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The *WRNewswire* is created exclusively for AALU Members by insurance experts led by Steve Leimberg, Lawrence Brody and Linas Sudzius. The *WRNewswire* provides timely reports and commentary on tax and legal developments important to AALU members, clients and advisors, delivered to your inbox as they happen

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## **TOPIC: New York Rather Than New Jersey Law To Be Applied to STOLI Case**

**CITES:** *American National Insurance Company v. Conestoga Settlement Trust*, No. 04–13–00719–CV, 2014 WL 3734215 (Ct. App. TX July 30, 2014); *New England Mutual v. Caruso*, 73 N.Y.2d 74 (1989).

**SUMMARY:** This is a case alleging STOLI (Stranger Originated Life Insurance) in which American National Insurance Company (“ANICO”) appealed a trial court’s order granting a request by The Conestoga Settlement Trust (“Conestoga”) to apply New York law to issues relating to the validity of a policy in the underlying suit rather than New Jersey law.

Here, the incontestable clause period had long expired before the insured’s death. The issue of which state’s law governed was critically important to both parties since New York law—unlike New Jersey law—essentially bars vitiation of a contract due to a lack of insurable interest or fraud due to misrepresentation once the two year period expires. This was the first Texas case to decide such a conflict of law question. ANICO had, of course, contended that New Jersey law should apply. But Conestoga prevailed when the Appeals Court held that New York’s law should apply.

This case compares and contrasts New Jersey (and most states’) interest in preventing and combating alleged STOLI fraud with the competing policy interest favoring finality of contracts as expressed in Texas and New York law.

**FACTS:** The underlying dispute concerns the proceeds of a \$10 million life insurance policy insuring the life of New York resident Rachel Einhorn. In 2007, Einhorn applied for a \$10 million dollar life insurance policy with ANICO. Einhorn designated the Rachel Einhorn Family Trust (“RE Family Trust”) as beneficiary. Through a series of assignments, Conestoga acquired

the rights to the “pay on death” benefits of Einhorn’s life insurance policy. When Einhorn died in 2011, Conestoga submitted a request to ANICO for payment.

ANICO denied Conestoga’s request. It contested its duty to pay the proceeds on the grounds it was part of a fraudulent STOLI scheme. Conestoga subsequently sued ANICO, which was domiciled and headquartered in Texas.

Before trial on the merits, Conestoga asked the trial court to make a choice of law determination with regard to the issues concerning the validity of the policy. Conestoga argued New York law should apply. ANICO argued New Jersey law should apply. (Neither party argued Texas law should apply). The trial court determined New York law should apply. ANICO appealed. It raised two issues on appeal—the major one being that New Jersey law, not New York law, should govern the issues relating to the validity of the policy.

There were three interested jurisdictions: (1) Texas (ANICO is domiciled and its home office is in Texas, and suit was filed in Texas); (2) New Jersey (Einhorn’s insurance policy application has alleged choice of law “contacts” with New Jersey); and (3) New York (Einhorn, the insured, was a resident of New York). Therefore, this court had to determine whether the laws of the interested jurisdictions differ for the issue presented in this case---and if so—which state’s laws should be applied.

The central issue in this case at the trial court level was whether ANICO could challenge the validity of Einhorn’s insurance policy after the period of contestability—as stated in the policy—had expired. No one disputed the existence of the “INCONTESTABILITY” clause which states:

This Certificate will be incontestable after it has been in force during the insured’s lifetime for 2 years from the Date of Issue except for nonpayment of premium and except as to any provision or condition relating to disability benefits or additional benefits for accidental death.

Nor did the parties dispute that the contestability period for Einhorn’s policy had expired before her death. She signed the application on July 7, 2007. She died August 22, 2011. So, since New York, New Jersey, and Texas all require a relatively similar version of the incontestability clause above in life insurance policies, no conflict existed as to the incontestability provision itself.

However, the parties *did* disagree, and the laws of the interested jurisdictions conflicted, as to what challenges to the policy’s validity, if any, an insurer is permitted to make after the expiration of the contestability period. Here, ANICO attempted to challenge the validity of Einhorn’s policy after the expiration of the contestability period on the grounds that: (1) public policy rendered the policy void (including its contestability provision) because there was never an insurable interest; and (2) there were fraudulent misrepresentations in the insurance application.

Texas common law requires a person insuring the life of another to have an insurable interest in the insured person's life. New York and New Jersey have specific laws stating insurable interest requirements. However, although all three states agree that a beneficiary must have an insurable interest in the insured, New Jersey, New York, and Texas do not agree as to the role that requirement plays *after* the contestability period on a life insurance contract has expired.

In New Jersey, the lack of an insurable interest at the inception of a life insurance policy renders it void from inception. In fact, the majority of most states' courts have held that life insurance contracts issued without an insurable interest at inception are akin to wagering contracts, and are therefore void *ab initio*. The Texas court also noted that New Jersey's state courts strongly disfavor the enforcement of contracts that are contrary to public policy.

Unlike New Jersey, New York does not permit a challenge to an insurance policy's validity based on the insurable interest requirement *after* the expiration of the contestability period. After holding that the lack of an insurable interest in the beneficiary does not render the life insurance contract void *ab initio*, New York's highest court held a beneficiary cannot be compelled to prove her insurable interest after the expiration of the contestability period. In a case called *Caruso*, the court acknowledged this is a harsh result for the insurance companies, but explained:

This inequity may be avoided, and the public purpose underlying the insurable interest requirement implemented, by a rule which encourages the insurer to investigate the insurable interest of its policyholders promptly within the two-year period. Such investigations would not only eliminate "wagering" contracts but would do so promptly, thereby furthering the policy behind the provisions to the statute.

*Caruso* appears to be the law of New York on this issue. It is also the state *minority* view of how jurisdictions have addressed insurable interest challenges in light of expired contestability periods. This minority position (*unlike* the result that would occur in New Jersey, Delaware, and most other jurisdictions) is because in those few states—a policy lacking an insurable interest is not void at the outset. Texas adheres to the same minority view as New York with respect to how to address policy validity challenges based on the insurable interest requirement. Therefore, ANICO would not have been able—under Texas law—to challenge Conestoga's insurable interest in Einhorn's life insurance policy.

For these reasons, this Texas Appeals Court held that a conflict of New Jersey, New York, and Texas states' law existed as to the issue of ANICO's ability to challenge the validity of Einhorn's insurance policy based on the insurable interest requirement.

ANICO had also challenged the validity of the contract in this case based on fraudulent misrepresentations in the policy application. Here again, this court noted that the laws of Texas and New York conflict with those of New Jersey regarding whether a party may challenge the validity of a life insurance policy *after* the expiration of the contestability period. Texas and

New York agree that such a challenge is not permitted. Under New Jersey law, however, an insurer may deny a claim if the insured committed fraud in the policy application.

This court concluded that—since the laws of Texas and New York are essentially the same and since both conflict with the law of New Jersey—that New York law should apply to the fraud issue as well as the insurable interest issue. It reasoned that:

it would be judicially inefficient and confusing to require the trial court to apply the law of two different jurisdictions to the same central challenge to the validity of Einhorn’s life insurance policy after the expiration of the contestability period. . . . because New York and Texas law are the same on the issue of the fraud-based challenge, neither party is harmed by the application of one jurisdiction to the exclusion of the other as they both conflict with the law of New Jersey.

ANICO’s central basis for this contention was that the place of negotiation and performance of the contract was allegedly New Jersey, although there were no facts stated in the case to back this contention.

**RELEVANCE:** Every STOLI case has made it clear that life insurers need to do a much better job underwriting and investigating an applicant’s statements at the time of and within the two year period following the issuance of coverage.

Similarly, every STOLI case is a reminder of the applicant’s duty to *read the contract and the application* and honestly answer each question asked.

Further, every STOLI case is an illustration of the importance of producer and insurer ethics. The economics upon which life insurance depends fails when the trust and honesty assumed between these parties breaks down.

This case also points out that—if state law is or may become important for some legitimate reason—it is possible for the applicant to specify which state’s law is to apply. When an insured has not specifically stated in the application which state’s law is to govern, generally the validity of and rights under a life insurance contract are determined by the local law of the state where the insured was domiciled at the time the policy was applied for. The exception is where—with respect to the particular issue—some other state has a more significant relationship to the transaction and the parties. In that case, the local law of the other state will be applied.

A post-script: If this case leads you to believe that there are states out there signaling they are a safe harbor for an agent to commit fraud and misrepresentation, think again. The well-known law firm of Drinker Biddle & Reath LLP just issued an Insurance Alert headlined, “More Arrests for Alleged Insurance Fraud.” Its lead sentence begins, “Just weeks before the sentencing of three insurance producers for insurance fraud and STOLI-related conduct in the Southern District of New York” (where Michael Bunday, James Kergil, and Mark Resnick were convicted of mail fraud, wire fraud, and conspiracy to obstruct justice and sentenced for 12, 9, and 6 years

respectively and ordered to pay over \$39,000,000 in restitution), the California Department of Insurance arrested Tyler Wilkinson, Ian Frisch, Reuben Banuelos, Edward Putnam, and Maxine Putnam for their alleged role in falsifying life insurance policies. Two face felony counts which could result in up to twelve years in prison, if convicted. The three others, if convicted, could serve as much as five years.

*WRNewswire* #14.8.12 was written by Steve Leimberg of [Leimberg Information Services, Inc. \(LISI\)](#) and [Leimberg & LeClair, Inc.](#)

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