*, 29 YALE L. & POL'Y REV. 253, 254 (2010); *see also* NIH Researchers Recall the Early Years of AIDS, NAT'L INSTS. OF HEALTH, http://history.nih.gov/NIHInOwnWords/docs/page_26.html (last visited

settlements target policy owners who are terminally ill—usually defined as having a life expectancy less than two years.⁸⁰ When an individual is terminally ill, future costs are limited and the “risk-adjusted value of the death benefit” greatly exceeds a policy’s surrender value.⁸¹ Shortly after its discovery, the AIDS mortality rate for identified cases was approximately ninety-three percent in 1981 and eighty-nine percent in 1982.⁸² AIDS patients required money for the high cost of treatment and—given high mortality rates—investors saw an opportunity to make money by providing a portion of the patient’s life insurance benefit in exchange for becoming the policy’s beneficiary.⁸³ However, because the medical community began to make strides in the treatment of HIV/AIDS, extending the lives of those infected with the HIV virus,⁸⁴ the secondary life insurance market shifted its focus to other terminal diseases, like cancer and Lou Gehrig’s disease.⁸⁵

The secondary market then began to develop in another direction, shifting its focus beyond only individuals with terminal illness to senior citizens with non-terminable diseases.⁸⁶ This second type of policy owner falls under the life settlement category. These policies are owned by seniors between sixty and eighty years old who have stable spouses and children and large annual insurance premiums.⁸⁷ In turn, a third market, this time fraudulent, grew from the life settlement market: the STOLI policy market.⁸⁸ This market sought senior citizens who would take out a life insurance policy with the intent to then sell that policy on the secondary market.⁸⁹

In terms of value, the life insurance secondary market has grown significantly from its modest viatical settlement roots. In 1989, an

Mar. 25, 2013).

80. A.M. BEST CO., *supra* note 37, at 1.

81. Neil A. Doherty & Hal J. Singer, *The Benefits of a Secondary Market for Life Insurance Policies 2* (Univ. of Pa. Wharton Sch. Fin. Insts. Ctr., Working Paper No. 02–41, 2002), available at <http://www.carnegieassociatesltd.com/articles/Wharton.pdf>.

82. WINN, *supra* note 2, at 4.

83. See TASK FORCE, *supra* note 6, at 3.

84. See *Global Summary of the AIDS Epidemic 2011*, WORLD HEALTH ORG., http://www.who.int/hiv/data/2012_epi_core_en.png (last visited Mar. 25, 2013).

85. Martin, *supra* note 79, at 185–86.

86. TASK FORCE, *supra* note 6, at 4; WINN, *supra* note 2, at 5.

87. WINN, *supra* note 2, at 5; Martin, *supra* note 79, at 186.

88. See Mancini & Murphy, *supra* note 8, at 438–39.

89. *Id.* at 439; Martin, *supra* note 79, at 186.

estimated \$5 million in life insurance policies were settled.⁹⁰ By 1998, that number rose to \$200 million.⁹¹ This high rate of growth continued until the 2008 financial crisis: in 2005 the value of settled policies jumped to about \$10 billion before peaking in 2007 at about \$12 billion.⁹²

Both investors and Wall Street were excited about the growth in the young market.⁹³ Research firm Sanford C. Bernstein & Co. predicted in 2007 that the face value of life settlement deals would exceed \$160 billion.⁹⁴ The insurance industry research firm Conning Research and Consulting estimated that by 2016 the face value of life insurance policies settled in the secondary market would be between \$90 and \$140 billion.⁹⁵

These high expectations were based on several factors, not the least being that the deals provide a payment upon an event that is certain to happen.⁹⁶ In the investment world, such certainty can be hard to find. Given such certainty, if investment banks could effectively securitize life settlements, the detrimental effect of individuals who survive past their life expectancy would be offset by other individuals in the “portfolio” who die sooner than anticipated. This arrangement made consistent and significant returns seem within reach.⁹⁷ Generally, life settlement assets were projected to return between nine percent and thirteen percent to investors.⁹⁸

The fact that these returns are known as “uncorrelated returns” offers a second benefit. An uncorrelated asset generates returns independently of the market.⁹⁹ That is to say, even if the market is plunging, people are still going to die. Therefore, it was believed that

90. Martin, *supra* note 79, at 186.

91. *Id.*

92. See TASK FORCE, *supra* note 6, at 4; Matthew Goldstein, *Profiting from Mortality*, BUSINESSWEEK, July 30, 2007, at 44, 46.

93. Goldstein, *supra* note 92, at 46.

94. *Id.*

95. TASK FORCE, *supra* note 6, at 4.

96. Everyone dies. The only uncertainty is when the person will die and, in turn, when the investor will get paid. The same cannot be said about the direction of a particular stock or bond.

97. Goldstein, *supra* note 92, at 48.

98. Rosenfeld, *supra* note 37, at 11. Such returns are especially attractive since from 1926 to 1998 the realized—that is, actual—rate of return on equities was 5.2%. Peter A. Diamond, *What Stock Market Returns to Expect for the Future?*, 63 SOC. SECURITY BULL., no. 2 2000, at 38, 38.

99. Goldstein, *supra* note 92, at 46.

institutional investors would find securitized life settlement products especially attractive, perhaps serving as a way to hedge riskier bets made elsewhere by the firm.¹⁰⁰ This hedging ability is an intrinsic benefit that life settlement assets offer to investors that does not appear in the expected rate of return.

Yet another consideration that went into the expected growth of the life settlement market was the changing demographic makeup of the United States.¹⁰¹ In just ten years, from 2010 to 2020, the number of Americans sixty-five years of age and over is expected to grow by thirty-six percent, from about forty million to about fifty-five million.¹⁰² Similarly, and likely of more interest to the life settlement market, the number of people aged eighty-five and over is expected to increase by about fifteen percent from 2010 to 2020.¹⁰³ The ranks of the elderly will soon begin to swell in the United States.¹⁰⁴ It seems that there will be many opportunities for life settlements in the future, making the development of a stable and legitimate marketplace especially important.

D. Development of the Secondary Life Insurance Market—Busts

Despite these benefits, the life settlement market's rate of growth has fallen short of some Wall Street expectations.¹⁰⁵ In 2008, with the market continuing its upward trend, the life settlement market was estimated at \$15 billion.¹⁰⁶ Then, in 2009, the market plunged to an estimated \$7 billion of settled policies.¹⁰⁷ At the same time, some of the major banks that had entered the life settlement market—including Goldman Sachs and Deutsche Bank—began to pull back.¹⁰⁸

100. *Id.*; see also Rosenfeld, *supra* note 37, at 11.

101. See Goldstein, *supra* note 92, at 50.

102. See *Projected Future Growth of the Older Population*, ADMIN. ON AGING, http://www.aoa.gov/AoARoot/Aging_Statistics/future_growth/future_growth.aspx (last updated June 23, 2010).

103. *Id.*

104. See Bill Glauber, *65-and-Older Numbers Jump 10%*, MILWAUKEE J. SENTINEL, Dec. 1, 2011, at 5B (stating that, nationally, the number of Americans 65 and older increased by 5.3 million from 2000 to 2010 and that older populations grew faster than the general population).

105. See Goldstein, *supra* note 92, at 46 (explaining Wall Street's hope of "turning most of the life settlements created each year into death bonds").

106. TASK FORCE, *supra* note 6, at 4.

107. *Id.*

108. Matthew Goldstein, *Deutsche Kicks the Grim Reaper*, BUSINESSWEEK (Jan. 30, 2009), http://www.businessweek.com/investing/wall_street_news_blog/archives/2009/01/deutsc

Such a pullback was not completely unforeseen given the economic and credit conditions of 2009.¹⁰⁹ Along with the loss of confidence in the financial system came a lockup in financing and liquidity.¹¹⁰ Thus, assets that require significant payment of capital up-front—like life insurance policies, which usually have premiums around five to ten percent of face value per year¹¹¹—and take several years to pay off were not particularly attractive to investors in an environment where capital was extremely difficult to secure.¹¹²

While a lack of liquidity certainly contributed to the industry's malaise, the more damning issue seems to be the inherent negative connotation associated with an investor profiting from the death of a disinterested third party, especially when this result is achieved in a fraudulent way.¹¹³ Because the market is not as well regulated as the insurance and securities markets, brokers have an easier time altering, or lying about, expected costs and returns to make the products appear more appealing.¹¹⁴

To illustrate, consider the case of Curtis Somoza and Robert Coberly.¹¹⁵ In 2004, these two California men orchestrated a \$64 million Ponzi scheme using life settlements.¹¹⁶ The men promised investors a 25% return on a “sophisticated bond trading program[]” that involved

he_kicks.html; Darla Mercado, *Goldman Sachs Abandoning Life Settlements Market*, INVESTMENTNEWS (Jan. 29, 2010), <http://www.investmentnews.com/article/20100129/FREE/100129850>.

109. See Scott Lanman, *Bernanke Warns of Credit Market 'Relapse'*, BLOOMBERG (May 5, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aNX4ZbLkEXtA> (explaining that, although the credit market was showing signs of bottoming after a three year decline, “unprecedented” efforts to boost credit by the Federal Reserve were likely to continue); Ari Levy & Caroline Salas, *Obama Becomes Banker-in-Chief in Credit Market Freeze*, BLOOMBERG (Jan. 20, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aBKDYyojIxfk> (quoting Kenneth Rosen as stating that “[u]nfreezing credit ‘is the single most important thing’” for then President-Elect Obama).

110. See *supra* note 109 and accompanying text.

111. TASK FORCE, *supra* note 6, at 4.

112. *Id.* at 5.

113. Particularly, the advent of the STOLI market created a nuanced, but fraudulent, version of a life settlement.

114. See Goldstein, *supra* note 92, at 46.

115. Martin Zimmerman, *Westlake Village Man Sentenced in \$44-Million Ponzi Scheme*, L.A. TIMES (Nov. 5, 2009), <http://articles.latimes.com/2009/nov/05/business/fi-ponzi5>.

116. Press Release, Fed. Bureau of Investigation, *Westlake Village Man Who Orchestrated \$64 Million Ponzi Scheme Sentenced to 25 Years in Federal Prison* (Nov. 3, 2009), available at <http://www.justice.gov/usao/cac/Pressroom/pr2009/128.html> [hereinafter FBI Press Release].

purchasing \$275,000 life insurance policies and paying premiums on behalf of around 2,000 members of an inner Los Angeles church.¹¹⁷ From there, the policy that was taken out on each individual would be split in three parts upon the death of the covered individual: \$15,000 would go to the deceased's family, \$20,000 would go to the church group, and \$240,000 to a trust that would be used to pay premiums and pay investors.¹¹⁸ Investors liked what they heard because it was sold as a "risk-free" investment opportunity that promised large returns.¹¹⁹ The pastor of the church group approved because both the members of his group and the organization itself would benefit.¹²⁰ Somoza and Coberly especially liked the scheme because the investors' money went right into their pockets and allowed the two to live out what the sentencing judge deemed "an orgy of self-indulgence."¹²¹ On his own, Somoza spent \$27 million in sixteen months.¹²² However, as some investors began requesting their money, Somoza and Coberly could only return about \$28 million before the scheme fell apart.¹²³

Somoza and Coberly are hardly the only individuals to conduct questionable, and in many instances illegal, practices in the life settlement market.¹²⁴ As the director of enforcement for the Texas State Securities Board stated, an "absolutely unreal" amount of fraud exists in the life settlement arena.¹²⁵ Thus, Somoza and Coberly's scheme is illustrative of numerous problems that have plagued the young market. These men took advantage of a regulatory hole by claiming that the investment was "risk-free" and by offering 25% percent returns.¹²⁶ Additionally, there is an especially wide information gap between

117. *Id.*; Goldstein, *supra* note 92, at 49.

118. See FBI Press Release, *supra* note 116.

119. See *id.*

120. See Goldstein, *supra* note 92, at 49.

121. FBI Press Release, *supra* note 116.

122. *Id.*

123. *Id.*

124. See, e.g., Leslie Scism, *Regulators Crack Down on Murky Life-Insurance Policies*, WALL ST. J., June 22, 2010, at D1 (providing the example of Steven Brasner, a Florida insurance sales agent who arranged STOLI transactions for hedge funds and inserted false wealth and other information on the insurance application).

125. Rob Curran, *The Pros and Cons of Betting on Death*, WALL ST. J., Apr. 12, 2010, at R7.

126. FBI Press Release, *supra* note 116. Industry groups have addressed some of these problems by, for example, proposing regulation on advertising that would eliminate the use of words like "free" or "no cost" insurance. See *infra* note 246 and accompanying text.

investors and brokers.¹²⁷ Investors cannot know whether the claims made by doctors and actuaries about the life expectancy of the insured are legitimate or whether they have been skewed so that the broker can earn larger commissions.¹²⁸

Furthermore, as mentioned earlier,¹²⁹ each party in the chain has the incentive to depress the life expectancy of the individual so that the deal is larger and a larger commission may be earned. It follows that, if the life expectancy is artificially low, the projected return on the investment will be artificially high, and investors will not realize the returns expected or promised. These unrealized expectations can lead to investors pulling cash from the investments and causing major problems because of the high liquidity requirements of these investments.¹³⁰

E. The Impact of the Secondary Life Insurance Market on the Primary Life Insurance Market

The secondary life insurance market may be beneficial to some individuals who wish to sell their policy, but does the presence of a secondary market negatively impact the primary market? The answer to this question, of course, depends on who is asked.

Some argue that life settlements will drive up the cost of insurance in the primary market and affect the profitability and financial condition of the insurers.¹³¹ As mentioned earlier, prior to life settlements policy owners who no longer wanted to own their policy could either let the policy lapse or accept the cash surrender value.¹³² Based on experience and industry studies, insurers build assumptions regarding lapse rates into their pricing models.¹³³ If the actual lapse rate falls short of the

127. See Curran, *supra* note 125.

128. See *id.* (stating that investors cannot independently verify assertions that doctors and actuaries make, a problem that is compounded by the market's still developing regulatory approaches).

129. See discussion *supra* Part II.B.

130. See *supra* notes 111–12 and accompanying text.

131. TASK FORCE, *supra* note 6, at 19; Hanming Fang & Edward Kung, *How Does Life Settlement Affect the Primary Insurance Market?* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 15761, 2010) (stating that life insurance companies claim "that the life settlement market, by denying them the return on lapsing or surrendered policies, increases the costs of providing policies in the primary market").

132. TASK FORCE, *supra* note 6, at 19; see also Fang & Kung, *supra* note 131, at 2.

133. DELOITTE CONSULTING & THE UNIV. OF CONN., *THE LIFE SETTLEMENTS MARKET: AN ACTUARIAL PERSPECTIVE ON CONSUMER ECONOMIC VALUE* 12 (2005) [hereinafter *ACTUARIAL PERSPECTIVE*] ("Life insurance companies rely on their own lapse experience and industry lapse studies when determining appropriate lapse assumptions.");

assumed rate, the insurer may run into financial difficulty because of the inability to raise fixed premium payments on other policy owners.¹³⁴ Furthermore, insurers have relied on not having to pay some policies due to termination or surrender, but a thriving life settlement market could “significantly increase the average death claim incurred per policy,”¹³⁵ thereby eroding some of the insurer’s profits.¹³⁶ The end result would be insurance companies seeking to make up that lost profit, which would likely result in higher costs for customers in the primary market.¹³⁷

On the other hand, industry observers informed the SEC Task Force on Life Settlements that “the extent of [the secondary market’s] impact is likely to be small.”¹³⁸ While the secondary market offers a mutually beneficial economic opportunity between a policy owner and investors that the insurance companies do not provide,¹³⁹ growth estimates project the market to, perhaps generously, achieve a size of between \$90 and \$140 billion by 2016.¹⁴⁰ In contrast, in 2011 the total life insurance in force in the United States was worth \$19.2 trillion.¹⁴¹ In early 2010, only

TASK FORCE, *supra* note 6, at 19–20 (“Life insurers typically base assumed lapse rates on experience.”).

134. TASK FORCE, *supra* note 6, at 20; *see also* ACTUARIAL PERSPECTIVE, *supra* note 133, at 12 (“Ultimately, these pricing assumptions determine the sources of profit and long-term viability of the life insurance company.”).

135. Press Release, Conning Research & Consulting, Life Settlements—The Market Stabilizes as Insurer Impact Grows (Nov. 1, 2010), *available at* <http://www.conning.com/pressrelease-detail.aspx?id=5152> [hereinafter Conning].

136. Goldstein, *supra* note 92, at 50; *see also* Fang & Kung, *supra* note 131, at 2. The premiums paid in the early years of a fixed premium long-term health insurance policy exceed what is actuarially fair. *Id.* Known as “front-loading,” the insured secures premium payments that are likely lower than what the insured would be able to acquire later in life. Fang & Kung, *supra* note 131, at 2. As a result, over the course of the policy, the actuarial value begins to balance out. *Id.* An insured that allows a policy to lapse or accepts the cash settlement value allows the life insurance company to retain the front-loaded premiums before the actuarial value has an opportunity to balance out. *Id.* By removing from the market policies that would otherwise settle or lapse, the secondary market, in theory, harms the primary insurance market. *Id.*

137. *See* Fang and Kung, *supra* note 131, at 2 (“[T]he life settlement market, by denying [the insurance companies] the return on lapsing or surrendered policies, increases the costs of providing policies in the primary market. They allege that these costs will have [to] be passed on to consumers . . .”).

138. TASK FORCE, *supra* note 6, at 20.

139. TASK FORCE, *supra* note 6, at 3. Some commentators have stated that the life insurance industry “is well positioned to create a more efficient secondary market for impaired policyholders . . .” ACTUARIAL PERSPECTIVE, *supra* note 133, at 2.

140. Rosenfeld, *supra* note 37, at 7.

141. AM. COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 2012, at 66 tbl.7.1 (2012), *available at* [http://www.acli.com/Tools/Industry%20Facts/Life%20Insurers%20Fact%](http://www.acli.com/Tools/Industry%20Facts/Life%20Insurers%20Fact%20Book)

about 1% of all life insurance policies issued by that date were settled.¹⁴² Nominally, it seems unlikely that a secondary market of this size will meaningfully undercut the stability of the primary insurance market.¹⁴³

Furthermore, some commentators believe that the presence of an efficient secondary life insurance market will ultimately be beneficial to the primary market. For example, Neil A. Doherty¹⁴⁴ and Hal J. Singer¹⁴⁵ argue that the secondary life insurance market makes the life insurance policy a more liquid asset and, therefore, more valuable in the primary market.¹⁴⁶ Doherty and Singer liken the secondary market for life insurance to the secondary market for catastrophe risk insurance.¹⁴⁷ Both secondary markets strengthen their respective primary market by assuring the consumer that selling the policy in the future will not result in a below market price.¹⁴⁸ This limit on downside risk led to higher sales of catastrophe risk in the primary market, and a similar outcome should be expected in the life insurance primary market.¹⁴⁹ Indeed,

20Book/Documents/_factbook2012_entirety_020813.pdf (noting that the \$19.2 trillion worth of in force policies can be broken down into the following subtotals: individual, \$10.99 trillion; group, \$7.83 trillion; credit, \$111.8 billion).

142. Michael Shumrak, *Life Settlements—A Window of Opportunity for the Life Insurance Industry?*, REINSURANCE NEWS, Feb. 2010, at 14, 16 (stating, despite the relatively small size, that the “financial impact of life settlements on life insurer’s future earnings is complex and probably not immaterial”).

143. *See id.* (noting that growth rates in new settlements suggests that the percentage of policies settled “will not increase to a very large percentage”). *But see* Conning, *supra* note 135 (“The life settlements industry has generally targeted a small number of insurers’ universal life policies with higher face amounts . . .”). While the percentage of policies settled relative to the whole industry may be small, if those policies are targeted at a few insurers the impact on those insurers could be more severe.

144. Neil A. Doherty is the Fredrick H. Ecker Professor of Insurance and Risk Management and Professor of Business Economics and Public Policy at The Wharton School, University of Pennsylvania. *Business Economics and Policy Department*, WHARTON, <https://bepp.wharton.upenn.edu/profile/1673/> (last visited Mar. 25, 2013).

145. Hal J. Singer is the Managing Director and Principal at Navigant Economics. *Experts*, NAVIGANT ECON., http://www.naviganteconomics.com/who/singer_pri.php (last visited Mar. 25, 2013).

146. Doherty & Singer, *supra* note 81, at 7.

147. *Id.* at 15. The article also likens the life insurance secondary market to the secondary market for mortgages. *Id.* Written in 2002, the article pre-dates the recent financial crisis that was caused in part by the securitization of very risky home mortgages. *See* Knowledge @Wharton, *Securitization 2.0*, FORBES.COM (Apr. 3, 2008), http://www.fortune.com/2008/04/03/credit-crisis-subprime-ent-fin-cx_kw_0403whartonsecuritize.html (“[S]ecuritization of subprime real estate loans is blamed for the global liquidity crisis . . .”); *see also* discussion *supra* Part II.D.

148. Doherty & Singer, *supra* note 81, at 15.

149. *Id.*

other studies have determined that the life insurance secondary market will benefit both consumers and insurers by allowing consumers to obtain higher prices for their policies, in turn strengthening demand for the policies on the primary market.¹⁵⁰

III. JUDICIAL AND INSURANCE INDUSTRY EFFORTS REGARDING THE SECONDARY LIFE INSURANCE MARKET

The current demand and expected growth of the secondary life insurance market suggests that it is here to stay.¹⁵¹ Therefore, the best option appears to be embracing the market while regulating it in a way that prevents and eliminates fraud, but encourages lawful and beneficial settlements. Indeed, by addressing and proscribing STOLI transactions, this appears to be the approach adopted by courts, state legislatures, and the life settlement industry.¹⁵²

A. Case Law—Examples from Delaware and New York

1. Delaware

American courts adopted the English common law view that a valid life insurance policy requires an insurable interest.¹⁵³ An 1876 Supreme Court decision reflects this understanding by stating that “statutes to the same effect [as those insurable interest statutes passed in England] have been passed in some of the States; but where they have not been, in most cases either the English statutes have been considered as operative, or the older common law has been followed.”¹⁵⁴ This decision was followed shortly after by *Warnock v. Davis*, one of the earliest examples of the attempted assignment of a life insurance policy.¹⁵⁵ The

150. See, e.g., Nadine Gatzert et al., *The Impact of the Secondary Market on Life Insurers' Surrender Profits*, 76 J. RISK & INS. 887, 905–06 (2009) (pointing out that life insurers would need to “abandon lapse-supported pricing”).

151. See *supra* notes 101–04 and accompanying text (regarding the size of the market and the graying population).

152. See discussion *infra* Parts III.A–B.

153. Peter Nash Swisher, *The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 DRAKE L. REV. 477, 481 (2005). Before the eighteenth century, there were no insurable interest laws in England and wagering contracts on the lives of others were allowed (for example, whether an individual would ultimately be convicted and executed of a capital offense). *Id.* In 1774, the British Parliament passed a statute requiring an insurable interest. *Id.*

154. Conn. Mut. Life Ins. Co. v. Schaefer, 94 U.S. 457, 460 (1876).

155. See generally *Warnock v. Davis*, 104 U.S. 775 (1881).

Warnock decision involved the assignment of a life insurance policy to an individual with no insurable interest who agreed to pay the premiums.¹⁵⁶ The Court considered this agreement to be a wager policy and held it invalid.¹⁵⁷ Importantly, the Court went even further and stated that “[t]he assignment of a policy to a party not having an insurable interest is as objectionable as the taking out of a policy in his name.”¹⁵⁸

The Court later backtracked on the *Warnock* wager comparison in *Grigsby v. Russell*,¹⁵⁹ a move that has since been judicially reinforced, and in many instances codified.¹⁶⁰ As these cases and statutes illustrate, an insurable interest is always present when one takes out a life insurance policy on one’s own life.¹⁶¹ As a result, in the secondary life insurance market, insurable interest typically becomes a problem when a third person attempts to procure a policy on an individual whom the

156. *See id.* at 778–79.

157. *Id.* at 779.

158. *Id.*

159. *See supra* Part II.C. Specifically, the *Grigsby* court’s suggestion that the holder of a valid life insurance policy should be able to transfer the policy to “one whom [the insured], the party most concerned, is not afraid to trust” indicates that the transferee’s insurable interest in the transferor is irrelevant. *Grigsby v. Russell*, 222 U.S. 149, 155 (1911).

160. *See, e.g.,* *Bajwa v. Metro. Life Ins. Co.*, 776 N.E.2d 609, 617 (Ill. App. Ct. 2002) (“[O]ne may insure his own life for the benefit of another having no insurable interest therein.” (quoting *Colgrove v. Lowe*, 175 N.E. 569, 571 (Ill. 1931))); *Estate of Bean v. Hazel*, 972 S.W.2d 290, 291 (Mo. 1998) (“[A] person may purchase an insurance policy on his own life and name as beneficiary a person who has no insurable interest in the person’s life ‘provided it not be done by way of cover for a wagering policy.’” (quoting *Lakin v. Postal Life & Cas. Ins. Co.*, 316 S.W.2d 542, 552 (Mo. 1958))). For statutes, see for example, DEL. CODE ANN. tit. 18 § 2704(a) (1999) (“Any individual of competent legal capacity may procure or effect an insurance contract upon his/her own life or body for the benefit of any person, but no person shall procure or cause to be procured any insurance contract upon the life or body of another individual unless the benefits under such contract are payable to the individual insured or his/her personal representatives or to a person having, at the time when such contract was made, an insurable interest in the individual insured.”) and N.Y. INS. LAW § 3205(b) (Consol. 2000) (“(1) Any person of lawful age may on his own initiative procure or effect a contract of insurance upon his own person for the benefit of any person, firm, association or corporation. Nothing herein shall be deemed to prohibit the immediate transfer or assignment of a contract so procured and effectuated [and] (2) [n]o person shall procure or cause to be procured, directly or by assignment or otherwise[,] any contract of insurance upon the person of another unless the benefits under such contract are payable to the person insured or his personal representatives, or to a person having, at the time when such contract is made, an insurable interest in the person insured.”).

161. HARNETT & LESNICK, *supra* note 16, § 2.04 (“[A] person has an insurable interest in his own life, which means that he can insure his own life for the benefit of whomever he chooses and to whatever amount the insurer will write.”).

purchaser has no insurable interest.

To illustrate, the 2011 Delaware case *Sun Life Assurance Company of Canada v. Berck* illustrates a common challenge that STOLI policies face in the courts: the lack of an insurable interest voiding the incontestability clause.¹⁶²

In *Berck*, a group of investors assisted 77-year-old Daniel Berman in applying for a life insurance policy with the intention of purchasing the policy from Berman to sell to other investors on the life settlement market.¹⁶³ On June 6, 2007, a \$4 million policy was issued to Berman with an incontestability clause¹⁶⁴ that stated, in part, “In the absence of fraud, after this Policy has been in force during the lifetime of the Insured for a period of two years from its Issue Date, [the insurance company] cannot contest it except for non-payment of Premiums.”¹⁶⁵ During the procurement of the policy, Berman indicated that the policy was for an estate plan, and an attached Broker’s Report that was signed by one of the investors corroborated Berman’s indication.¹⁶⁶ Upon Berman’s death, the insurance company argued that the policy was void *ab initio*¹⁶⁷ because of a lack of insurable interest.¹⁶⁸ The investors argued that an insurable interest existed and that the incontestability clause barred the insurance company from claiming the policy is invalid.¹⁶⁹

The court found that there was no insurable interest at the time of the policy’s creation.¹⁷⁰ The court defined an insurable interest as benefits payable to individuals related by blood, law, or “substantial interest engendered by love and affection[]’ or [] other individuals with ‘a lawful and substantial economic interest’” in the continuing life of the

162. See *Sun Life Assurance Co. of Can. v. Berck*, 770 F. Supp. 2d 728, 733 (D. Del. 2011); see also *PHL Variable Ins. Co. v. Morello 2007 Irrevocable Trust*, 645 F.3d 965, 967 (8th Cir. 2011); *Ohio Nat’l Life Assurance Corp. v. Davis*, No. 10C2386, 2011 U.S. Dist. LEXIS 73197, at *12 (N.D. Ill. July 6, 2011).

163. *Berck*, 770 F. Supp. 2d at 729.

164. *Id.* at 730. Delaware requires two-year incontestability clauses in life insurance contracts. *Id.* at 731. The Delaware statute reads in part: “There shall be a provision that the policy shall be incontestable after it has been in force during the lifetime of the insured for a period of not more than 2 years after its date of issue.” DEL. CODE ANN. tit. 18 § 2908(a) (1999).

165. *Berck*, 770 F. Supp. 2d at 730.

166. *Id.*

167. Latin for “[f]rom the beginning.” BLACK’S LAW DICTIONARY 5 (9th ed. 2009).

168. *Berck*, 770 F. Supp. 2d at 731.

169. *Id.*

170. *Id.* at 733.

insured.¹⁷¹ As the court stated, the insurable interest requirement is meant to prevent life insurance contracts from being used as wagering contracts that give policyholders “a sinister counter interest in having the life come to an end.”¹⁷² It is precisely this concern that faces STOLI policies. Furthermore, lack of insurable interest is an issue at the time that the policy is acquired, and in this case the disinterested third parties and their STOLI scheme presented no insurable interest in the Berman policy.¹⁷³

Because there was no insurable interest, the court held that the policy was void *ab initio*.¹⁷⁴ The court pointed out that, with New York as an exception, an insurable interest in the insured is required for enforcement of a life insurance contract.¹⁷⁵ Furthermore, because invoking an incontestability clause “presupposes a basically valid contract[,]” the court held the incontestability clause to be inapplicable.¹⁷⁶ Since the policy was void from the beginning the court held that the incontestability period did not prevent the insurance company from challenging the policy.¹⁷⁷ Finally, the “in the absence of fraud” proviso¹⁷⁸ contained in the incontestability clause appeared to be the nail in the coffin for the investor’s argument.¹⁷⁹

Importantly, the court held that when an insured does not plan on using the policy as a cover for a wager—a non-STOLI case—“it is well established that . . . the beneficial interest may be legally transferred to an individual or entity without an insurable interest.”¹⁸⁰ Clearly, then,

171. *Id.* (quoting DEL. CODE ANN. tit. 18 § 2704(c) (1999)). Though “insurable interest” is “difficult to define with precision,” PLITT ET AL., *supra* note 14, at § 41.20, the *Berck* court’s view accurately reflects the modern view of the insurable interest, *see, e.g., id.* at § 41:21 (noting that the majority of cases indicate that spouses and blood relatives usually have an insurable interest, as do individuals with an affinity for the person).

172. *Berck*, 770 F. Supp. 2d at 733–34 (quoting *Grigsby v. Russell*, 222 U.S. 149, 154 (1911)); *see also supra* notes 71–78 and accompanying text.

173. *See Berck*, 770 F. Supp. 2d at 733, 735.

174. *Id.* at 733. “The issue of whether a plaintiff is legally entitled to contest the validity of an insurance contract on grounds of fraud or misrepresentation after the two-year incontestability period is a matter of first impression in Delaware.” *Id.* at 732.

175. *Id.*; *see also infra* notes 209–31 and accompanying text (discussing the New York rule).

176. *Berck*, 770 F. Supp. 2d at 732–33 (quoting *Beard v. Am. Agency Life Ins. Co.*, 550 A.2d 677, 689 (Md. 1988)).

177. *Id.* at 733.

178. *Id.*

179. *Id.*

180. *Id.* at 734.

the court indicated a bright line between STOLI transactions and viatical and life settlement transactions.

The position of Delaware is further developed in a pair of September 2011 cases that involved intricate trust organizations trying to evade STOLI prohibitions.¹⁸¹ In *PHL Variable Insurance Co. v. Dawe 2006 Insurance Trust*, the insurance company, PHL, issued a \$9 million policy on the life of Price Dawe with the Price Dawe Trust as the policy's owner and beneficiary.¹⁸² The policy had an incontestability provision that activated after two years and was effective except against fraud.¹⁸³ Three and a half years after the policy was issued, and following Dawe's death, PHL contested the policy, arguing that it was a STOLI and was never intended for legitimate insurance needs.¹⁸⁴

The facts of *Lincoln National Life Insurance Co. v. Schlanger 2006 Insurance Trust* are very similar to *Dawe* and include the insurance company, Lincoln National Life Insurance Company, issuing a \$6 million policy on Schlanger's life with the Schlanger Trust as the beneficiary.¹⁸⁵ In both cases, the insurance companies argued that a trust scheme was established to conceal STOLI transactions.¹⁸⁶ Basically, the scheme established an insurance trust, and the beneficiary of the insurance trust was a family trust.¹⁸⁷ After the insurance policy was issued to the insurance trust, the insured sold his interest in the family trust to a third party who paid the premiums on the policy.¹⁸⁸

The *Dawe* court answered three certified questions, two of which are applicable here, and the first being the same question certified in the *Lincoln* case.¹⁸⁹ The first certified question was whether Delaware law

181. See generally *PHL Variable Ins. Co. v. Dawe 2006 Ins. Trust*, 28 A.3d 1059 (Del. 2011); *Lincoln Nat'l Life Ins. Co. v. Schlanger 2006 Ins. Trust*, 28 A.3d 436 (Del. 2011).

182. *Dawe*, 28 A.3d at 1063.

183. *Id.*

184. *Id.*

185. *Schlanger*, 28 A.3d at 437.

186. *Dawe*, 28 A.3d at 1063–64; *Schlanger*, 28 A.3d at 438.

187. *Schlanger*, 28 A.3d at 438.

188. *Id.*

189. *Dawe*, 28 A.3d at 1064; *Schlanger*, 28 A.3d at 438. The third certified question—inapplicable to the scope of this Comment—asked whether Delaware law

“confer[s] upon the trustee of a Delaware trust established by an individual insured an insurable interest in the life of that individual when, at the time of the application for life insurance, the insured intends that the beneficial interest in the Delaware trust would be transferred to a third-party investor with no insurable interest in that individual's life following the issuance of the life insurance policy[.]”

permitted an insurer to challenge the validity of a life insurance interest after the incontestability period had lapsed.¹⁹⁰ The Delaware Supreme Court held that the insurable interest requirement of a life insurance policy may be challenged after the incontestability period had lapsed.¹⁹¹ The court considered this decision to be “consistent with that reached by the majority of courts.”¹⁹² The court reasoned that an incontestability period required a valid contract, but under Delaware common law, “contracts that offend public policy or harm the public are deemed *void* as opposed to voidable.”¹⁹³ Because no policy was ever effectuated, the incontestability clause also never came into effect.¹⁹⁴

The second certified question was whether an individual may procure a life insurance policy on his own life with no intent to provide insurance protection to a party with an insurable interest and immediately transfer the policy to a party with no insurable interest.¹⁹⁵ The court answered this question in the negative, effectively adding an intent component to the validity of a life settlement deal.¹⁹⁶ It is critical to note, however, that the court stated that the intent of the insured is “not the relevant inquiry.”¹⁹⁷ Instead, the relevant inquiry is determining who procured the policy and whether that person possessed an insurable interest.¹⁹⁸ This addition helps to avoid a “triumph of form over substance.”¹⁹⁹

To clarify, the court’s distinction focuses on preventing third parties from using an insured as nothing more than a straw man to get around the insurable interest requirement. Otherwise, a disinterested third party who requests that an individual purchase a policy and then immediately assign that same policy to the disinterested third party is effectively the same as the disinterested third party acquiring a policy on the insured’s life.²⁰⁰ Indeed, the court nicely summarized its view by

Dawe, 28 A.3d at 1064.

190. *Dawe*, 28 A.3d at 1064.

191. *Id.* at 1065.

192. *Id.*

193. *Id.* at 1067.

194. *Id.* at 1068.

195. *Id.* at 1064.

196. *Id.* at 1068, 1071.

197. *Id.* at 1076.

198. *Id.*

199. *Id.* at 1071.

200. *Id.* at 1073–74. Such an arrangement violates the statutory framework that most states have adopted. *See supra* note 160 and accompanying text (describing Delaware and

stating that a validly issued life insurance policy “is assignable to anyone, with or without an insurable interest, at any time. The key distinction is that a third party cannot use the insured as a means . . . to procure a policy that, when issued, would otherwise lack an insurable interest.”²⁰¹ In other words, no straw man may be used and STOLI transactions are not allowed. Importantly, traditional viatical and life settlement transactions were not proscribed by the court’s decision.

The media coverage and industry responses to the Delaware decisions further illustrate the distinction between STOLI transactions and the traditional viatical and life settlement transactions. Shortly after the Delaware Supreme Court’s decisions, the *Wall Street Journal* published an article titled “Ruling Is Defeat for Death-Bet Investors.”²⁰² The article identified the rulings as significant because Delaware serves as a home to many trust companies, and, as these cases illustrated, trusts were being used by many to conceal an underlying STOLI transaction.²⁰³ Counsel for the insurance company in *Dawe* described the decision as “a great win for us.”²⁰⁴ On the other hand, the article also quoted one attorney who believed that the removal of the two-year incontestability clause could make it very difficult for investors holding older policies to receive payouts.²⁰⁵

Interestingly, *National Underwriter*, an insurance industry publication, started its article covering the Delaware decisions by stating that “[t]he life settlement industry is welcoming a pair of recent Delaware Supreme Court decisions, despite reports suggesting that the decisions were a blow.”²⁰⁶ The life settlement industry viewed the decisions as a victory because the decisions referred to the existing life settlement market as “perfectly legal” and “highly regulated.”²⁰⁷ In the life settlement industry’s view, the decision confirmed the validity and helped advance what the industry had been working to achieve: a

New York statutes related to third parties acquiring life insurance contracts on the lives of others).

201. *Id.* at 1074.

202. Leslie Scism, *Ruling Is Defeat for Death-Bet Investors*, WALL ST. J., Sept. 26, 2011, at C1.

203. *Id.*

204. *Id.*

205. *Id.*

206. Elizabeth Festa, *Delaware Court Weighs in on Life Settlement Cases*, NAT’L UNDERWRITER, Oct. 10, 2011, at 18, 18.

207. *Id.* (quoting *PHL Variable Ins. Co. v. Dawe 2006 Ins. Trust*, 28 A.3d 1059, 1069 (Del. 2011)).

legitimate secondary life settlement market without the presence of STOLI policies.²⁰⁸

2. New York

Delaware's decisions on STOLI transactions and the secondary life insurance market generally were at odds with New York case law until the legislature brought the state's law in line with Delaware.²⁰⁹ In *New England Mutual Life Insurance Co. v. Caruso*, the issue was whether an incontestability clause may bar the insurance company's claim that the policy is unenforceable because the original policyholder had sold the policy to an individual with no insurable interest in the insured.²¹⁰ The *Caruso* court maintained an established New York rule that once the incontestability period on an insurance policy passes, the insurer is barred from asserting the policy owner's lack of insurable interest.²¹¹

The insurance company argued that paying the policyholder who has no insurable interest in the insured would violate the New York Insurance Law and be contrary to public policy.²¹² The court responded to each argument in turn. First, the court stated that the New York insurance law does not make contracts void for an individual lacking an insurable interest in the insured.²¹³ Second, the court found no public policy problem with the assignment of a valid life insurance policy by the owner to a disinterested third party with no insurable interest in the insured.²¹⁴ The court pointed out that an arrangement between the owner and third party established a contract and that insufficient public policy reasons existed to void a legal contract between the two parties.²¹⁵ The court went on to say:

208. See *supra* notes 88–89 and accompanying text.

209. Compare *supra* Part III.A.1, with *New England Mut. Life Ins. Co. v. Caruso*, 535 N.E.2d 270, 271 (N.Y. 1989), and *infra* notes 230–31 and accompanying text (demonstrating the difference between Delaware and New York judicial decisions before the New York legislature acted to bring the New York rule regarding STOLI policies in line with what is seen in other jurisdictions, like Delaware).

210. See *Caruso*, 535 N.E.2d at 271; see also *Sun Life Assurance Co. of Can. v. Berck*, 770 F. Supp. 2d 728, 732 (D. Del. 2011). In *Berck* the issue was whether Delaware law permits an insurer to challenge the validity of a life insurance interest after the incontestability period has lapsed. See *supra* note 164 and accompanying text.

211. *Caruso*, 535 N.E.2d at 271.

212. *Id.* at 272.

213. *Id.*

214. *Id.* at 274.

215. *Id.* at 273–74.

The statute requires that the policyholder have an insurable interest in the life of decedent only at the time the contract was made and to require evidence of insurable interest at this late date could not only impose an undue burden on the policyholder but also run counter to the policy considerations underlying incontestability requirements.²¹⁶

The court did not believe that it would be appropriate to put the investor who purchased the life insurance policy in a position that required the investor to prove an insurable interest after the policy had been in effect for longer than the incontestability period, especially with the deceased insured being unable to corroborate the arrangement that the parties had freely entered into.²¹⁷

In *Kramer v. Phoenix Life Insurance Co.*, New York's highest court confirmed what was said in *Caruso*.²¹⁸ In *Kramer*, a New York attorney, Arthur Kramer, took out several life insurance policies on his own life and immediately assigned the beneficial interests of the policies to individuals without an insurable interest in his life.²¹⁹ Upon Kramer's death, his wife, Alice Kramer, sought the insurance proceeds because the individuals who held the beneficial interest lacked an insurable interest in Kramer.²²⁰ Mrs. Kramer argued that this lack of insurable interest violated New York insurance law and would result in her receiving the policy benefits.²²¹

After an interlocutory appeal was granted by the district court to the Second Circuit, the Second Circuit certified the following question to the New York Court of Appeals:

Does New York Insurance Law § 3205(b)(1) and (b)(2) prohibit an insured from procuring a policy on his own life and immediately transferring the policy to a person without an insurable interest in the insured's life, if the insured did not ever intend to provide insurance protection for a person with an insurable interest in the insured's life?²²²

In response to this question, the court of appeals held that New

216. *Id.* at 274 (internal citations omitted).

217. *Id.*

218. *See Kramer v. Phoenix Life Ins. Co.*, 940 N.E.2d 535, 536–37 (N.Y. 2010).

219. *See id.* at 537. The aggregate value of the policies taken out was \$56,200,000. *Id.*

220. *Id.*

221. *Id.*

222. *Id.* at 536.

York law allows a policy owner to immediately transfer a life insurance policy on his own life to a third party with no insurable interest in the insured's life, "even where the policy was obtained for just such a purpose."²²³

To support its decision, the *Kramer* majority looked at the language of both section 3205(b)(1) and section 3205(b)(2).²²⁴ Section 3205(b)(1) allows for any individual of lawful age to buy an insurance policy on his own life for the benefit of any entity, and nothing in the insurance laws prevent the individual from immediately transferring or assigning the properly acquired policy.²²⁵ On the other hand, section 3205(b)(2) requires a third party to have an insurable interest in the insured.²²⁶ This case clearly fell within 3205(b)(1) and, under the language of the section, therefore did not require the assignee to have an insurable interest in the insured party.²²⁷

This decision by the court is consistent with both the legal and public policy holdings from *Caruso*.²²⁸ Furthermore, it continues to build upon the foundation from *Grigsby* by viewing life insurance policies as property and refusing to question the appropriate assignment of a valid life insurance policy to a party with no insurable interest.²²⁹ However, the language used by the court, especially the allowance of immediate transfers, leaves the door open for STOLI transactions.

Shortly after the decision in *Kramer*, a change to the New York insurance law regarding life settlements took effect and prohibited STOLI transactions.²³⁰ As a result, an individual is still not be prevented

223. *Id.* at 536–37.

224. *Id.* at 539.

225. N.Y. INS. LAW § 3205(b)(1) (Consol. 2000) ("Any person of lawful age may on his own initiative procure or effect a contract of insurance upon his own person for the benefit of any person, firm, association or corporation. Nothing herein shall be deemed to prohibit the immediate transfer or assignment of a contract so procured or effectuated.").

226. *Kramer*, 940 N.E.2d at 539. Section 3205(b)(2) states: "No person shall procure or cause to be procured, directly or by assignment or otherwise any contract of insurance upon the person of another unless the benefits under such a contract are payable to the person insured or his personal representatives, or to a person having, at the time when such a contract is made, an insurable interest in the person insured." N.Y. INS. LAW § 3205(b)(2).

227. *See supra* notes 219–23 and accompanying text.

228. *See Kramer*, 940 N.E.2d at 540; *see supra* notes 210–17 and accompanying text (discussing *Caruso*).

229. *See Grigsby v. Russell*, 222 U.S. 149, 155–56 (1911).

230. *See Life Settlements Act*, ch. 499, 2009 N.Y. Sess. Laws 1530, 1546 (codified as amended at N.Y. INS. LAW § 7815(c) (Consol. 2012)) ("No person shall directly or indirectly engage in any act, practice or arrangement that constitutes stranger-originated life

from immediately transferring his policy to another party, but the assignor's intent at the time of the policy's creation would have to be for the benefit of an insurable interest, and not for a STOLI transaction, for the transfer to be valid.²³¹

B. Insurance Industry Regulation Efforts

The courts are not the only group that disapproves of STOLI policies. Insurance industry organizations have also taken note of STOLIs and published comprehensive model acts to provide regulation to the secondary market, especially STOLI transactions. One group, the National Association of Insurance Commissioners (NAIC)²³² has created the NAIC Viatical Settlements Model Act.²³³ Similarly, the National Conference of Insurance Legislators (NCOIL)²³⁴ has also adopted its own life settlements model act.²³⁵ Both the NAIC and NCOIL intend for their model acts to serve as guides for state legislatures.²³⁶ Each will be briefly discussed in turn.

The NAIC Model Act provides a wide range of rules, covering the licensing of viatical settlement brokers and providers,²³⁷ prohibited practices for market participants,²³⁸ fraud prevention, and remedies.²³⁹

insurance.”).

231. N.Y. INS. LAW § 7815(b) (“Stranger-originated life insurance arrangements do not include lawful life settlement contracts as permitted by this article or those practices set forth . . . [in] this article, . . . provided that such contracts or practices are not for the purpose of evading regulation under this article.”).

232. The NAIC is composed of elected or appointed state officials who set regulatory standards throughout the United States. *About the NAIC*, NAIC, http://www.naic.org/index_about.htm (last visited Mar. 25, 2013).

233. The NAIC adopted the Viatical Settlements Act in December 1993 and amended the model extensively in June 1998 and again in March 2001. VIATICAL SETTLEMENTS MODEL ACT: LEGISLATIVE HISTORY § 17 (Nat'l Ass'n of Ins. Comm'rs 2009). Of particular importance here, in June 2007 the Model was amended again to address STOLI policies. *Id.*

234. NCOIL is a group that defines itself as the “voice of state legislators in Washington in the face of mounting federal initiatives to preempt state insurance regulation.” *History and Purpose*, NCOIL, <http://www.ncoil.org/ncoilinfo/about.html> (last visited Mar. 25, 2013).

235. *See generally* LIFE SETTLEMENTS MODEL ACT (Nat'l Conf. of Ins. Legislators 2007).

236. Kenneth W. Kingma & Stephan R. Leimberg, *Detering STOLI: Two New Model Life Settlements Acts*, EST. PLAN., July 2008, at 3, 3.

237. VIATICAL SETTLEMENTS MODEL ACT § 3 (Nat'l Ass'n of Ins. Comm'rs 2009); *see also* WINN, *supra* note 2, at 54–55 (summarizing the licensing and bonding requirements of section 3 of the Viatical Settlements Model Act).

238. VIATICAL SETTLEMENTS MODEL ACT §§ 11–12 (Nat'l Ass'n of Ins. Comm'rs 2009).

239. *Id.* §§ 14–15.

While all states have different laws regarding life settlements, the Act has, for the most part, been the basis for most state regulation of the industry.²⁴⁰

Aside from standardizing and regulating activity within the secondary life insurance market, the NAIC Model Act also attempts to eradicate STOLI policies.²⁴¹ To accomplish this goal, the NAIC Act prohibits a policyholder from selling his policy in the secondary market before five years have passed from the date the policy was issued.²⁴² The idea behind this policy is to allow for legitimate settlements to occur while at the same time hampering the financial benefit that is associated with STOLI policies by forcing the investor to employ prohibitively high amounts of money.²⁴³ Interestingly, the NAIC Model Act does provide exceptions to the five-year prohibition when certain events, such as being diagnosed as terminally ill or having a spouse die, occur.²⁴⁴

Much like the NAIC Model Act, the primary focus of the NCOIL Model Act is to deter and prevent STOLI transactions.²⁴⁵ For example, the NAIC act contains similar recommendations on advertising, such as prohibiting the use of words that imply “free” or “no cost” insurance.²⁴⁶

However, some notable differences do exist between the model acts. Chief among these differences is the NCOIL act only placing a two-year waiting period on the settlement of new policies.²⁴⁷ Importantly, the NCOIL act also possesses a broader scope. The NAIC act addresses the most basic STOLI transaction: the acquisition of a policy at the request of an investor for the sole purpose of selling that policy to the investor.²⁴⁸ On the other hand, the NCOIL act attempts to cover “all manifestations of STOLI, whether they involve direct settlements of life insurance, or

240. WINN, *supra* note 2, at 53.

241. VIATICAL SETTLEMENTS MODEL ACT § 11 (Nat’l Ass’n of Ins. Comm’rs 2009); WINN, *supra* note 2, at 58.

242. VIATICAL SETTLEMENTS MODEL ACT § 11 (Nat’l Ass’n of Ins. Comm’rs 2009); WINN, *supra* note 2, at 58.

243. See WINN, *supra* note 2, at 72.

244. VIATICAL SETTLEMENTS MODEL ACT § 11 (Nat’l Ass’n of Ins. Comm’rs 2009) (other examples include a divorce, retirement from full-time employment, or physical or mental disability).

245. The NCOIL Model Act contains the following drafting note: “It is an essential public policy objective to protect consumers against stranger-originated life insurance (STOLI).” LIFE SETTLEMENTS MODEL ACT (Nat’l Conf. of Ins. Legislators 2007).

246. *Id.* § 8.

247. *Id.* § 11(N).

248. Kingma & Leimberg, *supra* note 236, at 4–5.

indirect sales of life insurance to investors through a sale of interest in trust . . . or through other practices.”²⁴⁹ This broader scope takes on greater significance in light of recent cases.²⁵⁰

IV. LOOKING FORWARD: THE BENEFITS OF A MARKET-BASED APPROACH

Properly created life settlements can offer a promising deal for two competent parties.²⁵¹ Furthermore, because of the utility offered by these products, there should be an incentive to cultivate a market to allow people to benefit from the utility that the market presents. However, at least two major roadblocks are holding back the life settlement market: the questionable legality of life settlements and the persistent fraud that has plagued the industry.²⁵² When addressing these dual roadblocks facing the maturation of the life settlement market, the most prevalent issue in front of courts appears to be the lack of insurable interests found in STOLI transactions.²⁵³ Underlying these concerns are the competing interests between allowing the life settlement market to develop and protecting the interests of primary insurance providers. The best way to balance these interests is to couple a strict judicial adherence to incontestability clauses with a five-year holding period on newly acquired life insurance policies. This arrangement would provide investors with certainty and make STOLI transactions less financially attractive.

As *National Underwriter* pointed out, in some ways the life settlement industry welcomed the *Dawe* and *Schlanger* decisions.²⁵⁴ The industry has been trying to rid itself of STOLI policies for some time,

249. *Id.* at 4–5.

250. See generally, e.g., *PHL Variable Ins. Co. v. Dawe 2006 Ins. Trust*, 28 A.3d 1059 (Del. 2011). For an example of trust schemes used by investors, see *supra* notes 185–88 and accompanying text.

251. See *supra* Part II.A.

252. See Lazarus, *supra* note 79, at 273–74 (discussing the role that securitization could play in the growth of the life settlement market and noting that some of the factors holding back the move toward securitizing life settlements include legal concerns). This Comment already discussed the questionable legality of life settlements and the fraud that is present in the market. For a discussion on the legality issues facing the market, especially STOLI policies, see *supra* Part III. For a discussion on fraud, see *supra* Part II.D.

253. See *supra* notes 200–01 and accompanying text (explaining that the life settlements are freely assignable at any time and that the problem comes in when there is no insurable interest at the time the contract was made).

254. See *supra* note 206 and accompanying text.

and court decisions that help expose elaborate trust schemes as nothing but enablers for STOLI policies help that cause. However, the Delaware decision creates serious dangers to the life settlement industry's survival. For this reason, the Delaware view on incontestability clauses is both different and inferior to the approach articulated in New York courts. Again, the Delaware Supreme Court held that a life insurer may contest "the validity of a life insurance policy based on a lack of insurable interest after the expiration of the two-year [in]contestability period."²⁵⁵ New York, on the other hand, firmly upheld the incontestability period, stating that "passage of the incontestability period bars the insurer from thereafter asserting the policyholder's lack of an insurable interest."²⁵⁶

This distinction represents a significant difference between the states because both the New York and Delaware legislatures have joined the general trend away from STOLI policies.²⁵⁷ However, once STOLI policies are out of the picture, the vast majority of what remains are legitimate life settlements. These life settlements, which were properly acquired by an individual and later sold to an investor, may be negatively impacted by the lack of an incontestability period. As discussed earlier, the life insurance industry does not approve of the secondary market.²⁵⁸ With the Delaware Supreme Court's ruling, the industry will be more emboldened to challenge life settlements after the insured dies.²⁵⁹

One of the main problems with lifting the incontestability period is that it introduces a tremendous amount of uncertainty into the life settlement market.²⁶⁰ Not only will potential investors now view a life settlement with even more suspicion, but existing investors, who followed the rules set forth by the industry and state regulators, may now be left susceptible to a legal challenge when attempting to receive payment.

This problem is particularly concerning when it appears that eliminating the incontestability provisions is unnecessary in light of the simple options available to the insurance industry. It would not be

255. *PHL Variable Ins. Co.*, 28 A.3d at 1064–65.

256. *New England Mut. Life Ins. Co. v. Caruso*, 535 N.E.2d 270, 271 (N.Y. 1989).

257. *See Dawe*, 28 A.3d at 1074–75 ("After *Kramer* the New York legislature revised the state's insurance laws to prohibit STOLI transactions").

258. *See discussion supra* Part II.E.

259. *Scism, supra* note 202.

260. *See id.*

difficult for a life insurance application to include language that could constrain, or even eliminate, the possibility that the policy be settled on the secondary market. For example, an insurance company could include in its application a provision that the insurance policy shall not be assigned to an individual without an insurable interest in the insured or that any assignment of the insurance policy must be approved by the insurance company first. No valid reason exists to explain why these policies cannot be included in a contract between two knowledgeable actors.

The ability of the insurance market to function as a market makes New York's rule regarding a firm incontestability period the most appropriate because it allows for the market to operate. Such an approach seems to offer two possible ends. First, the industry locks out the ability for people to settle life insurance policies on a secondary market, and the life settlement market fades away. Alternatively, if enough of the individuals acquiring life insurance demand policies that can be settled on the secondary market, some insurers will undoubtedly supply such policies.

Either result would provide certainty to investors because they would know that after the incontestability period, the policy that they purchase will pay out upon the death of the insured. Furthermore, either result is preferable to the Delaware decision to look past the incontestability provision. A strong incontestability period allows the market, and not courts or other government entities, to determine the fate of the secondary market for life insurance.²⁶¹ In short, the life settlement market's fate should be determined by its interaction with the primary life insurance market and whether people seeking life insurance from the primary market provide adequate demand for policies that provide for the ability to later settle the policies on a secondary market. A strong incontestability period helps to achieve this goal by deterring STOLI transactions while providing repose to investors who are able to provide meaningful value to the insured.

However, to effectively deter STOLI policies, the holding period for new policies must be long enough to discourage investors from initiating such policies. In this sense, state legislatures²⁶² should codify the NAIC's

261. This result should be welcomed, especially since, as the Supreme Court held in *Grigsby*, life insurance policies are personal property. *Grigsby v. Russell*, 222 U.S. 149, 156 (1911).

262. The McCarran-Ferguson Act makes insurance the exclusive domain of the states. McCarran-Ferguson Act, ch. 20, 59 Stat. 33, 33-34 (1945) (codified at 15 U.S.C. § 1012(a)).

qualified five-year prohibition on selling newly acquired life insurance policies.²⁶³ This method is viewed by many as one of the best ways to eliminate STOLI policies because it diminishes their economic incentive.²⁶⁴ At the same time, bona fide settlements are still an available option to those who choose to engage in such a transaction.²⁶⁵

Some argue that such a restriction on the sale of a life insurance policy is “anti-consumer” because it prevents the owner of a life insurance policy from freely selling his policy.²⁶⁶ While this argument has merits, there are reasons why it is unconvincing. First, without effective eradication of STOLI policies, it seems possible that the life settlement market will either cease to exist or never grow to its potential. Since the five-year holding period provides an effective way of eradicating STOLI policies, it will help create and preserve a market that makes settling policies not only possible, but also legitimate. Indeed, developing and preserving such a market is fundamentally pro-consumer.

Second, exceptions can help alleviate any “anti-consumer” effects of the five-year moratorium. For example, both the NAIC and NCOIL model acts contains several “life events” that allow policyholders to sell their policies.²⁶⁷ These exceptions include becoming terminally ill, becoming bankrupt or insolvent, and undergoing divorce.²⁶⁸ Because these exceptions are based on events that the policyholder either does not control or that carry serious implications, the chance of people attempting to engage in an event for the purpose of settling a policy before the five-year period lapses seems unlikely. Still, the exceptions prevent complete foreclosure on the ability of a consumer to settle a policy when he is in a situation that requires urgent action.

(2006)); *Life Partners, Inc. v. Morrison*, 484 F.3d 284, 297 (4th Cir. 2007). As a result, while slow, piecemeal adoption through individual state legislatures, as opposed to federal action, is necessary.

263. WINN, *supra* note 2, at 72.

264. *Id.* While it may still be practical for some investors to endure a five-year lag, it seems unlikely that many investors would be willing to tie up significant amounts of capital for five years in an asset in which the investor has no legal title for a deal.

265. *Id.*

266. *Id.*

267. *Id.*; VIATICAL SETTLEMENTS MODEL ACT § 11 (Nat’l Ass’n of Ins. Comm’rs 2009); NCOIL LIFE SETTLEMENTS MODEL ACT § 11(N)(2) (Nat’l Ass’n of Ins. Comm’rs 2009).

268. VIATICAL SETTLEMENTS MODEL ACT § 11 (Nat’l Ass’n of Ins. Comm’rs 2009); NCOIL LIFE SETTLEMENTS MODEL ACT § 11(N)(2) (Nat’l Ass’n of Ins. Comm’rs 2009); WINN, *supra* note 2, at 72.

Insurance industry groups are already taking steps to eradicate STOLI policies. The courts and state legislatures can help legitimize the life settlement market by coupling a strict judicial understanding of a policy's incontestability clause with a modest regulation like the five-year holding period.²⁶⁹

V. CONCLUSION

At its core, the life settlement market provides an opportunity for a life insurance policy to be transferred from the owner to an investor. Driving this transfer is the mutual economic benefit available between the cash settlement value and the value payable upon the death of the insured.

To understand how to best promote the growth of this market, this Comment began with a discussion of the life insurance industry before detailing the origin of the life settlement market. This discussion was followed by a description of the parties involved in the process of settling a life insurance policy. Some examples of the problems facing the secondary life insurance market, as well as the secondary market's interaction with the primary market, were then detailed.

Next, this Comment moved into case law by examining the view of the courts on STOLI policies and explaining how the view of the courts compares with the view of the life settlement industry. Decisions from the highest courts in both New York and Delaware were then detailed after a brief discussion of a few of the foundational Supreme Court cases.

After considering the differences between the decisions and how those differences could impact the growth and viability of the secondary market, this Comment moved into the variety of efforts being used to help rid the market of STOLI transactions. Among these efforts, the model acts of the NAIC and NCOIL were highlighted.

Finally, this Comment recommended coupling a strict judicial adherence to incontestability clauses with state codification of a five-year holding period on newly issued policies. This approach would help stabilize the market by providing certainty to investors of validly settled

269. Such a market could help create products that are conducive to securitization, which is a goal that many commentators have sought because of the independent agency ratings and access to market exchanges that come along with the ability to securitize. See generally Franklin L. Best, Jr., *Securitization of Life Insurance Policies*, 44 TORT TRIAL & INS. PRAC. L.J. 911; Lazarus, *supra* note 79.

policies while at the same time reducing the financial benefit offered by STOLI transactions.

The end result will mean a stable market comprised of validly settled life insurance policies. Such a market provides an opportunity for two competent parties to achieve a mutual economic benefit.

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