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TOPIC: STOLI Decision Affirmed on Appeal

CITATIONS: *Ohio Nat'l Life Assurance Corp. v. Davis*, No. 14-3725 (7th Cir. Oct. 20, 2015); *PHL Variable Ins. Co. v. Bank of Utah*, No. 14-1210 (8th Cir. 2015).

SUMMARY: The Seventh Circuit Court of Appeals fully upheld the district court's decision which held seven policies – all of which were outside the legal contestable period - void for lack of insurable interest. In upholding the district court's decision, the Court of Appeals stated that the named insureds were used by the defendants as "puppets" and the policies were "bets by strangers."

The appeals court decision opined that the defendants' professed "innocent intent" and lack of knowledge the transactions were illegal was "hard to believe" and went on to note that in any event ignorance of the law is no defense.

This court makes its position clear on an insurer's ability to retain premiums in STOLI transactions: "Being to blame for the illegal contracts the defendants have no right to recoup the premiums they paid to obtain them; allowing recoupment would, by reducing the cost, increase the likelihood of unlawful activity."

The court also stated that it was proper to award legal fees to the insurer.

RELEVANCE: Despite the best efforts of the life insurance industry, STOLI cases can still occur. We know now that at least some courts will not only allow insurers to claw back commissions from agents but also allow insurers to recover legal fees from them. We also know that concealing STOLI long enough to get through the contestable period will not necessarily avoid a recession of the policy. We have also learned that some courts will allow insurers to retain the premiums. Finally, the court reminded the defendants that ignorance of the law is no excuse.

FACTS: As we noted in previous reports (*WRNewswires 14.02.21* and in *14.12.02*), the *Davis* case is important because it gives us insight into challenging and evolving issues of state insurance law (in this case Illinois) concerning insurable interest. The district court awarded summary judgment to the plaintiff, Ohio National, awarding it damages of $726,000 against all but one of the defendants, Egbert, whom the court awarded $91,000 that he had paid the company in premiums.

In a nutshell, Mavash Morady, an insurance agent contracted with Ohio National to sell its policies, and Defendant Douglas Davis, a lawyer formerly licensed in California, approached elderly African-Americans and persuaded them to become the nominal purchasers of the policies, with Morady as the insurance agent. Davis, working with Morady, promised to pay these persons small amounts of money for obtaining policies, and in exchange for the promises they filled out applications for life insurance. One such buyer was Charles M. Bonaparte, Sr. His application was accepted, the policy was issued to him, and the defendants had him place the policy in the Charles M. Bonaparte Sr. Irrevocable Life Insurance Trust (which they created), designating the trust as policy owner and beneficiary. This was an irrevocable trust, with Davis as trustee. The defendants paid (in the name of the trust) the premiums on the insurance policy. Bonaparte paid nothing.

Here, the defendants created trusts in the names of the insured in order to conceal from Ohio National the fact that they, rather than the insured, controlled the policy and planned – even before the policy was issued - to sell it as an investment. The need for concealment arose from the fact that an insurance policy would be more valuable to an investor the sooner the insured could be expected to die and therefore the proceeds of the policy realized. This in turn made it more costly to the insurer because it would receive fewer premiums and have to pay the policy proceeds sooner. In addition, controlling as they did the insurance applications, the defendants could conceal some of the life expectancy vulnerabilities of the (nominal) insured—making the insured appear more prosperous, healthier, and in short likelier to live a longer time than was realistic. The defendants targeted elderly people because of their diminished life expectancies and African–Americans because the average life expectancy of an African–American is shorter than that of other Americans.

Presumably the defendants arranged with the insureds to have the family of an insured give the defendants a copy of the death certificate upon his or her death. It was obvious to this court that the defendants were trying to make it look as if they had complied with the legal requirement of insurable interest. This is why they named Bonaparte's trust the "Charles M. Bonaparte Sr. Irrevocable Life Insurance Trust", to hide the fact that Bonaparte's policy was actually financed by a third party. To the insurer, it looked like a normal transaction but the defendants were, in the court's words, attempting "to hoodwink Ohio National." The trust documents listed either members of the insured's family or the insured's other trusts as the trust beneficiaries.

But shortly after the creation of each trust, Davis would have the nominal buyer of the policy (for instance Charles Bonaparte) assign the entire beneficial interest in the trust (and therefore in the policy) to a company owned by defendant, Paul Morady, Mavash Morady's husband. Paul would make the initial premium payments to Ohio National but then resell the beneficial interest in the trust to an investor who hoped that the insured would die quickly so, upon his death, the investor would obtain the proceeds of the policy. Having acquired the beneficial interest in the policy, the investor would pay the remaining premiums as they came due. (One of these investors was Defendant Steven Egbert. His special status in the case is discussed below.) So in reality, the insureds merely lent their names to the applications, in exchange for modest compensation, and the defendants quickly transferred effective ownership of the policies to themselves.

Ohio National's contracts with its agents contained an "absolute prohibition against participation in any type of premium financing scheme involving an unrelated third party"—an exact description of the defendants' stranger-originated life insurance scheme.

The appeals court here made it clear that this case is not one in which "a policy was procured in good faith by the person himself to be assigned thereafter," but rather one "in which the policy was procured by a person who had no insurable interest in the life of the person insured, thus making it a wager contract." The court clearly distinguished this case from one decided under Minnesota law (*PHL Variable vs. Bank of Utah*) which held that a stranger-owned life insurance policy was not void for lack of an insurable interest. But that case differs from this one because in that case a man bought a $5 million policy on his own life with the proceeds of a premium-financing loan that he obtained from a bank with the intention of later selling the policy to an investor. He owned the policy for two years, at the end of which period, not having sold it, he surrendered it to repay the loan. Thus the purchase of the policy was not "a mere cover for taking out insurance in the beginning in favor of one without [an] insurable interest," because the insured owned and controlled the policy before attempting to sell it. Here, the insureds' family members retained beneficial interests in the policies only for a short period of time and never controlled the trusts. The insureds were, in the words of the Appeals Court, the defendants' puppets and the policies were bets by strangers on the insureds' longevity.

The district court held that Mavash Morady's conduct constituted fraud and a breach of her contract and awarded the insurer $120,000 in damages, an amount equal to the commissions it paid her. She argued she wasn't responsible for the false statements on the applications because one of her employees communicated with the insureds and completed the forms. Yet her signature appears on the forms which included information that she knew to be false. Note that the damages awarded Ohio National were not limited to her fraudulent conduct, but were based more broadly on the tort of civil conspiracy, which is committed "when two or more people combine to accomplish, through concerted action, either an unlawful act or a lawful act in an unlawful manner." She argued that she "didn't know STOLI contracts were illegal." The court responded that it found that "hard to believe" and noted that ignorance of the law is of no defense.

The scheme resulted in a cost to Ohio National (beyond the commissions paid to Mavash Morady) of more than $605,000 in litigation expenses. Generally, the victorious party to a lawsuit can't charge litigation expenses to the loser. But here, Ohio National is merely seeking reimbursement of the expenses incurred to avoid future litigation over the death benefits in the policies that it was fraudulently induced to issue. The defendants' misconduct placed the insurer in the position of potentially having to litigate with purchasers of the policies upon the death of the insureds, and the expenses it incurred in the present suit to avoid such litigation by voiding the policies were in lieu of the future litigation that it would otherwise have had to engage in at considerable expense. It paid in advance, as it were, the expenses "in litigation with third parties ... necessary to ... protect [its] interest."

Not only did the court allow the insurer attorney's fees, it also allowed it to keep the premiums paid by the defendants (except Egbert). According to the court, "Being to blame for the illegal contracts the defendants have no right to recoup the premiums they paid to obtain them; allowing recoupment would, by reducing the cost, increase the likelihood of unlawful activity."

Egbert, a defendant but not one of the conspirators, had purchased the beneficial interest in one of the STOLI policies as an investment, and to prevent the policy from lapsing paid the required premiums, amounting to $91,000. Since Egbert was not to blame for the illegality, had no knowledge of the conspiracy, and the policy was void through no fault of his, retention of the premiums he paid would thus have been a windfall for Ohio National to which it had no entitlement. The court therefore ordered a repayment to him by the insurer of $91,000.
