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TOPIC: Lack of Insurable Interest Results in Void Contract

CITES: *Sun Life Assurance Company of Canada v. U.S. Bank National Association et al*, 2016 WL 161598;. Case No. 14-CIV-62610; (U.S.D.C. S.D. FL 01/14/2016); *Pruco Life Ins. Co. v. Brasner*, No. 10-80804-CIV-COHN, 2011 WL 134056 (S.D. Fla. Jan. 7, 2011). *Pruco Life Ins. Co. v. Wells Fargo Bank, N.A.*, 780 F.3d 1327, 1336-37 (11th Cir. 2015); *PHL Variable Ins. Co. v. Price Dawe 2006 Ins. Trust, ex rel. Christiana Bank & Trust Co.*, 28 A.3d 1059 (Del. 2011).

SUMMARY: U.S. Bank owned and was beneficiary of a $5 million policy on the life of Phyllis Malkin. The insurer, Sun Life, claimed the contract was a STOLI policy (it argued shadow investors utilized Malkin's life as a conduit to procure the policy, wager on her life, and profit from her death). The insurer asked the court to have the Malkin Policy rendered void *ab initio*. The court found the Malkin Policy lacked an insurable interest at inception, was "clearly a disguised wager on the life of Phyllis," and was therefore void *ab initio*. However, it denied Sun Life's request to retain the premiums.

RELEVANCE: This case is important because the issue of whether the Malkin Policy could be rendered void *ab initio* under the applicable law was impacted by the facts that

> (1) the two-year incontestability period contained in the Policy had lapsed, and
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> (2) resolution of this issue required the court to make a "choice of law" decision, a determination of whether Florida or Delaware law applies. (Delaware law permits a party to challenge the Policy *after* the contestability period has lapsed but this question remains unresolved in Florida courts.)

What's of particular interest to agents in this context is this question: "*The completion of what act created a binding contract?*" and the significance of the *absence* of a choice of law clause in the contract (had the policy specified it was a Florida contract with Florida law to apply, the result here *might* have been different).

This case is also instructive because it reveals at least one insurer's tiering system to monitor brokerage firms and (presumably) agents: It classifies firms in "green," "yellow," or "red" classifications. The "red" classification of firms included those with poor placement rates and those requiring a high resource strain due to large numbers of applications, unrealistic service expectations, or an extensive amount of rating appeals.

FACTS: Defendant Larry Bryan, named as broker on the Malkin Policy, had an insurance business in South Florida known as "Simba." Simba offered clients "life insurance capacity transactions," where life insurance policies were acquired by way of non-recourse premium financing. According to Bryan, in exchange the insureds would receive "big cash payments by the funders at no risk or expense." Simba targeted healthy seniors with "excess (unwanted, not needed) life insurance capacity $2 (million or more)" who wanted to "realize its value." (billed as "*The asset you never knew you had*)." Simba represented to potential clients that there was "no obligation or out of pocket expenses to you, when engaging in 'a life insurance capacity transaction.'" Simba sought clients who did not need or wish to purchase life insurance for their own personal use. "Simba and the funder were using the insured's body as the transaction."

Funders offered three types of deals to prospective insureds:

(1) a "front-end deal" under which the insured sold the policy to the funder at the very beginning of the transaction;

(2) a "back-end deal" under which the insured would take out a loan from a funder for a period of a little over two years to fund the premium payments necessary to keep the policy in force past the two-year contestability period; or

(3) a hybrid deal.

In almost 90% of the back-end deals, the insured would relinquish the policy to the funder and walk away.

Simba's staff was instructed to leave blank any questions on the client's application relating to the existence of any in-force or pending life insurance on the life of the potential insured. This was to allow Simba to acquire more policies on a potential insured's life than the insurers would knowingly have issued.

In 2005, Bryan formed a relationship with Coventry Capital LLC. Coventry provided financing for certain policies through loans to potential insureds. Simba introduced prospective clients to Coventry and solicited applications. Simba made "many deals" with Coventry (mostly back-end deals where the insured later relinquished the policy to Coventry). Coventry, American International Group, Inc. ("AIG"), and U.S. Bank had already entered into a contractual framework for the sale of life insurance policies originated by Coventry under which Coventry agreed to sell to AIG various life insurance policies, granting them the rights to collect death benefits. Coventry conveyed approximately 3,000 policies to AIG, the approximate value of which is estimated to be in the billions of dollars. The Malkin Policy was one such policy.

On April 11, 2006, Sun Life issued and delivered a $5 million life insurance policy to the Malkin Delaware Trust in Wilmington, Delaware. Initially the policy was applied for with Florida-specific forms, but Sun Life's administrative system updated the application state to Delaware based on:

(a) the application having been signed in Delaware,
(b) the address for the policy owner being shown as Delaware and
(c) a Delaware policy illustration.

The Delaware version of the Sun Life policy provides "In the absence of fraud, after this Policy has been in force during the lifetime of the Insured for a period of two

years from its Issue Date, Sun Life cannot contest it except for non-payment of Premiums." Delaware law also requires life insurance policies to contain incontestability provisions.

Sun Life demonstrated the insured's application was rife with misrepresentations. Although it indicated her assets exceeded $15,000,000, the actual value of her assets was shown to be closer to 1/10th of that amount. Malkin never traveled to Delaware, despite the application indicating that it was signed by her there, and Bryan's attestation that certain elements were filled out "in his presence" when they were not.

In July 2008, Coventry backed out after determining that it didn't "see any value in purchasing the Malkin Policy." Malkin defaulted on the loan. Default interest accrued. Simba paid the accrued default interest for Malkin. In August, Malkin relinquished all her rights in the Malkin Delaware Trust. Thereafter, Wilmington Trust, as trustee, entered into an agreement with Coventry assigning the Malkin Policy to it. On August 18, 2008, the Malkin Delaware Trust agreed to sell the Policy to Coventry for $255,000. The same day, U.S. Bank executed a beneficiary change request form, asking Sun Life to change the policy's owner of record from the Malkin Delaware Trust to U.S. Bank, acting as a securities intermediary for what would later be discovered to be AIG. Additionally, U.S. Bank submitted an ownership change request to Sun Life, naming U.S. Bank as the owner and beneficiary. The next day, U.S. Bank conveyed the policy from Coventry to AIG.

Malkin's Death and Sun Life's Investigation: U.S. Bank remained AIG's surrogate owner and policy beneficiary until Malkin's death on September 13, 2014. U.S. Bank submitted a death claim requesting Sun Life remit the $5 million death benefit. Upon receipt of that claim, Sun Life started an investigation. Sun Life learned Malkin never had the income to pay the premiums, and that Malkin had been approached by a person who spoke to her about buying a policy in place in exchange for financial compensation. According to her daughter, Malkin purchased the policy with the understanding she would never pay premiums and that Malkin would receive money up front.

By April 2005, Sun Life began monitoring activities indicative of questionable practices and began terminating brokers involved in STOLI. In 2010, the insurer, attempting to flag those responsible for repeated irregularities and misrepresentations on applications created a tiering system to monitor firms, placing firms in either a "green," "yellow," or "red" classification. The "red" classification of firms included those with poor placement rates and those requiring a high resource

strain due to large numbers of applications, unrealistic service expectations, or an extensive amount of rating appeals. Firms submitting policies exhibiting indicia of STOLI were in the "red" category. One of the firms involved in the Malkin Policy transaction was in the red category, but that did not prevent Sun Life from issuing the policy.

The parties' respective motions presented one critical issue: Could the policy be rendered void *ab initio* in light of the fact that the two-year incontestability period contained in the policy had lapsed. Resolution of this question requires a determination of whether Florida or Delaware law applies. This was crucial since Delaware law permits a party to challenge the policy *after* the contestability period has lapsed, whereas that question remains unresolved in the Florida courts. (See our commentary on *Pruco Life Ins. Co. v. Wells Fargo* at *WRNewswire 15.03.11*).

Choice of Law Issue: In determining which state's law applies, a federal district court applies the choice of law rules of the *forum* state. This action, commenced in Florida, meant Florida's choice-of-law rules applied. The court found there was a sufficient clash between the laws of Florida and Delaware concerning the incontestability clauses to necessitate the following analysis:

Absent a contractual provision specifying which state's law applies, with regard to insurance contracts, Florida follows the rule that the law of the jurisdiction where the contract was executed governs the rights and liabilities of the parties in determining an issue of insurance coverage. Broadly speaking, the critical inquiry concerns the location where the contract is "made" or "executed." Key to *that* determination is "The *last act* necessary to complete a contract, i.e. the offeree's communication of acceptance to the offeror."' Generally, this is the state where the insured executed the insurance application." But "the determination of where a contract was executed is fact-intensive. It requires a determination of where the *last act* necessary to complete the contract was done.

U.S. Bank asserted Florida law applied because:

> (1) Malkin signed the February application documents in Fort Lauderdale, Florida; and
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> (2) the policy as initially issued was a Florida-designated policy as evidenced by the inclusion of various Florida forms.

Sun Life successfully countered that Delaware law applies given:

> (1) the policy was delivered to the trust owner in Delaware; and
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> (2) the policy was not "accepted" until the Delivery form was signed and returned by the owner.

Here, the last act necessary to complete the contract was the owner's acceptance of the Malkin Policy, which indisputably occurred in Wilmington, Delaware.

Once this court determined Delaware law applied, the Florida Supreme Court's ultimate resolution of the question, "Can a policy be found void for lack of insurable interest *after* the contestable period has run?" was rendered irrelevant – because Delaware law clearly states it can be.

So the court moved on to the final question: Was the Malkin Policy merely a wager on Malkin's life, lacking an insurable interest at inception? Delaware law explicitly provides that an individual may not procure an insurance policy on the life of another without an insurable interest in the insured's life, and as noted above— in Delaware— the expiration of the two-year contestability period does not preclude an attack on the validity of a life insurance policy based on a lack of insurable interest. This conclusion is predicated upon the Delaware Supreme Court's finding that an insurance policy which lacks an insurable interest at inception is void *ab initio*, meaning no insurance policy "ever legally came into effect" and, therefore, the incontestability provision in the contract never applied. As noted by the *Price Dawe* court, "[t]he insurable interest requirement serves the substantive goal of preventing speculation on human life."

Because STOLI schemes "are created to feign technical compliance with insurable interest statutes," mere technical compliance is insufficient. Instead, "the relevant inquiry is who procured the policy and whether or not that person meets the insurable interest requirements." Delaware's insurable interest statute "requires courts to scrutinize the circumstances under which the policy was issued and determine who in fact procured or effected the policy." Sun Life demonstrated that the Malkin Policy lacked an insurable interest at inception because it was procured not by Malkin, but by shadow investors who intended to wager on her life. According to this court, Coventry's payment under the loan agreement was simply smoke and mirrors meant to obscure the identity of the party responsible for procuring the Policy. Given that Malkin was financially incapable of making the premium payments on her own, she

was obligated to obtain funding from a third-party, Coventry. Here, the entity that allowed Malkin to obtain the policy by providing her with the financial means to do so was the same entity that dictated the deal from its inception and ultimately purchased the policy. Malkin had no need for the insurance, would not have been able to procure such a considerable policy on her own merit given her financial position, and was able to obtain the policy only with Coventry's blessing and financial assistance.

The facts and circumstances of this case plainly expose the STOLI enterprise Malkin engaged in through Simba and Coventry. As a result, the Malkin Policy lacked an insurable interest at its inception and is rendered void *ab initio*.

Finally, because this court found Delaware law applies, it held U.S. Bank was entitled to a return of the premiums associated with the Malkin Policy.
