

# **Florida Office of Insurance Regulation**

**Report of Commissioner, Kevin M. McCarty**



## **STRANGER-ORIGINATED LIFE INSURANCE ("STOLI") AND THE USE OF FRAUDULENT ACTIVITY TO CIRCUMVENT THE INTENT OF FLORIDA'S INSURABLE INTEREST LAW**

**January 2009**

## **Executive Summary**

Florida Insurance Commissioner, Kevin M. McCarty, conducted a public informational hearing on the issue of stranger-originated life insurance or "STOLI", at the Capitol Building in Tallahassee, Florida on August 28, 2008. The Office of Insurance Regulation ("Office") submits this report to the citizens of Florida based on the testimony and voluminous documentation presented before, during, and after the public hearing; a review of documents and reports in the public domain; and relevant court filings made within the State of Florida concerning alleged STOLI transactions.

The STOLI transactions discussed in this report involve a plan to **initiate, or originate** a life insurance policy for the benefit of investors who seek to profit by purchasing life insurance on a stranger. STOLI is a scheme designed to procure life insurance on individuals, often using fraudulent means such as misrepresentation, falsification, or omission of material facts in the life insurance application. This may entail misrepresenting the true net worth of the proposed insured to obtain large face value life insurance policies.

STOLI transactions are occurring in Florida and involve Florida seniors who are induced into obtaining life insurance policies they otherwise would not buy or need. STOLI policies are procured in a manner that circumvents the insurable interest laws by allowing persons with no insurable interest in the life of the insured at the time of purchase to obtain a policy for which they could not directly apply.

Based on the testimony presented, STOLI transactions may involve varying degrees of insurance fraud and the violation of laws that were intended to protect consumers.

Initially, this may appear to be a “victimless” crime. Seniors are compensated by “the strangers” to purchase life insurance, and the strangers often pay the insurance premiums for the seniors as well. Assuming the medical information is correct on the application, life insurers presumably collect adequate premium and make a normal profit. If the transaction turns out as planned, the stranger/investor eventually receives the life insurance pay-out tax free, which is preferable to other similar investments. The reason that all three parties (seniors, agents, stranger/investors) can simultaneously profit is due to one simple fact: life insurance proceeds are tax-exempt. However, even if seniors are compensated for their involvement in STOLI schemes, there may be other serious consequences for this population.

### **STOLI Transactions Harm Seniors:**

- Seniors may exhaust their life insurance purchasing capability and not be able to protect their own family or business.
- The incentives, especially cash payments, used to lure seniors to participate in STOLI schemes are taxable as ordinary income.
- Seniors may subject themselves or their estates to potential liability in the event the life insurance policy is rescinded by an insurer who discovers fraud.
- Seniors may encounter unexpected tax liability from the sale of the life insurance policy.
- The “free” insurance is not free and may be subject to tax based on the economic value of the coverage.
- Seniors have to give the purchaser, and subsequent purchasers, access to their medical records when they sell their life insurance policy in the secondary market so that investors know the health status of the insured. The investors want to know the “status” of their investment and how close they are to getting paid.

- STOLI may lead to an increase in life insurance rates for the over 65 population.

As is mentioned later in the report, many of these “negative” consequences may also be true for viatical settlements, which are legal in the state of Florida. However, there are some distinct differences between STOLI arrangements and viaticals. These differences include the intent of the person at the time of purchase, the purpose of the sale of the life insurance product to the secondary market, and the fact that some “strangers” encourage fraudulent misrepresentation on the life insurance application for STOLIs; seniors are encouraged to exaggerate their net worth on life insurance applications to obtain a larger pay-out.

Florida is a unique state with over 17.6% of its population over the age of 65 years.<sup>1</sup> From 1990 to 2000 the number of seniors residing in the state increased by 438,000, or 18.5%.<sup>2</sup> It is imperative that the State act to protect its seniors and all Floridians from becoming victims of fraudulent STOLI transactions.

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<sup>1</sup> U.S. Census Bureau, “The 65 Years and Over Population: 2000”, Census 2000 Brief, issued October 2001.  
<sup>2</sup> Id.

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## Background

### Life Insurance and Insurable Interest – Historical Perspective

From a historical perspective, stranger-originated life insurance and the issue of insurable interest are not new. Life insurance dates to ancient Rome where burial clubs covered the cost of members' funeral expenses and monetarily helped survivors. Modern life insurance started in late 17th century England as insurance for traders.

While serving as a means of risk-avoidance, life insurance also appealed strongly to the gambling instincts of England's burgeoning middle class. Gambling was so rampant that when newspapers published names of prominent people who were seriously ill, bets were placed at Lloyd's on their anticipated dates of death. Prior to the end of the 18<sup>th</sup> century, English courts permitted and enforced various gaming or wagering contracts made by persons who had absolutely no insurable interest in the life of another person.<sup>3</sup>

Consequently, to put an end to the use of life insurance contracts as wagering devices, the British Parliament in 1774 passed a statute<sup>4</sup> holding that any life insurance contract without an insurable interest in the life of the insured would henceforth be null and void.

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<sup>3</sup> Peter Nash Swisher, *The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 Drake Law Review, 477 (2005).

<sup>4</sup> Life Assurance Act, 1774, 12 Geo. 3, c. 48, § 1 (Eng.). The Act provided in relevant part: Whereas it hath been found by Experience, that the making Insurances on Lives, or other Events, wherein the Assured shall have no Interest, hath introduced a **mischievous Kind of Gaming**: For Remedy whereof, be it enacted by the King's most Excellent Majesty, ... in this present Parliament assembled, and by the Authority of the same, That from and after the passing of this Act, no Insurance shall be made by any Person or Persons, Bodies Politick or Corporate, on the Life or Lives of any Person or Persons ... wherein the Person or Persons for whose Use, Benefit, or on whose Account such Policy or Policies shall be made, shall have no Interest, or by way of Gaming or Wagering; and that **every Assurance made, contrary to the true Intent and Meaning hereof**, shall be null and void, to all Intents and Purposes whatsoever. [Emphasis added].

During the 19<sup>th</sup> century and early 20<sup>th</sup> century, most American courts recognized the insurable interest requirement for life insurance policies, purportedly based on English common law precedent.<sup>5</sup> It is recognized today that an individual has an insurable interest as to his own life, body and health.<sup>6</sup> In addition, an insurable interest is founded on either a “love and affection” interest for persons closely related by blood or law, and, as to other persons, a lawful and substantial economic interest in the continued life, health, or bodily safety of the person insured.<sup>7</sup>

### **Public Policy Against Wagering on Human Life**

Until the recent development of viatical settlement arrangements, the legal system has shown a disdain for insurance policies that give positive incentives for the early death of the insured. For over 132 years American jurisprudence has generally agreed that mere wager policies--that is, policies in which the insured party has no interest whatsoever in the matter insured, will be considered void as they do not promote sound public policy.<sup>8</sup>

In 1876, the United States Supreme Court reviewed a case involving a life insurance policy procured by a husband and wife payable to the survivor on the death of either. Years later the couple divorced and upon the death of the former husband, the ex-wife tried to collect the life insurance benefit. The suit arose when Connecticut Mutual Life Insurance sued arguing that the ex-wife no longer had an insurable interest and should not receive the proceeds from the policy.<sup>9</sup>

In upholding the validity of the life insurance policy, the Supreme Court opined that:

It is well settled that a man has an insurable interest in his own life, and in that of his wife and children; a woman in the life of her husband; ... Indeed, it may be

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<sup>5</sup> Peter Nash Swisher, *The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 Drake Law Review, 477 (2005).

<sup>6</sup> See Section 627.404, Florida Statutes (2008).

<sup>7</sup> Id.

<sup>8</sup> Connecticut Mut. Life Ins. C. v. Schaefer, 94 U.S. 457 (1876).

<sup>9</sup> Id.

said generally that any reasonable expectation of pecuniary benefit or advantage from the continued life of another creates an insurable interest in such life. And there is no doubt that a man may effect an insurance on his own life for the benefit of a relative or friend; or two or more persons, on their joint lives, for the benefit of the survivor or survivors.... **The essential thing is, that the policy shall be obtained in good faith, and not for the purpose of speculating upon the hazard of a life in which the insured has no interest.**<sup>10</sup> [Emphasis added].

The 1881 case of Warnock v. Davis<sup>11</sup> was perhaps one of the earliest stranger-originated, premium-financed, life insurance cases to come before the United States Supreme Court. In the Warnock case there was collusion between the insured and the party to be benefited by his death. In brief, the facts of the case involve a 27 year old tanner who applied for a \$5,000 life insurance policy on his own life and on the same day entered into an agreement with a entity known as the Scioto Trust Association to transfer nine-tenths of the face value to the trust upon his death and for the trust to pay his wife the remaining one-tenth (\$500).

The policy was issued the same day as the application and on the next day the tanner assigned the policy to the Scioto Trust Association which agreed to pay the premiums and all fees due on the policy. The tanner agreed to keep the Trust informed as to his residence and post-office address and to pay a \$6.00 fee and annual dues of \$2.50. The tanner died a little over a year after the policy was issued and his estate administrator, Warnock, sought to recover the life insurance proceeds that were paid to the Trust. In a ruling against the Trust retaining the life insurance policy proceeds (except for the sums already advanced/paid by the Trust), the U.S. Supreme Court stated:

**The 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. Nor is its character changed because it is for a portion merely of the insurance money. To the extent in which the assignee stipulates for the proceeds of the policy beyond the sums advanced by him, he stands in the position of one holding a wager policy. The law might be readily evaded, if the policy, or an interest in it, could, in**

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<sup>10</sup>

Id.

<sup>11</sup>

104 U.S. 775 (1881).

consideration of paying the premiums and assessments upon it, and the promise to pay upon the death of the assured a portion of its proceeds to his representatives, be transferred so as to entitle the assignee to retain the whole insurance money. [Emphasis Added].<sup>12</sup>

In the 1911 case of Grigsby v. Russell,<sup>13</sup> the Supreme Court clarified Warnock, concluding that an assignment is not automatically condemned when the assignee lacks an insurable interest, so long as there is no prior agreement to assign. Hence, the Court held that while the lack of an insurable interest in the insured was not a bar to subsequent assignment, there must be an insurable interest in the first instance, as well as a good-faith intent to obtain insurance for the benefit of one's family or business. The Court reiterated that "[t]he very meaning of an insurable interest is an interest in having the life continue."<sup>14</sup>

In 1939, the Florida Supreme Court in Knott v. State ex rel. Guaranty Income Life Ins. Co.,<sup>15</sup> ruled in favor of then Insurance Commissioner W.V. Knott's denial to an insurer to issue a "special endowment benefit" stated that a wagering contract is against the public policy of the State of Florida.<sup>16</sup>

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<sup>12</sup> Id. at p. 4.

<sup>13</sup> 222 U.S. 149, 154-55, 32 S.Ct. 58, 56 L.Ed. 133 (1911).

<sup>14</sup> Id. at 155, 32 S.Ct. 58.

<sup>15</sup> 136 Fla. 184, 186 So. 788 (Fla.1939).

<sup>16</sup> The "Special Endowment Benefit" would have provided for payment of one thousand dollars upon the insured reaching the age of seventy or, upon his death, the same amount to the beneficiary. In addition... insured receives upon the death of each policyholder of his age and insured in the same year a sum equal to the ratio the face amount of the policy bears to the total of the face amounts of all policies in the same class. Thus if all policy holders in the same class except one should die before reaching the age of seventy years the sole survivor would have received his proportionate share on each death and the beneficiary of the first to die would have received only the first allotment. Id.

## **Florida's Insurable Interest Law**

Currently, Florida's insurable interest law, Section 627.404, Florida Statutes, attached to this report as **Appendix III**, does not require that an insurable interest exist after the inception date of coverage under the contract. Florida's insurable interest law was recently amended to clarify existing law.<sup>17</sup> Section 627.404, Florida Statutes states:

Any individual of legal capacity may procure or effect an insurance contract on his or her own life or body for the benefit of any person, but no person shall procure or cause to be procured or effected an insurance contract on the life or body of another individual unless the benefits under such contract are payable to the individual insured or his or her personal representatives, or to any person having, at the time such contract was made, an insurable interest in the individual insured. The insurable interest need not exist after the inception date of coverage under the contract. [Emphasis added].

Section 627.404(2)(b), Florida Statutes, lists nine categories in which an insurable interest as to life, health, or disability insurance are recognized to exist. For purposes of this Report, the categories are as follows:

1. An individual has an insurable interest in his or her own life, body, and health...
2. An individual has an insurable interest in the life, body, and health of another person to whom the individual is closely related by blood or by law...
3. An individual has an insurable interest in the life, body, and health of another person if such individual has an expectation of a substantial pecuniary advantage through the continued life, health, and safety of that other person...

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5. A trust, or the trustee of a trust, has an insurable interest in the life of an individual insured under a life insurance policy owned by the trust...

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<sup>17</sup> See Chapter 2008-36, Laws of Florida, approved by Governor Charlie Crist on May 28, 2008, and effective July 1, 2008.

6. A guardian, trustee, or other fiduciary, acting in a fiduciary capacity, has an insurable interest in the life of any person for whose benefit the fiduciary holds property...

## **Florida's Allowance for Viatical Settlements**

Florida allows viatical settlement agreements – the sale of life insurance policies to third-parties (with no insurable interest), before the life insurance policy matures. These transactions give cash to the insureds (often seniors) at a price discounted from the face value, but more than the surrender value. Viatical settlements grew in popularity in the late 1980s during the AIDS epidemic and were considered “humane” as they provided terminally ill patients with money prior to death. (Viatical settlements are also called life settlements.)

However, viatical settlement transactions feature many of the same elements as STOLI transactions. Viatical providers “wager” on human life, and initially focused on individuals with AIDS as these individuals died within short periods of time. Similar to STOLIs, viatical settlement purchasers have no insurable interest in the insureds and have a financial incentive for the death of the insured. They also receive these proceeds tax-free.

There are some distinct differences, however, especially as it relates to the timing of the insurable interest, and the intent of the person purchasing the life insurance policy. Life insurance later sold to viatical settlement providers was initially purchased in “good faith” as a life insurance policy, not an investment. Thus the insured had an “insurable interest” in his or her own life at the time of purchase (as do their beneficiaries), which complies with Florida’s insurable interest law. In these situations, the insured made the premium payments until the sale of the contract, and there is no pre-arrangement to sell the policy prior to the person becoming terminally ill. As importantly, there was

no encouragement of fraud to obtain abnormally large life insurance policies by the viatical settlement providers at the time of purchase.

## **Stranger-Originated Life Insurance – What it is and what it is not**

There are several definitions of stranger-originated life insurance or “STOLI”.<sup>18</sup> STOLI is a practice or plan to **initiate, or originate** a life insurance policy for the benefit of investors who seek to profit by purchasing life insurance on a stranger. STOLI policies enable the policy owners, usually the insured, to obtain cash by selling that policy to a stranger whose only interest is the early demise of the insured. STOLI is a scheme designed to procure life insurance policies on individuals, often using fraudulent means such as lying, misrepresentation or omission of material facts in the application, which may include misrepresentation of the true net worth of the proposed insured. Another facet is to encourage the insured to misrepresent the insurable interest of the intended policy owner to obtain a large face-value policy for the benefit of investors. Generally, the scheme involves the recruitment of senior citizens with high-net worth or those willing to misrepresent their net worth. At the public hearing held by the Office, one of the presenters, Marshall Jones, Esq., member of the Association for Advanced Life Underwriting (“AALU”), when asked whether the target was only the high-net worth seniors, responded:

It's always been anybody that can issue a policy, anybody over the age of 70 that can issue a policy. And what you're seeing, what you see visibly above the surface are the so-called legitimate deals where the target is the higher net worth

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<sup>18</sup> The National Conference of Insurance Legislators (“NCOIL”), defines STOLI as a “practice or plan to initiate a life insurance policy for the benefit of a third party investor who, at the time of policy origination, has no insurable interest in the insured.” See *NCOIL Life Settlements Model Act*, November 16, 2007.

Ohio has recently enacted legislation to protect consumers against STOLI transactions and defines STOLI as “a practice, arrangement, or agreement initiated at or prior to the issuance of a policy that includes both of the following: (a) The purchase or acquisition of a policy primarily benefiting one or more persons who, at the time of issuance of the policy, lack insurable interest in the person insured under the policy; (b) The transfer at any time of the legal or beneficial ownership of the policy or benefits of the policy or both, in whole or in part, including through an assumption or forgiveness of a loan to fund premiums.” Section 3916.01(W)(1), Ohio Revised Code.

person, where the approved plan gets issued because they think they're buying it for estate planning, but the real intent is to sell the policy two years from now.<sup>19</sup>

Seniors are: “wined and dined”; promised “free insurance”; told that they are in the situation of “heads, I win or tails, I can’t lose”; and promised cash or a profit for their participation in these schemes.<sup>20</sup> In some cases, seniors who have existing life insurance are encouraged to purchase additional policies solely for the purpose of resale to the STOLI promoters.<sup>21</sup> Seniors are induced into obtaining life insurance policies they otherwise would not buy or need.

Full disclosure to seniors regarding the tax implications and the maximization of the senior’s insurance capacity are rarely revealed by STOLI promoters.<sup>22</sup> Seniors are not told about misrepresentations made on their applications by an agent or broker involved in the scheme. Seniors are often coached to “properly” respond to the application questions to avoid alerting life insurance companies. STOLI promoters submit multiple applications to life insurance companies to maximize profits.

Scott Berlin, Senior Vice-President at New York Life, testifying at the August 28, 2008 public hearing, distinguished between traditional viatical settlements and STOLI:

[T]he difference is in the intent. If I own a policy, I have the right to assign it. That was made clear. I have the right to sell it. That was made clear. But the question is what is my intent at the time of the purchase. And if my intent is to

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<sup>19</sup> Transcript of Public Hearing - Appendix I, pp. 129 – 130.

<sup>20</sup> Appendix II – STOLI Promotional Materials.

<sup>21</sup> Appendix II– STOLI Promotional Materials. A very public example is the case of CNN’s Larry King’s lawsuit against insurance agent Alan Meltzer and Bethesda, Md.-based Meltzer Group Inc. alleging, among other things, that King was misled into purchasing a \$10 million policy on himself, which he promptly sold for \$550,000. King also sold an existing \$5 million policy for \$850,000 in cash. King’s suit alleged that the brokers were liable to him because he did not receive enough money for the policies, the brokers did not adequately advise him about his continuing life insurance needs and the unexpected tax consequences from the transactions. Larry King vs. Alan Meltzer, et al., Case No.: 07-cv-06813, filed October 24, 2007. The case settled during the summer of 2008; the details were not disclosed.

<sup>22</sup> Alan Jensen & Stephan R. Leimberg, Stranger-Owned Life Insurance: A Point/Counterpoint Discussion, 33 ACTEC J. 110, 110 (Fall 2007).

get around the insurable interest laws by setting up a creative scheme, I don't think that that should be allowed under Florida law.<sup>23</sup>

STOLI policies are procured in a manner as to circumvent the insurable interest laws. The sale of the policy is usually completed after the two-year contestability period has expired. This two-year period was established by law (Section 626.99287, Florida Statutes). This statutory provision does not forbid the sale within the two-year period, but provides that the viatical settlement contract is void or unenforceable by either party (subject to certain exemptions) during the contestability period. The exceptions are primarily for major life changes.

This two-year limited restriction period is designed to prevent wagering and fraud in life insurance policies. Since, by law, life insurers are limited to contesting the policy on the basis of fraud to that two-year window, STOLI promoters generally wait two years before selling the policy in the secondary market.

Generally, in a STOLI transaction, the promoters and investors will establish an irrevocable trust to obtain a premium finance loan, obtain an insurance policy on a senior, and pay the life insurance policy premiums for two years, i.e., the contestability period. The money needed to pay these premiums, which can amount to hundreds of thousands of dollars, is financed through various types of entities that can broadly be defined as "premium finance lenders." Typically, these premium finance loans are non-recourse loans meaning the life insurance policy is the only collateral for the loan and the premium finance lender can only pursue collection of the collateral if there is a default.

Not all life insurance policies obtained by the usage of a non-recourse loan are STOLI transactions. The seniors are told of various options they may have at the end of the financing period. For example, they can: (1) pay off the loan amount (principal, interest and other associated expenses) and take the policy over themselves (this scenario is unlikely given the large amount of money paid for

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<sup>23</sup> Transcript of Public Hearing - Appendix I, p. 29.

the first two years of coverage); (2) allow or arrange for the sale of the policy to a viatical settlement provider and pay off the balance due to the lender and keep any residual monies, if any; or (3) default on the loan and turn the policy over to the lender. Seniors are told that in a default situation, the trust will then sell the policy and the seniors will receive a profit, less cost of the loan and interest. This arrangement appears to be beneficial to seniors as they enjoy life insurance “free” for two years and then after two years, collect a significant cash payment for his or her participation in the scheme.

It is important to note that life insurance is an asset and an important estate-planning tool. The sale or assignment of a life insurance policy to a “stranger” or third party, based on the policy owner’s major change of life circumstances, financial or otherwise, is NOT a STOLI transaction. The sale or assignment of a life insurance policy to a trust established by the owner of the policy for the benefit of his or her family or estate is also NOT a STOLI transaction. A typical viatical transaction where the owner of the policy has a terminal illness or major medical problems and seeks to sell the policy to obtain needed medical care or to enjoy his or her last days is NOT a STOLI transaction.

The Office is aware of at least three multi-million dollar federal lawsuits recently filed in Florida by several life insurers, licensed to conduct insurance business in Florida, suing to rescind alleged STOLI policies because the true nature of the transactions were allegedly misrepresented.<sup>24</sup> The life insurers in these lawsuits are suing all involved, including the trusts and the Florida seniors who may or may not have known the full nature their involvement in the alleged STOLI schemes.<sup>25</sup>

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<sup>24</sup> See AXA Equitable Life Insurance Company vs. Infinity Financial Group, LLC, et al., Case No.: 08-cv-80611, filed June 6, 2008 (case involves alleged STOLI transactions on five life insurance policies with a total face value of \$73 million). The AXA case is currently scheduled for trial in July of 2009 although a joint motion to stay the lawsuit was filed by the Plaintiff and some of the defendants and was granted by the federal judge until November 3, 2008 to narrow or resolve issues in the case); American General Life Insurance Company vs. Steven Brasner, Infinity Financial Group, LLC, et al., Case No.:08-cv-80855, filed August 4, 2008 (case involves alleged STOLI transactions on 2 policies with a \$10 million total face value); West Coast Life Insurance vs. Life Brokerage Partners, LLC, et al., Case No.: 08-cv-80897, filed August 13, 2008 (case involves alleged STOLI transactions on nine policies with a total face value of \$50 million).

<sup>25</sup> Id.

The Florida agents and brokers are also defendants in these lawsuits in which the life insurance companies are seeking refunds for millions of dollars paid in commissions.

## **The Public Hearing on STOLI**

Florida Insurance Commissioner, Kevin M. McCarty, conducted a public informational hearing (hereinafter “hearing”) on the issue of STOLI at the Capitol Building in Tallahassee, Florida on August 28, 2008. The hearing was broadcast throughout the state via television and the Internet and was recorded by the Florida Channel.<sup>26</sup> Presenters at the hearing included representatives of agents and brokers; life insurance companies; viatical settlement providers; life insurance finance companies; and staff of the Office of Insurance Regulation. An attorney, who represents consumers in lawsuits against their employers that have taken out life insurance on the employee without the knowledge and consent of the employee, also testified.<sup>27</sup> One of the key issues addressed at the hearing was the harm and victimization that arises from STOLI transactions, in addition to the public policy concerns regarding wager policies. From the beginning of the hearing, Commissioner McCarty queried the presenters on these core issues.

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<sup>26</sup> The video of the STOLI Public Hearing can be seen in its entirety on the OIR website: [www.FLOIR.com](http://www.FLOIR.com). Click on link “Stranger-Originated Life Insurance (STOLI)” to view video that has been divided into Parts 1, 2, and 3.

<sup>27</sup> These types of policies are generally referred to as “COLI” policies or company-owned life insurance or Corporate-owned life insurance. There is federal law on this matter. Known as the COLI Best Practices Act, this provision is designed to codify industry “best practices” regarding employer owned life insurance. The provision amends the Internal Revenue Code of 1986 to exclude from gross income the proceeds from certain company-owned life insurance. The employer owned death benefit proceeds will be considered eligible for exclusion from the employers’ income provided all the notice and consent requirements are met. See **Internal Revenue Code** section 101(j).

Florida’s insurable interest law recognizes COLI for key employees: “A business entity has an insurable interest in the life, body, and health of any of the owners, directors, officers, partners, and managers of the business entity or any affiliate or subsidiary of the business entity, or key employees or key persons of the business entity or affiliate or subsidiary, if consent is obtained in writing...” Section 627.404, Florida Statutes.

## **Seniors May Lose the Ability to Purchase Additional Life Insurance**

An individual has only a finite amount of "insurance capacity" on his or her life, and insurers may refuse to write additional insurance. Once a senior has life insurance on his or her life and then sells the policy, the senior may be unable to obtain more life insurance should a legitimate need for life insurance arise. At the STOLI hearing, Scott Berlin, Senior Vice-President at New York Life Insurance Company commented on this issue and stated:

One of the things that's not well understood among the senior community is that there's a certain amount of insurance you can get, that you can qualify for... You can't -- it's not just you can get as much as you want. And once you've bought that insurance and given it to somebody else, it doesn't free up that capacity for you to get more. There's only a certain amount of insurable interest on you based on your current status.<sup>28</sup>

STOLI promoters often do not discuss the insurance capacity issue with the seniors that they are trying to induce into applying for multi-million dollar life insurance policies. Bob Rubin, on behalf of AALU, addressed the issue in his comments at the hearing and stated:

[T]he consumer thinks that he's taking care of his estate planning, business succession plan, or accomplished some sort of estate planning...the reality in most cases is exactly the opposite...he now has a significant life insurance policy on his life, usually up to the maximum allowed or more than the maximum allowed by a particular life insurance company's financial underwriting guidelines. Since he has now used up his capacity, his insurance capacity, he'll be hard-pressed to purchase any more life insurance that will truly benefit his family for whatever the future circumstances might dictate.<sup>29</sup>

Attorney Joy Ryan representing insurer MetLife echoed the sentiments of those expressed by New York Life regarding the dangers to consumers presented by STOLI arrangements. Ms. Ryan stated, "consumers may not be aware that participating in these types of arrangements may exhaust their life insurance purchasing capability..."<sup>30</sup> As Stephan R. Leimberg, Esq. has reported, "[T]his

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<sup>28</sup> Transcript of Public Hearing - Appendix I, pp. 38 – 39.

<sup>29</sup> Transcript of Public Hearing - Appendix I, pp. 104 –105.

<sup>30</sup> Transcript of Public Hearing - Appendix I, p. 136.

insurability limit is constantly being pushed downward because fewer insurers are willing to accept the risk of ultra-large policies” coupled with the fear by life insurers of what will happen if more and more policies are retained indefinitely by investors.<sup>31</sup>

## **Seniors May Face Unexpected Tax Liability**

The incentives used by STOLI promoters to induce seniors to apply for life insurance policies and the STOLI transaction may create an unexpected tax liability for seniors. Stephan Leimberg, Esq., author and co-author of many books on estate, financial, and employee benefit and retirement planning, states “any incentive, such as a car, cash, trip, or other ‘gift’ to entice a person to purchase the policy, will be taxable to that person immediately as ordinary income.”<sup>32</sup>

In 2007, *Business Week*<sup>33</sup> published a cover story on the legal and public policy concerns involving STOLI transactions. Following the publication of that cover story, two senior members of the U.S. House Ways and Means Committee, Richard E. Neal and Phil English, wrote a letter, dated November 16, 2007, to Treasury Secretary Henry M. Paulson, requesting action by the Treasury Department to protect seniors from the unexpected tax liability of STOLI transactions.<sup>34</sup>

Representatives Neal and English raised questions regarding the tax liability on the transaction; promotional incentives; and cancellation of indebtedness (i.e. the non-recourse loan). Stating “STOLI transactions take advantage of the secondary market in life insurance settlements at the expense of elderly Americans who are left with an unexpected tax liability,” both Congressmen urged the Treasury Department to issue a notice or other form of public guidance outlining the potential tax

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<sup>31</sup> Stephan R. Leimberg, *Stranger-Initiated Life Insurance: Scorpion or Frog?* Mr. Leimberg is CEO of Leimberg Information Services, Inc.

<sup>32</sup> Alan Jensen & Stephan R. Leimberg, *Stranger-Owned Life Insurance: A Point/Counterpoint Discussion*, 33 ACTEC J. 110, 110 (Fall 2007)

<sup>33</sup> “Profiting From Mortality,” by Matthew Goldstein, *Business Week*, July 30, 2007.

<sup>34</sup> See Letter to Secretary Paulson, Appendix IV.

consequences of participating in a STOLI transaction.<sup>35</sup> The Office is not aware of any response to the letter from the Treasury Department.

Bob Rubin, on behalf of the Association for Advanced Life Underwriting (“AALU”), addressed the tax liability issue and stated:

Tax issues are glossed over. Most of the time these deals involve quite a bit of premium to be paid up front. Since the premium is borrowed, a substantial debt is unsecured. Since it's a non-recourse type of finance, what happens in two years when the policy is sold or given up or whatever and that debt is discharged? I'm not a CPA, but is that a discharge of debt issue?<sup>36</sup>

Currently the proceeds to the beneficiary of a life insurance policy are non-taxable. In response to Commissioner McCarty's question of the potential of putting life insurance policies' favorable tax treatment in jeopardy due to STOLI profiteers, Scott Berlin of New York life responded:

Well, I think that there is the risk that the IRS could look in and say, you know, life insurance isn't providing the purpose that it once did. It's now a vehicle for speculators to get rich. It's not for people to protect their families and their businesses so we're going to change the tax law. And I think that that would be a very bad outcome for both individuals and the industry.<sup>37</sup>

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Id.

<sup>36</sup> Transcript of Public Hearing - Appendix I, pp. 105 – 106.

<sup>37</sup> Transcript of Public Hearing - Appendix I, pp. 31– 32.

## **Seniors Risk Substantial Liability if their Life Insurance Policy is Rescinded**

The relief sought by three multi-million dollar federal lawsuits recently filed in Florida by several life insurers include rescission of alleged STOLI policies because the true nature of the transactions were allegedly misrepresented.<sup>38</sup> Seniors that are lured into participating in STOLI schemes for financial gain are at risk of owing money when the fraudulent scheme is uncovered. As Bob Rubin stated at the public hearing:

The rescission of the policy should be the one issue that should really scare the consumer from never going near one of these transactions. Assume for a minute that the policy is rescinded. Big debt was incurred. The consumer received some money up front. He signed an indemnification clause. And further assume the life insurance company rescinds the policy. It wants the commissions it paid back, that same commission that was used to make the deal work in the first place. Guess who wants to be made whole? The promoter. Guess where they're going to try to get their money back, besides obviously the agent? The consumer. He signed an indemnification to make whole if something goes wrong. This is not a good place for the average consumer to be.<sup>39</sup>

The “free insurance” that may have been part of the incentive to participate in the STOLI scheme may be voided if the policy is rescinded based on fraud.

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<sup>38</sup> See AXA Equitable Life Insurance Company vs. Infinity Financial Group, LLC, et al., Case No.: 08-cv-80611, filed June 6, 2008 (case involves alleged STOLI transactions on 5 life insurance policies with a total face value of \$73 million). The AXA case is currently set for trial in July of 2009 although a joint motion to stay the lawsuit was filed by the Plaintiff and some of the defendants and granted by the federal judge until November 3, 2008 to narrow or resolve issues in the case); American General Life Insurance Company vs. Steven Brasner, Infinity Financial Group, LLC, et al., Case No.:08-cv-80855, filed August 4, 2008 (case involves alleged STOLI transactions on 2 policies with a \$10 million total face value); West Coast Life Insurance vs. Life Brokerage Partners, LLC, et al., Case No.: 08-cv-80897, filed August 13, 2008 (case involves alleged STOLI transactions on 9 policies with a total face value of \$50 million).

<sup>39</sup> Transcript of Public Hearing - Appendix I, pp. 107 – 108.

## **Proliferation of STOLI may cause increase in life insurance rates**

Based on the testimony presented at the hearing, STOLI transactions may lead to an increase in life insurance rates. Scott Berlin, Senior Vice-President at New York Life, responsible for the individual life business, raised concerns regarding the potential for an increase in life insurance rates due to the proliferation of STOLI:

And so I think that the victim in the long run is the purchasers of life insurance, for legitimate reasons. So some people can get rich today, there is that potential, there is the possibility of that potential today or at least it appears that way. But the ultimate result five years from now will be that the price of life insurance will go up, that arbitrage opportunity will get closed, and people who want to buy life insurance for legitimate reasons like estate planning and protecting their families will have to pay more for that insurance.<sup>40</sup>

Bob Rubin, Senior Vice-President and insurance advisor with Wachovia Insurance Services, testified on behalf of the Association for Advanced Life Underwriting (“AALU”). Mr. Rubin stated that he has been in the insurance business since 1985 and has lived in South Florida for over 35 years. He further stated that STOLI transactions are “reducing the availability of life insurance of people over the age of 70. There's less companies that are offering them. And the ones that are, they're charging more for it, making it harder to get.”<sup>41</sup>

In response to Commissioner McCarty’s question about the affect on price already seen in the market, Mr. Rubin responded:

Everybody reprices their products. I mean, company [sic] always reprice products, but they generally used to go down. Now they go up. You know, it's one of the few times that insurance costs have actually gone up.<sup>42</sup>

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<sup>40</sup> Transcript of Public Hearing - Appendix I, p. 32.

<sup>41</sup> Transcript of Public Hearing - Appendix I, p. 110.

<sup>42</sup> Transcript of Public Hearing - Appendix I, p. 110.

Attorney Marshall Jones echoed the concerns regarding the cost of life insurance for Florida seniors:

And so the policies that go through this stranger premium finance programs are policies where the insurance companies are almost guaranteed to lose...and the cost is going to be passed on to the average American...I've been in the insurance business since 1973. Life insurance costs historically have gone down because of improved mortality, because of improved efficiencies of administration, because of variable life products that allow you to realize a hundred percent of the net profit on the investments. Life insurance costs are going up for seniors because it's just impossible for the insurance companies to keep track of the newest deal on the street.<sup>43</sup>

Apart from supply and demand issues (STOLIs will increase the demand for life insurance products) the reason STOLIs may contribute to an increase in premiums is due to low levels of lapses and surrenders relative to other life insurance policies. Insurance companies profit on lapsed and surrendered life insurance (as opposed to paying the face amount of the policy on the death of the insured). STOLI transactions (as well as viatical settlement agreements) decrease the number of lapses and surrenders as the investors owning the policy have a financial interest in retaining the policy until the insured dies to collect their tax-free profits. Thus, the price of life insurance policies may increase over the long term.

### **Insurance Fraud and Other Violations of the Law**

Based on the testimony presented, it is clear that STOLI transactions may involve varying degrees of insurance fraud and the violation of laws that were intended to protect consumers. "The agent will know that if he puts truthful answers on these applications, the policy will generally not be issued by the life insurance company...and in order to make these deals larger, \$73 million, and more

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<sup>43</sup> Transcript of Public Hearing - Appendix I, pp. 122 – 123.

profitable for all involved, the client including, fudging of the numbers regarding net worth is generally done.”<sup>44</sup>

The current Florida Statutes are specifically aimed at insurance entities, insurance agents, insurance brokers, and consumers (seniors) signing the insurance applications. It is not clear the Florida Statutes on unfair trade practices directly apply to individuals (STOLI promoters) who are not party to the insurance application or insurance contract.

### **Section 627.409, Florida Statutes**

Section 627.409, Florida Statutes, deals with misrepresentation in an insurance application, including a life insurance policy. This section provides that “a misrepresentation, omission, concealment of fact, or incorrect statement may prevent recovery under the policy if the representation, omission, concealment, or statement is fraudulent or is material either to the acceptance of the risk or to the hazard assumed by the insurer or if the true facts had been known to the insurer, the insurer in good faith would not have issued the policy...or would not have issued it at the same premium rate or would not have issued a policy or contract in as large amount.” [Emphasis added].

Life insurers are taking action to “root out STOLI transactions”<sup>45</sup> by asking questions of the applicants for the policies such as those represented by Scott Berlin of New York Life Insurance Company at the hearing:

We are asking if there's intent to sell the policy, have you ever sold a policy before, and under what circumstances. We are looking carefully at the trust to make sure that everything is set up for the benefit of the insureds or of their beneficiaries. We're checking the ownership. We're continuously monitoring ownership, especially during the first two years of the contract, to make sure that the ownership is not changing to a life settlement company. And, you know,

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<sup>44</sup> Transcript of Public Hearing - Appendix I, p. 107.

<sup>45</sup> Transcript of Public Hearing - Appendix I, p. 40.

we're trying our best to discourage the use of life insurance in STOLI transactions.<sup>46</sup>

Testimony presented to the Office revealed that those who engage in STOLI transactions, as described in this report, violate Section 627.409, Florida Statutes, when individuals involved lie, omit facts, and make misrepresentations on the policy application to obtain life insurance policies for speculation. Currently there are no criminal penalties for violation of Section 627.409, Florida Statutes, and there are no specific civil penalties other than the life insurer commencing an action in court to rescind the policy.

AXA Equitable Life Insurance Company and American General Life Insurance Company have lawsuits pending in federal court in Florida over alleged STOLI transactions where these two insurance companies are asking the court to rescind policies. According to the OIR Market Share Report dated July 2007 (<http://www.floir.com/pdf/MarketShareLH2006.pdf>), these two companies account for over \$1.3 billion in premiums written in Florida for life insurance and annuity products and approximately 5% of the life insurance and annuity market in Florida. Both court cases allege that false representations by the insureds were made on the life insurance applications to obtain the policies.<sup>47</sup>

Attorney Marshall Jones, member of Association for Advanced Life Underwriting ("AALU")<sup>48</sup> whose stated mission is to promote, preserve and protect advanced life insurance planning, stated at the hearing briefly how these fraudulent schemes are hatched:

So what they do is they will get a local agent. They'll go to an industry meeting and then they'll host a dinner. And they'll say, man, we can provide the funding. You just provide the people and we'll show you how to make millions. And it's

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<sup>46</sup> Id.

<sup>47</sup> AXA Equitable Life Insurance Company vs. Infinity Financial Group, LLC, et al., Case No.: 08-cv-80611, filed June 6, 2008 (case involves alleged STOLI transactions on 5 life insurance policies with a total face value of \$73 million). The AXA case is currently set for trial in July of 2009 although a joint motion to stay the lawsuit was filed by the Plaintiff and some of the defendants and granted by the federal judge until November 3, 2008 to narrow or resolve issues in the case); American General Life Insurance Company vs. Steven Brasner, Infinity Financial Group, LLC, et al., Case No.:08-cv-80855, filed August 4, 2008 (case involves alleged STOLI transactions on 2 policies with a \$10 million total face value).

<sup>48</sup> To learn more about AALU see their website at <http://www.aalu.org>.

very tempting. The agents then put themselves on the application. They're the front agent. They get a hundred percent of commission. That's what the insurance company thinks. They're the ones that are coached, coached in how to trick the insurance company. They're the ones that are then taught how to coach the senior person to lie on the application. See, now, we don't want you to lie, but we're going to have to coach you, because if you tell them everything, they're not going to issue the policy .<sup>49</sup>

Where STOLI transactions involve life insurance agents, agencies, or brokers, which are licensed by the Department of Financial Services (“DFS”), Sections 626.611, 626.6115, 626.6215, and 626.621, Florida Statutes, Florida law gives DFS the authority to suspend or revoke the license or appointment of any licensee, agency, or appointee on several grounds. These grounds include: willful misrepresentation of any insurance policy or willful deception with regard to any such policy; violation of any provision of the insurance code; knowingly aiding, assisting, procuring, advising, or abetting any person in the violation of the insurance code; unlawfully rebating; and using fraudulent or dishonest practices in the conduct of business under the license.

### **Unfair Insurance Trade Practices Act**

The Office heard repeatedly at the hearing that STOLI promoters entice seniors with the offer of “free insurance,” usually for the duration of the two-year contestability period. The offer of “free insurance” by an insurance company, insurance agent or insurance broker is a violation of the Unfair Insurance Trade Practices Act, specifically Section 626.9541(1)(n)(4), Florida Statutes, which states in part:

***(n) Free insurance prohibited.—***

4. Using the word "free" or words which imply the provision of insurance without a cost to describe life or disability insurance, in connection with the advertising or offering for sale of any kind of goods, merchandise, or services.

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<sup>49</sup> Transcript of Public Hearing - Appendix I, p. 125.

Additionally, a transaction where seniors are offered bonus money for signing on to the scheme or are given cars and cash, is a violation of Section 626.9541(1)(h), Florida Statutes, which states in part:

**(h) Unlawful rebates.--**

1. Except as otherwise expressly provided by law, or in an applicable filing with the office, knowingly:
  - a. Permitting, or offering to make, or making, any contract or agreement as to such contract other than as plainly expressed in the insurance contract issued thereon;
  - b. Paying, allowing, or giving, or offering to pay, allow, or give, directly or indirectly, as inducement to such insurance contract, any unlawful rebate of premiums payable on the contract, any special favor or advantage in the dividends **or other benefits thereon, or any valuable consideration or inducement whatever** not specified in the contract; [Emphasis added].

Further, STOLI transactions as described in this report (where misrepresentations are made on the insurance application) may violate Section 626.9541(1)(k), Florida Statutes, which states in part:

**(k) Misrepresentation in insurance applications.--**

1. Knowingly making a false or fraudulent written or oral statement or representation on, or relative to, an application or negotiation for an insurance policy for the purpose of obtaining a fee, commission, money, or other benefit from any insurer, agent, broker, or individual.
2. Knowingly making a material omission in the comparison of a life, health, or Medicare supplement insurance replacement policy with the policy it replaces for the purpose of obtaining a fee, commission, money, or other benefit from any insurer, agent, broker, or individual. For the purposes of this subparagraph, a material omission includes the failure to advise the insured of the existence and operation of a preexisting condition clause in the replacement policy.

The Unfair Insurance Trade Practices Act was recently amended with increased penalties for violation of the Act.<sup>50</sup> Now, anyone who violates any provision of the Act is subject to a fine in an amount not greater than \$5,000 for each nonwillful violation and not greater than \$40,000 for each willful violation.

The recent amendments to the Act have also created criminal penalties for three unfair insurance practices – “twisting”, “churning”, and willfully submitting fraudulent signatures on an application or policy-related document.<sup>51</sup> Twisting is knowingly making any misleading representations or incomplete or fraudulent comparisons or fraudulent material omissions of or with respect to any insurance policies or insurers for the purpose of inducing, or tending to induce, any person to lapse, forfeit, surrender, terminate, retain, pledge, assign, borrow on, or convert any insurance policy or to take out a policy of insurance in another insurer. “Churning” is the practice whereby policy values in an existing life insurance policy or annuity contract, including, but not limited to, cash, loan values, or dividend values...are directly or indirectly used to purchase another insurance policy or annuity contract with that same insurer for the purpose of earning additional premiums, fees, commissions, or other compensation.

Although some STOLI transactions, as described within this report, may have “twisting and churning” components, STOLI is a unique and separate scheme that is not specifically addressed by this statute.

It is clear that the practices of STOLI promoters clearly violate the spirit of these laws which attempt to prohibit offers of “free” insurance, unlawful rebates, and misrepresentation on the insurance application.

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<sup>50</sup> Chapter 2008-66, §7, Laws of Florida, approved by Governor Charlie Crist on May 28, 2008, and effective July 1, 2008.

<sup>51</sup> Chapter 2008-237, §§5, 6, Laws of Florida, approved by Governor Charlie Crist on June 30, 2008, and effective January 1, 2009.

## Regulation of STOLI in Other States

The National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL) have provided model legislation intended to be enacted by state legislatures that prohibit and/or deter STOLI transactions. The NAIC's *Viatical Settlements Model Act* was amended in June of 2007. NCOIL's *Life Insurance Settlements Model Act* was approved by NCOIL in November of 2007.<sup>52</sup> Several states have already adopted either the NAIC model, the NCOIL model or created a hybrid by combining the best of both models.<sup>53</sup>

There are also some key differences between the NAIC and NCOIL model acts. The NAIC Model Act establishes a five-year moratorium on the settlement of policies having STOLI characteristics; the NCOIL model does not contain a five-year moratorium but instead defines and bans STOLI practices.

## Conclusion

Florida is a unique state with over 17.6% of its population over the age of 65 years.<sup>54</sup> With over 2.8 million seniors in our state, it is imperative that we act to protect our seniors and all Floridians from becoming victims of fraudulent activity.

As insurance companies are becoming more sophisticated in uncovering these transactions, STOLI promoters are increasingly turning to encouraging fraud (misrepresentation on the insurance application) to obtain these policies. As importantly, it is the seniors that may be subject to financial liability if the policy is rescinded, or even subject to a tax liability for not declaring free insurance and

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<sup>52</sup> See NAIC/NCOIL Model Act Comparison Chart, Appendix V.

<sup>53</sup> See Ohio's anti-STOLI legislation, H.B. 404, effective September 11, 2008.

<sup>54</sup> U.S. Census Bureau, "The 65 Years and Over Population: 2000", Census 2000 Brief, issued October 2001.

the STOLI payment as ordinary income.

As Don Brown, a third generation life insurance professional and immediate past president of the Florida Association of Insurance and Financial Advisors, now known as NAIFA-Florida, an association of agents who sell life and health insurance policies, stated at the hearing:

If we allow human life to become a commodity, why not allow other insurance contracts to be commodities too. Why not allow people to buy or purchase excess coverage on properties of others as a profit tool, not for if the property burns but when it burns. And the question that we have to ask ourselves, if we lived in a home that was insured by some stranger that would profit from it, how well would we sleep at night? And that's a real concern.<sup>55</sup>

***This document has been prepared as a general reference document for informational purposes and the information contained herein is not intended to be and should not be construed as legal advice.***

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<sup>55</sup> Transcript of Public Hearing - Appendix I, p. 89.