

# AMERICAN NATIONAL INSURANCE COMPANY

## STOLI UPDATE

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# Disclaimer

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- **American National Insurance Company does not provide legal or tax advice**
- **Any concepts or examples are for illustrating purposes only and should not be relied upon**
- **This presentation is to be used for agents and actuaries only and is not to be shown to the public**
- **Any individual should consult their tax, legal and financial advisors prior to entering into any transaction**

# TOPICS

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- **Premium Financing Update**
- **Life Settlements**
- **Interaction Between Premium Financing and Life Settlements**
- **STOLI**
- **State Regulatory Activity**
- **Carrier lawsuits**
- **Life Settlement Update**

# Premium Financing

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- **Last September bottom fell out of premium financing market**
- **Credit crunch dried up money for hybrid financing programs and for longer term programs**
- **With less cash available to pay premiums, more policies came into the market but with fewer buyers**
- **Some premium finance companies found some money again in March 2009 and we still see new programs every month**



# Premium Financing

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- **New programs spell out that loan is year to year based upon availability of capital and credit worthiness of insured**
- **Even old programs usually contained an out if financing not available**
- **Who would make a commitment for financing that may only last a couple of years unless there is an intent to sell?**
- **Would you buy a car with a loan that could be called annually?**

# Premium Financing

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- **Would you take out a loan with a variable interest rate that could be called each year in current economic environment?**
- **If things get worse, there will be no money for premium payments as we move to depression**
- **If things get better, we are bound to have rampant inflation from printing money and the interest accrual will soon turn the policy upside down financially**
- **Who can win in that environment?**

# Premium Financing

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- **Solid providers such as Credit Suisse and Goldman Sachs have left the market**
- **Their sources for cash for premium financing have dried up**
- **Seminar at AALU last month on what to do when the financing is gone – refinance-sell-surrender**
- **Premium Financing cash is moving to a new market; a market that is not impacted by the stock market**
- **The Life Settlement Market**

# What is a Life Settlement

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- **Life Settlement is a financial transaction**
- **Life Insurance policy owner has an unwanted or unneeded insurance policy**
- **Insured sells the policy for its fair market value**
- **Fair market value is greater than the cash surrender value in the policy**
- **Purchaser becomes new beneficiary at maturity and pays all future premiums**



# What is a Life Settlement

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- Typically, owner of policy receives cash but owner may also receive benefit of premium financed loan being paid off
- Life settlement company/investors then own policy
- When insured dies death benefit paid to settlement company/investors
- Life settlement generally involves sale of policy by a senior citizen or where the insured may have medical condition resulting in shorter life expectancy

# Life Settlement Example

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- **Joe has a \$1,000,000 policy that was bonused out to him at the time he sold his closely held business**
- **Joe no longer needs the policy in that he is now totally liquid**
- **Joe's agent tells him he can sell the policy and receive significantly more money than the cash value he would receive if he surrendered the policy**
- **Joe goes through the settlement process, receives an offer he accepts and sells the policy for more than the cash value**

# Life Settlement Uses

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- **An individual buys insurance to fund buy- sell and then sells business and no longer needs policy**
- **An individual has financial reversals and can no longer afford to pay premiums**
- **The Individual's beneficiary dies or insured gets divorced and no longer wants to benefit beneficiary**
- **Individual needs money to pay down debt or enters into bankruptcy**
- **Whatever the reason, when a policy is no longer needed or wanted, there is now a settlement market where an enhanced value may be available**

# Life Settlement Uses

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- **Estate Planning Uses**

- A single life insurance policy may no longer be appropriate – a survivorship policy meets estate planning needs better and 1035 rule avoided
- There is a reduction in estate size due to loss of net worth and less insurance is required to fund projected estate tax liability
- Policy needs to be removed from estate and three year rule can be avoided by purchasing a new policy

# Life Settlement Uses

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- **Business**

- Key person policy no longer required due to retirement or change in business
- Buy/Sell funding no longer needed
- Bankruptcy causes liquidation of assets
- Deferred Compensation programs have changed
- Business owns policies that are performing below expectations

# Life Settlement Uses

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- **In all of these situations, individual had a need for insurance and a use for the proceeds which changed sometime after purchase of the policy**
- **These policies are “untainted” and an attractive purchase by settlement market as long as the state mandated holding period has passed**
- **Agent may have fiduciary duty to inform insured about settlement market so insured can realize maximum amount from policy no longer wanted or needed**



# Life Settlement Uses

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- **A great number of settled policies come from policies that have been premium financed**
- **These are policies that the insured may have not paid any out of pocket expenses to obtain**
- **And this area is where the concept of investing in life insurance policies of the elderly came from**
- **This is also the area where the majority of the abuses come from**

# Life Settlements – Typical Transaction

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- **In the past an individual had to actually die to reap the benefits of life insurance**
- **Not anymore!**
- **Life Settlement is a way for people to make money on their life before they die (and they don't even have to fake their death)**
- **People in the business are now selling ways for individuals to create money without having to do much more than sign your name and take a medical exam**

# Life Settlements – Typical Transaction

- **How are companies creating a market for life settlements?**
- **Premium Financing is where it starts**
- **The agent sells the client on the idea of insurance for “free”**
- **A Hybrid premium financing program is used where the client is assured they will never have to pay the note they sign**
- **If the client dies in the first two years, it is a windfall for the client’s family**

# Life Settlements – Typical Transaction

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- **If the client does not die in the first two years, the agent will find a life settlement company to purchase the policy**
- **The insured will receive a significant cash life settlement and the loan will “go away”**
- **Life settlement company will pay off the premium finance loan**
- **Agent will realize second commission on sale of policy**

# Life Settlements – Typical Transaction

- Although life settlement company pays off loan, they typically do not send out 1099's to insured for income received in cash plus income from forgiveness of debt
- By life settlement company paying off premium finance loan, they relieve insured of making payment thereby subjecting insured to taxable income not only for cash received but also for loan paid off on behalf of insured
- This is similar to 1099's sent out by mortgage company until Bailout Bill eliminated taxation for mortgage relief

# Life Settlements – Typical Transaction

- **5/1/09 Revenue Rulings 2009-13 and 2009-14 released**
- **Discussed taxation of life insurance sale or surrender**
- **In sale situation, selling insured realizes ordinary income on excess of cash value over premiums paid and capital gains on the remainder after basis is reduced by “cost of insurance”**
- **Investor must pay ordinary income on death benefit over and above basis (basis = purchase price plus premiums paid unreduced by cost of insurance)**
- **Even foreign investors pay if insured and carrier in US**



# Life Settlements – Typical Transaction

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- **Life settlement companies typically do not wish to purchase “wet paper” which are policies less than two years old**
- **Investors who fund life settlement companies are concerned about all the lawsuits from carriers**
- **Carriers have a difficult time proving collusion between the agent and the insured or the insured’s children**

# What is STOLI?

- STOLI stands for Stranger Originated Life Insurance
- STOLI does not stand for Stranger Owned Life Insurance
- NCOIL defines STOLI as an act, plan, practice, or arrangement to initiate a life insurance policy for the benefit of a third party
- Settlement advocates persuaded some states to delete “plan” stating that it should be legal for someone to intend to sell a policy at purchase, but not have specific agreement to do so

# What is STOLI

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- **Investors identify older high net worth individuals**
- **Free steak lunch at Ruth Christ's**
- **Targeted due to short life expectancy**
- **Offers opportunity to obtain large amount of life insurance for free or in exchange for up-front cash payment**
- **Investor loans money to pay premium for two years (non recourse debt)**
- **Need to avoid wet paper laws**

# What is STOLI?

- **If insured survives contestability period, insured can either re-pay the loan or transfer ownership of the policy in complete satisfaction of debt – may receive additional payment**
- **Investor betting insured will live longer than two years but less than life expectancy**
- **Insured becomes a chip on the gambling table**
- **Instead of protecting the insured's loved ones, it is initiated by investors betting on when the insured will die**

# STOLI Impact on Insured

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- **Seniors may lose ability to buy more insurance**
- **Money seniors receive is taxable income**
- **Forgiveness of premium financing debt taxable income**
- **Could end up being charged with theft or fraud**
- **Could be sued by insurance company**
- **Could be sued by premium finance company as documents are real and may contain provisions placing risk on insured**

# STOLI Laws – Insurable Interest

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- **Insurable Interest laws have been part of public policy due to the repugnance of wagering on human life**
- **Pending state legislation would gut the insurable interest laws in the name of providing charity a small piece of the policy**
- **If this occurs, life insurance will be marketed to third parties as an investment with a small payment to the insured or the charity of their choice**
- **If that occurs, we will see life insurance proceeds being taxed by the government**



# STOLI Laws

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- **STOLI has been impacted by:**
  - NAIC Model Act
  - NCOIL Model Act
  - State Regulation
  - Insurer Lawsuits

# State Regulatory Activity

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- **Legislation in Regulated States is Based on Either:**
  - NAIC Model Act (National Association of Insurance Commissioners)
  - NCOIL Model Act (National Conference of Insurance Legislators)
  - Hybrid of both NCOIL and NAIC Model Acts

# State Regulatory Activity

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- **NAIC act prohibits settlement within five years of issuance while NCOIL uses two year time frame**
- **NAIC has longer rescission period than NCOIL**
- **NAIC requires \$250,000 bond as part of licensing requirement while NCOIL has no such requirement**
- **NCOIL computes compensation as a percentage of offer, not policy face amount**
- **NAIC makes certain actions illegal to make STOLI difficult while NCOIL defines STOLI and makes practice illegal**

# State Regulatory Activity

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- **Commonalities in Regulated States**

- Some OK to have only life license and others require separate settlement license
- All states require agent and broker to act as fiduciaries
- Most states require disclosure documents
- All states require anti-fraud plan
- All states require mandatory reporting of fraudulent acts
- Typically, life settlement sale not covered under E & O

# State Regulatory Activity

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- **Commonalities in Regulated States**

- Knowingly presenting false information on life settlement application is a crime
- Must disclose all offers, counter offers, gross settlement price and amount of broker compensation
- Must report annually transactions to state by broker, entity or sub-agents

# State Regulatory Activity

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- **Conflict of Laws**

- Controlling law determined by state of residence of policy owner
- Where multiple owners, transaction should meet strictest state requirements in state where any owner lives

# State Regulatory Activity

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- **Civil and Criminal Penalties and Liability**
  - Criminal misdemeanor or felony in regulated states
  - NAIC model has graded sentencing guidelines and may require restitution in addition to fine or imprisonment
  - NCOIL says look to state law for penalties
- **In 2008 most states that enacted new legislation used the NCOIL model (13 states used NCOIL and three states used NAIC)**
- **Companies will not do transactions in state with criminal penalties until rules sorted out**

# State Regulatory Activity

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- **Case Example**

- Insured live in Texas and create Minnesota trust to hold policy at inception
- Insured later moves to Oklahoma
- Agent resides in Louisiana

- **Licensing/Registration Issues**

- State of owner comes into play
- Resident state and non resident state insurance or settlement issues apply to agent

- **Comply with strictest state rules to comply with all**



# State Regulatory Activity

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- **Washington State Passes Anti STOLI Law**
  - May not enter into settlement agreement first two years
  - Sales within five years must be reported to state
  - Carriers must notify terminally and seriously ill insured's 60 and over that they have alternatives to cashing in policy

# State Regulatory Activity

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- **4/1/09 – Idaho passes legislation on life settlement taking from both NAIC and NCOIL**
- **4/2/09 – Utah Governor signs anti STOLI legislation**
- **4/21/09 - North Dakota legislation signed by Governor – follows NCOIL – In 2007 passed 5 year waiting period**
- **3/26/09 – Georgia legislation goes to Governor – follows NCOIL model and removes “plan” from def.**
- **4/16/09 Vermont House passes bill – 5 year wait to sell**
- **1/16/09 – Man kills friend to collect on two \$25,000 life policies**

# State Regulatory Activity

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- **4/16/09 – California Senate Committee approves settlement legislation**
  - Bans insurers from denying life insurance application solely because applicant planned to use premium financing
  - Uses NCOIL two year waiting period
  - Contains consumer safeguards

# Carrier Attacks on STOLI

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- **Where carriers have been successful is in attacking the transaction based upon the signed application**
- **Insured is typically asked on the application whether they have applied for coverage with other carriers and are asked how much with each carrier**
- **The applications also ask if the insured intends to transfer the policy to a third party**
- **It asks the insured if they have been offered any inducement to enter into this transaction**

# Carrier Attacks on STOLI

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- **They ask if it is intended that the policy will be owned by an entity for the purpose of investment**
- **Lastly, they typically ask if the source of funds for premiums involve premium financing**
- **Most carriers will only allow policies to be financed by carrier approved premium finance companies**
- **The application will also ask the insured about their net worth to ensure there is a need for the amount of insurance requested**

# Carrier Attacks on STOLI

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- **The carrier will always investigate if someone dies during the first two years the policy is in place**
- **In some of the court cases, the insurance company has investigated and found that an individual made a material misrepresentation regarding their net worth**
- **Courts have found that this is cause for rescinding the policy**

# Carrier Attacks on STOLI

- Carriers have also attacked policies on the basis of the insured applying for multiple policies while failing to disclose this fact or under disclose this to the carrier
- In a case where someone failed to disclose they applied for \$11,000,000 of other insurance which was purchased and not all disclosed, the court allowed for rescission stating that until the policy is issued, the insured has a duty to report any additional insurance they are applying for or any other changes to questions on the application

# Carrier Attacks on STOLI

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- **If someone does not disclose that the policy will be premium financed and it later is, this is also cause for rescission**
- **Much more difficult to prove that the insured and the agent colluded to obtain the insurance with the idea of a sale at the earliest possible time**
- **Occasionally facts will support collusion or older insured will slip up and admit, but usually difficult to determine and prove in court**



# Carrier Attacks on STOLI

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- **Allegations contained in carrier lawsuits include**
  - Fraudulent Misrepresentations and omissions
  - Lack of insurable interest
  - Gross Negligence
  - Violation of state insurance laws
  - RICO Conspiracy violations

# Carrier Attacks on STOLI

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- **American General vs Ellman et al**

- Cash payments alleged to have been made to insured to execute application
- Misrepresentations regarding income and net worth
- Trust misrepresented as for estate planning; Trust purpose was to speculate on Ellman's life
- RICO – engaged in a pattern of behavior with respect to other policies
- Denied death claim

# Carrier Attacks on STOLI

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- **AXA vs Infinity Financial Group LLC, et. al**
  - Suit for rescission based upon lack of insurable interest, fraud and negligence
  - In motion to dismiss, Court held that Plaintiffs did not need to allege a “mutual intent” based upon existence of known purchaser in order to state claim
  - In First Penn-Pacific Life and Sun Life cases, court had held there needed to be “mutual intent” based upon known purchaser

# Carrier Attacks on STOLI

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- **Courts in general have held there needed to be a prearranged sale in order to make the STOLI case**
- **Merely intending to sell is not sufficient**
- **Has caused carriers to concentrate on finding misrepresentations on application**
- **Carriers have beefed up questions they ask**

# Life Settlements - Investors

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- **Until life settlement industry has standardized forms and life expectancy tables, cannot mature into separate asset class**
- **Investors do not want direct exposure to liability from lawsuits**
- **Currently, life settlement companies becoming investment managers with funds to invest in**
- **Synthetics market is where current investments taking place rather than direct investment**

# Life Settlements – Market Today

## ● Buyers' Criteria

- Most buyers now want face amount of \$1,000,000 or less for diversification purposes – cost of underwriting settlement is issue in smaller policies
- Buyers looking for LEs less than 15 years max so that would be males age 70 or above and females age 74 and above
- The older the insured, the higher the offer
- If health has worsened since policy inception, insured receives higher offer

# Life Settlements – Market Today

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- **More difficult to do deals today**
- **Tight money situation makes it harder to find investors**
- **Credit managers are frozen and don't know what to do**
- **Investors scared of lawsuits which even if they win will lower ROI**
- **Many settlement companies only buying carrier approved premium financing deals to avoid suits**

# Life Settlements – Market Today

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- **Life settlement companies feel insurance carrier's accelerated death benefit provisions ratifies the life settlement market**
- **Feel that if industry loses tax favored status of life insurance, it will destroy COLI and BOLI markets but will not impact life settlements**
- **Life settlement companies remind us STOLI means Stranger Originated Life Insurance and not Stranger Owned Life Insurance – life settlements are legal**



# Conclusions

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- **Difficult to prove collusion in STOLI transactions**
- **State Regulatory activity protects consumers while creating anti STOLI laws**
- **Carriers actively filing lawsuits in situations where abuses have taken place**
- **Premium financing contracting in this economy**
- **Economic conditions will result in more life settlements**

# Questions?