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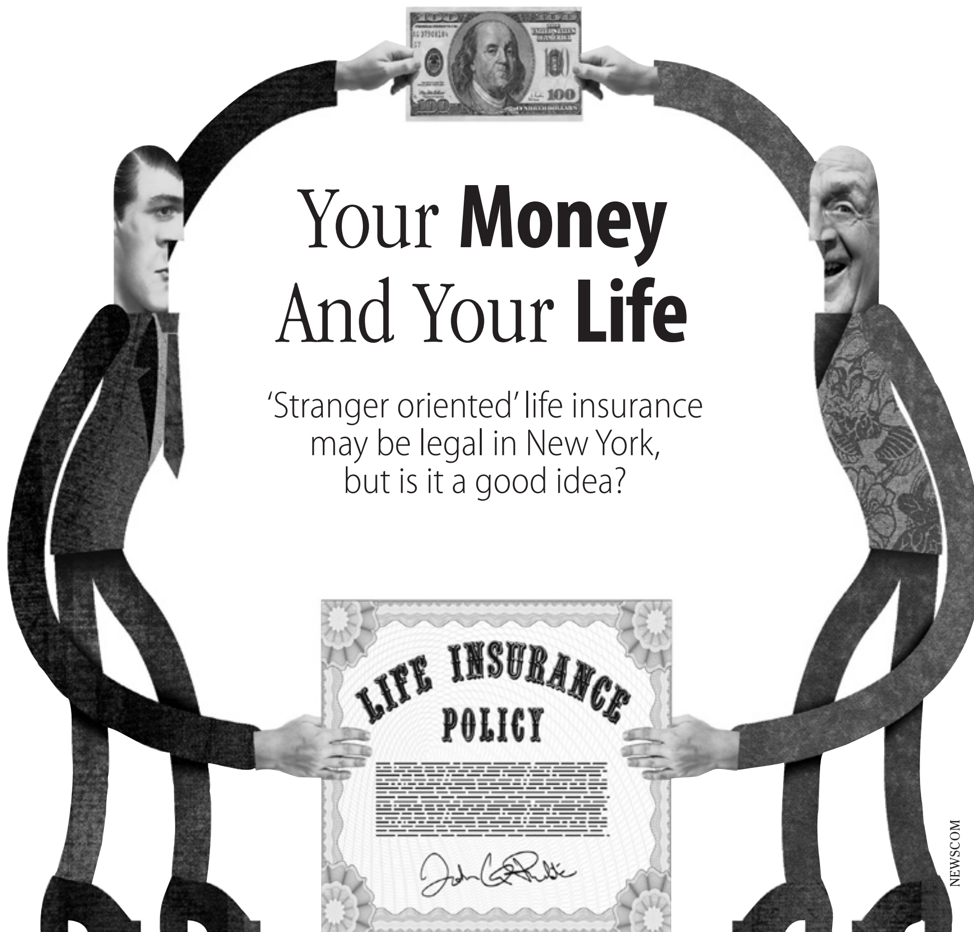

NEWSCOM

Your **Money** And Your **Life**

'Stranger oriented' life insurance may be legal in New York, but is it a good idea?

BY TERENCE E. SMOLEV AND MARY E. MONGIOI

FROM 1957 to December 1963, ABC broadcast the show "Who Do You Trust?" The host was a young, new to television, Johnny Carson.

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In an ironic twist, for a good part of that time, the show's young announcer was Ed McMahon, who years later would become a sales and spokesperson for many life insurance companies, companies that are directly affected by the holding of the New York Court of Appeals in the recently decided *Kramer v. Phoenix Life Insurance Co.*[1]

The question posed in 1957 is particularly relevant in today's world, one in which the U.S. Court of Appeals for the Second Circuit certified a question to the New York Court of Appeals, asking for a ruling with respect to New York Insurance Law §§3205 (b)(1) and (b)(2), to clarify whether the intent to immediately transfer a life insurance policy could be considered when determining if an insurable interest existed at the time the policy was issued.

The Court of Appeals held that "New York law permits a person to procure an insurance policy on his or her own life and immediately transfer it to one without an insurable interest in that life, even where the policy was obtained for just such a purpose."[2]

The question that now exists for many is whether or not this holding means that the New York Court of Appeals has somehow endorsed the concept of "stranger oriented life insurance," a policy that is purchased solely with the intent of transferring it to a person or entity who does not have an insurable interest in the life of the insured, in exchange for a present cash payment and the continuing right on the part of the purchaser to pay the premium of the policy. This is in exchange for the collection of the policy proceeds upon the death of the insured.

In recent years, the insurance industry has seen the growth of this new use of life insurance policies. This has caused a complete review of the life insurance industry by regulators, insurance carriers, life insurance agents and customers of those agents.

Traditional Life Insurance

Traditionally, life insurance policies were purchased by insureds or other individuals or organizations that had an "insurable interest" in the life of the insured. Typically, the term "insurable interest" was defined as the insured himself, a dependent of the insured or a creditor of the insured.

If someone did not have such an "insurable interest" in the insured, that person was not permitted to purchase a life insurance policy on the insured's life. Why not?

One reason enunciated for the restriction was that having someone purchase a life insurance policy on the life of a stranger created a possible dangerous situation for the insured by placing his or her life at risk should the policy holder take unethical or illegal steps to end the insured's life.

A second was that it essentially created a gambling transaction, wherein the purchaser of the policy was gambling on the life expectancy of the insured. The owner of that policy was seeking a gain on the insured's possible premature death.

The old game show from 1957 came to mind when we started to follow the growing trend of the purchase and subsequent sale of life insurance policies by insureds to investment groups that in essence, gambled that they would make a sizeable profit from the death of insureds for whom they had no insurable interest.

The questions that came to mind for us were twofold and are the same that must be asked by a prospective insured in such a transaction:

• In exchange for a sum certain during your life, would you trust a stranger to own a policy of insurance on your life whereby that stranger would financially benefit greatly on your death?

• Would you worry that your death may be hastened for financial gain by strangers?

Certainly, it was never contemplated by the drafters of life insurance laws and regulations of the various states that such policies would be used for the financial gain of strangers or gambling on the life of an insured. If in fact those purposes were to be contemplated and permitted, the necessity of an "insurable interest" definition and limitation for purchase of policies would not have been needed.

In exchange for a sum certain **during your life**, would you trust a **stranger** to **own** a policy of insurance **on your life** whereby that stranger would **financially benefit** greatly on your death?

'Viatical' Settlements

Some years ago, insurance carriers began establishing procedures for the "viatical" transfer and/or surrender of life insurance policies on individuals proven to be terminally ill with less than a certain period of time to live.

This provided monies to those individuals during the remainder of their life for various personal and family matters. In fact, the U.S. Securities and Exchange Commission issued the following advice to consumers and investors with respect to the same:

"A viatical settlement allows you to invest in another person's life insurance policy. With a viatical settlement, you purchase the policy (or part of it) at a price that is less than the death benefit of the policy. When the seller dies, you collect the death benefit. Your return depends upon the seller's life expectancy and the actual date he or she dies. If the seller dies before the estimated life expectancy, you may receive a higher return. But if the seller lives longer than expected, your return will be lower. You can even lose part of your principal investment if the person lives long enough so that you have to pay additional premiums to maintain the policy."[3]

What has occurred more recently, however, is the sale of life insurance policies to individuals who immediately, or shortly thereafter, sell those policies to a financial group (partnership or otherwise) that invests in groups of insurance policies on various insureds' lives.

The expectation of the purchasers is that they will, upon the deaths of individuals who do not exceed their life expectancy, gain significantly in excess of what they paid for these policies plus the premiums paid over the individuals' lifespan, premiums that must be paid in order to keep the policies current and collectible to the time of death.

Until the ruling in *Kramer*, the general rule regarding the sale of life insurance policies was that it was not contemplated by the insurer, at the time the policy was sold, that the purchaser would transfer the same to a person or organization without an insurable interest, once the initial policy purchase was made by someone with an insurable interest.

Now that such transactions have become commonplace, and have been found to be permitted under New York insurance law, it is likely that the re-sale of these policies will skew or alter the assumptions that are used by an insurance carrier to determine the premiums

charged for various types of policies. This will ultimately impact the premium charged for insurance policies, likely to the detriment of all consumers.

For example, it is widely known that statistically many life insurance policies are never held until the insured's death. Rather, they lapse for lack of tendered premium payment, whether because the insured or other policy owner no longer needs the insurance at a later time, or for other various and sundry reasons.

Insurance carriers are finding that insurance policies being purchased for investment in return for present day monies, do not lapse for historically existing reasons, upon which premiums were based. Instead, such policies are held until death, causing insurance carriers to pay more money in policy payments than was contemplated when the actual risk assumptions were created.

This impacts the profit margin of the insurance companies and the bottom line. In turn, the price of policies is directly affected, and the practice has even led some companies to alter the vetting process when considering a policy application, in an attempt to limit or decline insurance where such a sale is contemplated.

In the alternative, if upon application, an insured answers in the negative when asked if such a sale is contemplated, and then transfers the policy after purchase, the company may deny payment of the death benefit even though the law permits such a transfer.

What Should the Answer Be?

There is certainly a place in estate and financial planning for insureds and/or individuals with insurable interests who presently own policies on an insured's life, to consider selling the policy for fair market value rather than allowing it to lapse, or surrendering it for a small sum.

This was not, however, a type of transaction that the insurance carriers and regulators contemplated when the policies and premiums were designed.

Insurance carriers have tried to prohibit purchase of life insurance policies for investment. In some situations, the policy salesperson is required to complete a "producer's statement" and is questioned as to what information he or she may have relative to the use of the policy being applied for.

For example, Massachusetts Mutual Life Insurance Company's producer's statement has a question that states:

"…Do you have any knowledge or reason to believe the Proposed Insured has any present or future intention to sell or assign this policy, or has ever sold or assigned any policy, to a life settlement, viatical or other secondary Market provider?"

That question is aimed at detecting an insurance salesperson who may be employing this tactic in an effort to generate commissions on the sale of such policies and assisting insureds and financial organizations in these transactions, which skew the actuarial assumptions.

With all the efforts by the insurance carriers to stem the increasing use of life insurance as an investment vehicle, New York now has its first legal decision regarding these transactions, clearly stating that "New York law permits a person to procure an insurance policy on his or her own life and immediately transfer to one without an insurable interest in that life, even where the policy was obtained for just such a purpose."

Some may view this as a victory for consumers who wish to sell their policies, because it will prevent insurers from attempting to invalidate policies that they believe were purchased with the intent to resell. What actually this may have accomplished is the establishment of legalized gambling on another's life expectancy by investors willing to purchase policies on a stranger's life.

It also accomplished having insureds interested in immediately selling policies on their life to strangers, raising the risk of their untimely deaths for third party gain. This brings us full circle, back to the question first posed by Johnny Carson in 1957:

"Who do you trust?"

1. *Kramer v. Phoenix Life Insurance Co.*, 176, NYLJ, 1202475023100, at *1 (Ct. of App., Decided Nov. 17, 2010).
2. Id. at *2.
3. See http://www.sec.gov/answers/viaticalsettle.htm.

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