

INVESTOR NOTES

As the Dust Settles in the Life Settlement Industry: A Review of the Major Legal Decisions in 2010 and What's in Store for 2011

Introduction

Over the last several years, many participants in the life settlement industry have devoted significant resources to help formulate the new life settlement laws that govern how the industry operates, and over thirty states adopted legislation dealing with life settlements in the last three years. State insurance departments were equally active during this period, adopting rules and regulations affecting the marketplace.

In 2010, the rate of legislative activity declined slightly, but the life settlement industry still garnered a disproportionate share of attention from legislators, regulators and the public. In July 2010, both the Securities and Exchange Commission and the Government Accountability Office issued reports commenting on life settlements. In addition, over the course of 2010 numerous articles about life settlements were published in the *New York Times*, *Wall Street Journal* and other publications throughout the country, and in just the first few days of 2011 several more articles were published. Put simply, life settlements were a hot topic in 2010 and, in all likelihood, they will continue to attract significant attention in 2011 as new investors, including leading private investment partnerships, enter the asset class.

In the second half of 2010, however, the life settlement industry was shaped more by events in the courtroom than by those in the halls of the legislatures or the press. In this edition of Investor

Notes, we will look at several key decisions issued in 2010 and discuss what the future may hold.

The Litigation Landscape

For most of 2010, the legal landscape surrounding life settlements was clouded by several key questions, as certain insurers became more aggressive in their challenges to settled policies. In particular, some insurance carriers proffered novel interpretations of insurable interest laws and sought new theories on which to challenge policies. With a number of key decisions issued by courts in 2010, most of which were viewed as favorable to life settlement investors, it is far easier to assess the legal risks. In fact, in 2011 we may see increased litigation brought by life settlement investors against insurers.

The Question of Intent

In 2010, much of the key litigation focused on the question of intent, i.e. whether an insured at the outset must have the intention to provide insurance protection for a person with an insurable interest in the insured's life. As intent is subjective and difficult to determine, many in the industry eagerly watched these cases unfold.

This question came to a head in *Kramer v. Phoenix Life Insurance, et. al.* Arthur Kramer, a prominent attorney, formed a number of trusts initially naming his children as beneficiaries. These trusts were used to acquire over \$56 million of insurance on Mr. Kramer's life. After these policies were issued to

the trusts, the beneficial interest in the trusts were immediately transferred to third party investors who had no insurable interest in Mr. Kramer's life.

Relying on a New York law that provides that the estate of an insured has the right to claim death benefits payable on policies that were issued without the requisite insurable interest, Mr. Kramer's wife initiated litigation that spurred a series of counter-claims and cross-claims among the investors, the family, the insurance companies and the life insurance agents, as the investors sought to have the death benefits paid to them and certain insurance companies argued that no death benefits should be paid at all.

Ultimately, the case turned on the interpretation of New York State's insurable interest law. The District Court in the Southern District of New York held that there is an implied good faith requirement in the insurable interest law. Specifically, an insured must acquire a life insurance policy with the intent of providing protection to his family. Given how quickly the beneficial interests in the Kramer trusts passed to third party investors, this lower court reasoned that it was evident that such good faith intent was lacking.

Recognizing that this ruling was controversial, the District Court stayed its decision pending an appeal to the Second Circuit Court of Appeals. Deciding that this was a question best handled by the New York courts, the Second Circuit certified the question regarding the proper interpretation of New York's insurable interest laws to the New York State Court of Appeals.

The New York Court of Appeals found that the District Court's interpretation of Section 3205(b) of New York's insurable interest law was untenable and that no such good faith requirement existed. In its concluding remarks, the Court of Appeals stated, "It is not our role . . . to engraft an intent or good faith requirement onto a statute that so manifestly

permits an insured to immediately and freely assign such a policy." Despite the fact that ILMA does not endorse the sale of life insurance policies or the transfer of beneficial interests in trusts owning such policies before the expiration of the contestability period, the decision by the New York Court of Appeals is a victory for the life settlement industry.

The decision by the New York Court of Appeals puts New York State squarely in the camp of those courts, such as courts in Minnesota and Arizona, that have ruled that subjective intent does not matter. If an insurable interest existed at the time the policies were issued, a subsequent transfer is not a basis to challenge the validity of the policy. As other states address this issue, those courts may also look to the *Kramer* decision as useful precedent. Recently, a court cited the *Kramer* decision when it ruled against an insurer with respect to discovery motion. The *Kramer* case may continue to yield important decisions as the insurers are continuing to litigate other aspects of this case in the District Court.

Contestability After the Expiration of the Contestability Period

One issue that was raised by the insurance companies in *Kramer*, but not addressed by the New York Court of Appeals, is whether an action to rescind a policy for lack of insurable interest may be brought in New York following the expiration of the contestability period. In a case decided more than 20 years ago, *Caruso*, the New York Court of Appeals ruled that the expiration of the contestability period bars any challenges by the carrier to the validity of a life insurance policy. Among the states that have addressed the issue, only New York and Michigan have held that the expiration of the contestability period prevents a carrier from contesting a policy on the grounds that it was issued without the requisite insurable interest.

The *Caruso* ruling was called into question in another decision by the District Court for the Southern District of New York, *Settlement Funding v. AXA Equitable*. The *Settlement Funding* case involved a trust that was created to obtain a \$5 million policy from AXA Equitable insuring the life of Esther Adler. There were significant questions as to whether Ms. Adler ever executed the trust agreement and there were allegations of fraud throughout the transaction. For instance, although the application for this policy indicated that Ms. Adler had a net worth of \$12 million, it was alleged that Ms. Adler lived in a rented apartment and had a net worth of less than \$100,000.

After Ms. Adler's death, AXA refused to pay the death benefits to Settlement Funding, the entity that then owned the policy. In the ensuing litigation, Settlement Funding claimed that AXA should be barred from contesting the policy because the contestability period had expired. The District Court held that, notwithstanding the expiration of the contestability period and the precedent set by the court in *Caruso*, the action could proceed because "the aggregate allegations brought here involving both lack of insurable interest and fraud, and arising from a context of allegedly widespread, systematic fraud involving careful planning, multiple policies, imposters, forgeries and misstatements, all in pursuit of an improper STOLI scheme, raise additional issues of material fact." In a subsequent trial, a jury concluded that AXA Equitable was required to pay the death benefit to Settlement Funding. Nonetheless, the case is significant as it increases the risk that New York policies may be challenged after the expiration of the contestability, so long as the insurance company can allege both a lack of insurable interest and fraud.

In *PHL Variable v. U.S. Bank*, another case worthy of note, an insurance company filed a three count action to rescind a life insurance policy. The action was filed approximately thirty minutes after the

filing deadline on the last day of the policy's contestability period. With respect to the allegations of material misrepresentation, the court found that the claim was barred by the contestability period.

Challenges by Investors

In August of this year, Coventry First filed suit against AXA, claiming that the carrier has a "practice of identifying potential life settlement transactions and unlawfully frustrating or preventing those transactions". Specifically, Coventry alleged that AXA regularly misleads it with regard to whether a policy is past the contestability period. In addition, Coventry also claimed that AXA organized a "Delta Force" of lawyers to intimidate and frustrate insureds and life settlement providers. This case is currently pending in U.S. District Court for the Eastern District of Pennsylvania.

Despite losses suffered in 2010 (particularly in relation to the question of intent), there is no indication that the insurance industry is ready to give up on its legal battles with the life settlement industry. As the dust settles on the 2010 litigation, life settlement investors can take some comfort in the legal questions that have been settled. Nevertheless, the insurance industry may find new lines of attack in the legal battle and 2011 promises to be another year in which investors will actively monitor and participate in ground breaking litigation.

The Institutional Life Markets Association, Inc. (ILMA) is a not-for-profit trade association comprised of a number of the world's leading institutional investors and intermediaries in the longevity marketplace, formed to encourage the prudent and competitive development of a suite of evolving longevity related financial businesses, including the businesses of life settlements and premium finance. ILMA's members include: Credit Suisse; EFG Bank; Mizuho International plc; and WestLB AG.