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TOPIC: Incontestability Period Forecloses Insurer's Argument Policy Was *Void Ab Initio* Because of Lack of Insurable Interest

CITATION: *PHL Variable Insurance Company v. Bank of Utah*, 2015 WL 1086246 (U. S. Ct. App. 8th Cir. March 13, 2015).

SUMMARY: This case involves the validity of what the court referred to as a $5,000,000 "Stranger owned Life Insurance" or "STOLI" policy issued in 2007 by PHL Variable Life Insurance Company ("PHL"). When the insured died in 2011 (long after the incontestability period expired), the policy was owned, after a number of interim transfers, by the Bank of Utah as custodian for investors. As the named beneficiary, the bank demanded payment of the death benefit. PHL refused to pay and requested a declaratory judgment that the policy was "void ab initio" for lack of an insurable interest. The district court had granted the insurer's request (which we wrote about in *WRNewswire #13.12.05*) but the Eighth Circuit Court of Appeals has reversed the lower court's grant of a summary judgment.

From time to time, when there is no state court decision directly on point, a federal court will decide how the state's highest court "would have" held on the issue. This was such a case and it turned on two issues:

> (1) whether the incontestability clause trumps an insurer's ability to rescind a policy as *void ab initio* upon discovery of what the court called misrepresentations made to obtain a policy by a third party lacking insurable interest, and
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> (2) if it is necessary (for an insurer to establish that an insurance contract is *void ab initio* as a cover for a wagering contract) to prove that the scheming parties had agreed that the insured would resell the policy to a *specific and identified* party who has no insurable interest, rather than merely prove a *general* intent to resell the policy to a party with no insurable interest.

The court applied its interpretation of Minnesota common law and held:

> (1) once the contestability period has expired, an insurer cannot rescind a policy—even upon proof of what the court itself called "misrepresentations made to obtain a policy by a third party lacking insurable interest", and
>
> (2) even if it *is* shown—(it was *not* shown by the insurer in this case)—that the scheming parties had agreed at policy issuance that the insured would resell the policy to a *specific and identified* person without an insurable interest, the contestability clause *still* trumps an insurer's ability to rescind a policy.

RELEVANCE: At this point, some would say that reporting on yet another STOLI case is a repeated beating of a long deceased *equus*. Yet these cases help us to refine our knowledge of the law of insurable interest and how it works in conjunction with, or in opposition to, the incontestable period clause in a policy.

It also reminds us that states are constantly balancing these objectives:

- protecting insureds and their designated beneficiaries from a dilatory challenge by an insurer to the validity of an insurance policy while also encouraging the insurer to be diligent in performing its duty to investigate within a specified period and penalize it if it does not;

- protecting a policy owner's property right to freely assign a policy;

- preventing insurance fraud;

- protecting insureds from potential harm when the insurable interest concept is ignored or abused; and

- preventing or discouraging gambling on human lives.

Clearly, states can have radically divergent views on the priorities that should be given to these objectives.

Here, it is significant that the appeals court also went out of its way to state:

> The policy (of insurable interest) is based upon the relationships between the insured, the person purchasing a life insurance policy, and the death benefit beneficiary. It does not address whether the *insurer* should be permitted to renege on its contractual obligations. (emphasis added).

Finally, this case is (yet again) a reminder to insurers that they must be diligent in the initial underwriting investigative process in their duty (and opportunity) to investigate after the policy is issued and within the contestable period—or potentially pay a high price.

This is but one case reflecting a federal court's interpretation of the law of just one state. This holding is at the extreme end of the range of nationwide decisions on these points. Relatively few courts will likely follow this court's ruling requiring proof of the insured's intention to sell to a specific identifiable buyer to invoke the insurable interest rule. Requiring such proof arguably guts the spirit of the insurable interest laws and helps those associated with making misrepresentations and gaming the system. In addition, few courts are likely to hold that if the insurer *is* able to meet this almost impossible burden of proof that the incontestable clause trumps the public policy of making a life insurance contract *void ab initio* when the real buyer clearly never had an insurable interest in the insured's life.

FACTS: Briefly, the key facts as set forth in the court records are as follows. In 2006, William Close, a 74–year old retiree, completed an application for a $5 million life insurance policy which according to court records was far more than he could afford. The policy application falsely stated that Close had a net worth ten times greater than actual and failed to disclose his prior felony conviction for receiving illegal kickbacks as a union pension fund trustee. With his agent's guidance, Close submitted a loan application that falsely stated his net worth and obtained a two-year, $300,225 premium financing loan from CFC of Delaware. Funding for the loan came from New Stream Insurance, LLC ("New Stream"), a now-bankrupt hedge fund that invested in life settlements and premium finance loans. The policy was pledged as collateral for the loan. Close personally guaranteed twenty-five percent of the loan in the event of default. CFC and New Stream determined that the policy would be worth $1.3 million in two-years, when it became "incontestable" under Minnesota law. Close was told he would likely be able to sell the policy in the secondary market for ten percent of its face value (i.e. he'd receive $500,000) at the end of the two-year period.

PHL issued the $5,000,000 policy in September 2007. As part of the Financing Arrangement with CFC, Close formed an irrevocable trust to own the insurance policy, naming his wife as trust beneficiary. The trustee was BNC National Bank. A Minnesota lawyer was named trust protector, a position intended to "give the insured and his family some input over the ongoing trust administration."

In March 2009, six months before the loan was due, BNC sent Close a letter explaining his options for repaying it:

> (1) refinance with the lender or a third party,
> (2) sell the policy and use the sale proceeds to repay the loan, or
> (3) relinquish his interest in the policy to the lender.

Close sought his agent's help in selling the policy, but the secondary market had crashed by the fall of 2009, and those efforts were unsuccessful. Unable to sell it, Close surrendered the policy to New Stream in full satisfaction of the loan. New Stream filed for bankruptcy in June 2011. Its portfolio of life insurance policies, including the Close policy, was sold to Limited Life Assets Services Limited ("LLAS").

When Close died of lung cancer in November 2011, the Bank of Utah held the policy as securities intermediary for LLAS. The Bank of Utah filed a claim for the death benefit in January 2012.

PHL's claim investigation revealed what it considered fraudulent misrepresentations on Close's policy application. At that point, any claim to rescind the policy for fraud in its procurement was foreclosed by the two-year incontestability provision. However, PHL asserted that the incontestability provision never took effect because "there never was a valid contract", i.e. the policy was void *ab initio* as contrary to public policy for lack of an insurable interest. In other words, PHL argued (A) that the Close policy was *void ab initio* for lack of an insurable interest, and (B) that, if a policy is *void ab initio*, any incontestability provision in that contract would be meaningless and unenforceable.

The district court, relying on decisions from other states, agreed with PHL's arguments. It held that "a policy may be challenged for lack of insurable interest beyond the contestability period" and therefore granted PHL's request for a declaratory judgment. Minnesota law governed the contract in this case. The appeals court agreed that:

> The securitization of life settlements for purchase by investors, and the dramatic increase in suspect marketing practices to sell STOLI policies, raise legitimate public policy and legislative concerns that have led to legislation and regulation in nearly every State, and have prompted a raft of litigation around the country, illustrated by this case.

However, it went on to say:

> …while decisions from other jurisdictions may be highly instructive, as a federal court exercising diversity jurisdiction, we must remain grounded in Minnesota law and determine how the Supreme Court of Minnesota would apply that law in this case.

(NOTE: Minnesota, responding in 2009 to problems created by STOLI marketing practices, enacted the Minnesota Insurable Interest Act. However, this Act is prospective only. It does not apply to the policy at issue. Consequently, this case is governed *solely* by Minnesota *common* law. Therefore, a Minnesota court—or in this case, a federal court applying Minnesota law—would apply decisions from other jurisdictions having relevant statutes or differing judicial precedents with great care.)

The concept of insurable interest is based on the principle that, if a policy on one person's life is issued to another person or party who has no interest in the continuation of the insured's life, the resulting contract is essentially both (1) a gambling contract on which the subject of the bet is a human life, and (2) a contract which creates a motive for desiring the termination of the insured's life. In insurance parlance, this is a "moral hazard." The requirement of an insurable interest is designed to reduce or eliminate the incentive to murder the insured by someone betting on his demise.

All states provide that when a person purchases insurance on his or her own life, the requisite insurable interest is present and once that contract is issued, it could then be validly assigned or sold to a person lacking an insurable interest in the insured's life. This is based on the treatment of a life insurance contract under state law of life insurance (*as far as reasonable safety permits*) as a form of property.

NOTE: The law, or the spirit of the law, in most states provides a very important caveat to this general rule.

If a person acts merely as a “straw man”—in other words, if a person who has an insurable interest in his own life buys the policy merely to disguise and cloak what is essentially a purchase by a person or party who has *no* insurable interest—that policy is, in its inception, a wager on a human life that violates pubic policy. It therefore bears no similarity to a life insurance contract that is purchased in good faith and then sold after its issue in “good faith” to a party with no insurable interest, i.e. a stranger.

One more time: An insurable interest in the assignee of a policy of life insurance is not essential to the validity of the assignment IF (1) the party to whom it was originally issued had such an interest, and (2) the assignment is not made as a cover for the issue of a wager policy, i.e., if made in good faith and not as a mere cover for taking out insurance from inception in favor of a person or party without insurable interest.

This exceptionally important caveat frames the key issue in this case. However, unlike the district court, this appeals court concluded that neither PHL contention would be supported by Supreme Court of Minnesota decisions applying the applicable Minnesota common law.

First, it noted that the district court accepted PHL’s assertion that life insurance policies lacking an insurable interest violate public policy are *void ab initio*, based *entirely* on cases from other jurisdictions.

However, according to this court:

> where the insured himself procures the insurance, the contract is between him and the insurer, not between the beneficiary and the insurer, and his interest in his own life sustains the policy and need not be proven. In such case he has the right to appoint the person to whom the proceeds of the policy shall go.” …Nowhere in this discussion is there even a hint that a policy purchased by an insured on his own life would ever be “void ab initio” at the instance of the insurer.
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> When a person purchases insurance on his own life and later assigns it to a stranger, the contract between the insured and insurer is valid - unless voidable for fraud or other defenses – and these causes of action are subject to the incontestability bar.

This case points out the lengths to which a court will go (or not go) to arrive at the decision it wants to make. Evidence of that point can be found in the following statements by the appeals court:

> The court’s power to declare a contract void for being in contravention of sound public policy is a very delicate and undefined power, and ... should be exercised only in cases free from doubt.’ …We believe the Supreme Court of Minnesota would conclude the public policy issue is not free from doubt. The question is whether Minnesota public policy requires that we permit an insurer who collected over $500,000 in premiums—a

> windfall it will keep if we affirm—to renege on its contractual obligation because a third party "schemed" with the insured before the policy issued to help him achieve his intent to purchase the policy for resale, an intent which, if unilateral, was consistent with the public policy recognizing that life insurance policies are legitimate investments, as well as insurance.
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> This court subscribes to the notion that a person's unilateral intent to purchase a policy on his own life to exploit the secondary market for life policies does not make the policy void ab initio under the common law. Recalling that the Supreme Court of Minnesota has never even considered an insurer's claim that its policy should be invalidated on this common law ground, this court concluded that if the Supreme Court of Minnesota heard this issue, it would not declare the Close policy void ab initio, permitting PHL to walk away from its bargain.

The district court had declared the Close policy void as against public policy because it "was procured by a scheme to assign it to a party lacking an insurable interest and with the mutual intent of circumventing the law against wagering policies." However, according to the appeals court:

> This reasoning bears little if any relationship to the "moral hazard" on which both federal and Minnesota common law are grounded. Moreover, it would permit life insurers to resist paying a death benefit any time there is some evidence that an insured used premium financing to obtain a policy he or she planned to sell. Subjecting insureds and their beneficiaries to this inquiry cannot be squared with the public policy declaration in *Grigsby* that "it is desirable to give to life policies the ordinary characteristics of property."

The appeals court also disagreed with the district court's answer to the second issue, i.e. that a lack of an insurable interest is not foreclosed by Minnesota's incontestability statute. It concluded the Supreme Court of Minnesota would not agree.

Here the appeals court (arguably naïvely in the light of how cleverly the parties to many STOLI schemes hide the true nature of the transaction) states:

> Whether the insured has an agreement with an insurance agent or broker or a premium financing company at the time the policy is issued that it will be sold, either to an identified person who lacks an insurable interest or, more typically, into a secondary market of insurance policy investors, is a risk the insurer can promptly investigate (assuming it is relevant to the decision to insure). …To declare that a facially valid policy on which PHL collected substantial premiums for over four years was never "in force" is simply a fiction.

Finally, the appeals court concluded:

> To establish that an insurance contract is void ab initio as a cover for a wagering contract, the Minnesota court likely would require an insurer to

> show that the scheming parties agreed that the insured would resell the policy to an identified person without an insurable interest.
>
> A broader rule—that the insurer need only show that the parties intended that the insured would resell the policy to someone without an insurable interest—would interfere with the ability of insureds to use premium financing, and could not meaningfully be distinguished from the generally accepted rule that permits an insured to purchase a life insurance policy with his own funds while harboring a unilateral intent to resell the policy to a stranger.

The appeals court agreed with the district court that Close intended to transfer the policy to "a third party lacking an insurable interest on his life." Nevertheless, the court decided that "that conclusion is insufficient to render judgment for PHL. …there is no evidence that Close intended from the outset to transfer the policy to CFC of Delaware, the premium financing company, or to New Stream, the entity that funded the loans to Close and ultimately acquired the policy. The evidence shows at best that Close intended to sell the policy to an unknown third party on the secondary market."

The appeals court concluded, "…that is not the rule that the Minnesota courts likely would adopt. Because there is insufficient evidence to establish that the parties agreed to resell the life insurance policy to an identified person, Bank of Utah is entitled to judgment."

Note that, according to the appeals court, the insured's mere intention to sell a newly acquired policy would not be considered a violation of the insurable interest rule. What would be necessary would be an understanding or agreement with a *particular* person or entity who or which does not have an insurable interest to acquire the policy. This almost impossible to violate rule would essentially require someone waiting in the wings with checkbook in hand to find no insurable interest.

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