INVESTOR NOTES

Limits on Playing the STOLI Card:
A Carrier's Duty to Investigate Fraud

Crafted as a legislative compromise between two competing interests, the contestability period for life insurance policies provides a two year window after issuance of a policy, during which a carrier may continue its due diligence review of an insured and matters relating to policy origination. Following expiration of the contestability period, however, a carrier generally may not contest a policy for fraud or misstatements in the application,[1] thus giving comfort to policy owners that carriers will not collect premiums for years and then challenge a policy after the insured has died.

With the alleged rise of so-called stranger originated life insurance ("STOLI"), carriers have sought to undo this well-established compromise. After collecting premiums on policies for many years, carriers now seek to have these policies declared void *ab initio* for lack of insurable interest. To support their insurable interest allegations, carriers are alleging fraud in the application (often with respect to net worth, income, source of funds for premium payments or the purpose for which the insurance was obtained). Increasingly, actions to rescind policies for lack of insurable interest are also coupled with a demand by the carrier to retain premiums previously collected by it. Like a card player waiting to reveal an ace up his sleeve, carriers ignore their own underwriting guidelines, and potential red flags in policy applications, and subsequently bring STOLI claims. Sometimes these STOLI claims are brought as late as when a death claim is filed, a risk from which the contestability period was designed to protect the consumer.

But are there limits to playing this STOLI card? Recent court decisions and jury verdicts have cast doubt on this carrier strategy. These cases are a reminder to carriers that they cannot continue to accept premiums after learning of fraud and then later seek to rescind policies on that same basis. They are also a reminder that, even if significant, fraud in the application is immaterial where the carrier knowingly turns a blind eye to problems in the application. This investor note examines a carrier's duty to investigate fraud and questions what constitutes a carrier's waiver of its ability to seek to rescission after the contestability period is over.

A recent case, ***Steven A. Sciarretta vs. The Lincoln National Life Insurance Co.***, brought a carrier's underwriting guidelines to the forefront. The carrier sought to have a policy declared void *ab initio* because, at the time the policy was issued, the insured allegedly intended to transfer the policy to an investor. The fact that no such transfer was ever made did not deter the carrier from bringing the claim. Rather, the carrier alleged that the insured misstated his net worth and income, his source of funds for premium payments and the purpose for which the insurance was obtained. The insured's estate countered that, even if these allegations were true, they were

[1] In a small number of states, carriers are also barred from challenging policies for lack of insurable interest after the contestability period.

immaterial because the carrier ignored its own underwriting guidelines. Additionally, an internal Lincoln memo was produced at trial suggesting that Lincoln knew it was issuing STOLI policies (but it nevertheless chose to continue issuing them) and that it had set premium payments at a rate sufficient to ensure that these STOLI policies would be profitable. Based on the evidence presented at trial and the testimony of Lincoln employees, the jury determined that any misstatements in the application were not material because Lincoln did not rely on them when issuing the policy. Although the *Sciarretta* case involved only one policy, the decision highlights carrier practices and attitudes that could have great significance for the life settlement industry as a whole.

In addition to *Sciarretta*, in *Ashkenazi etc. v. AXA Equitable Life Insurance Company*, a New York court recently denied a carrier's motion for summary judgment in a policy rescission action so as to allow for discovery to determine whether the carrier "routinely ignored its own requirement to confirm an insured financial net worth . . ." and to determine whether certain financial information about the insured was "material" to the carrier's "underwriting decisions regarding similarly situated applicants." Here too, it appears that courts may not be prepared to allow carriers to re-underwrite policies if the underwriting guidelines were willfully ignored at the time a policy was issued.

Even if it abides by its underwriting guidelines, a carrier still has an obligation to act timely after learning of potential fraud. This obligation was the focus of *The United States Life Insurance Company in the City of New York v. Rebeka Blumenfeld, et. al.*, a recent New York decision where the court refused to allow a carrier to challenge a policy on the basis of financial fraud because the carrier had waited over a year, and continued accepting premium payments, before filing an action with the court. In *Blumenfeld,* the court noted that the carrier's conduct ". . . constituted a ratification of the policy and a waiver of its right to rescind."[2] Similarly, in *Pruco Life Insurance Company v. Brasner et al.*, a closely watched case in Florida, it has been alleged that the carrier may have been investigating the policy in question two years before the carrier challenged the policy. It remains to be seen whether this allegation can be proven, and what impact it may have on the case.

These cases all highlight a troubling carrier practice – delaying policy investigations and rescission actions while continuing to collect premiums. This is especially egregious where a carrier delays investigating a policy until a death benefit is sought. But these cases also highlight important limitations on a carrier's ability to challenge policies. If investigating fraud was not important to a carrier when a policy was issued, that carrier should not be able to change its mind and make it important at a time that is convenient to it. Similarly, if a carrier learns of wrongdoing but chooses not to take action, that carrier should not be allowed to hold that knowledge as a "trump card" to be played after an insured has died. Courts may soon be asked to address what obligation a carrier has to investigate if it suspects fraud, and whether that an investigation designed to determine if a policy was originated in a STOLI transaction may be deferred, and, if so, for how long.

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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

[2] *Blumenfeld*, citing *S.E.C. v. Credit Bancorp,. Ltd.*, 147 F Supp 2d 238, 256-6.

businesses, including the businesses of life settlements and premium finance..

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