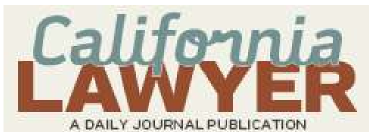
The Wayback Machine - https://web.archive.org/web/20121120161751/http://www.callawyer.com/clstory.cfm?eid=921395



You Bet Your Life

Life settlement deals promise cash benefits to policyholders, profits to third-party investors, and huge premiums to insurers. What's not to like?

by Matthew Heller | April 2012

Ocean/Corbis

Last spring attorney Steven G. Sklaver appeared before the Fourth District Court of Appeal on behalf of trust investors who had bought beneficial interest in two insurance policies on the life of a 79-year-old retiree in San Diego.

Under the agreement the investors made with Jack Teren and his son, the trust would pay the $909,000 annual policy premiums. It also paid Teren's son $600,000 to transfer ownership of the policies, making the trust the sole beneficiary of $20 million in death benefits once Teren died.

According to industry actuarial tables, a 79-year-old male with Teren's demographics can expect to live another eight years. If Teren met that timetable, the investors would realize a profit of nearly $12.3 million. If he died sooner, they would make a killing.

Teren's insurer, Lincoln Life and Annuity Company of New York, wasn't pleased about this life settlement, an arrangement in which the insured sells the policy to a third party for more than its cash surrender value but less than its net death benefit. Lincoln sued Teren and his trust in California, and won declaratory relief in August 2009. The policies, Superior Court Judge John S. Meyer ruled after a bench trial, were void because they lacked insurable interest *ab initio*, or at the time of their inception (*Lincoln Life v. Teren*, No. 37-2008-83905 (San Diego Super. Ct. statement of decision Aug. 27, 2009)).

Sklaver, a partner in the Los Angeles office of Susman Godfrey, recognized that the investors might not be the most sympathetic of clients. "The initial instinct is, 'You are merchants of death,' " he admits. In addition, there was undisputed evidence that the policies were procured through what Judge Meyer had called "extreme, egregious, pervasive and astounding" fraud. A financial supplement Teren had signed and submitted with his insurance application represented his net worth at $46.4 million - but he testified at trial it was actually less than $50,000. Likewise, instead of the annual income of $3.1 million he'd claimed, Teren testified he lived on fixed retirement benefits of $1,333 a month. Because Meyer declared the policies void, he never addressed the insurer's misrepresentation claim.

Teren's life settlement, in fact, bore all the hallmarks of what the insurance industry calls "Stranger Originated Life Insurance," or STOLI. The pejorative term broadly applies to any policy purchased in the secondary market by a party with no insurable interest in the life of the insured. "Life settlement investors treat life insurance not as a means to financially protect against tragedy, but as an investment in a commodities market - the human commodities market," wrote industry attorneys with Houston's Edison, McDowell & Hetherington in a white paper about STOLI.

During oral argument in *Teren* at the Court of Appeal, Justice Cynthia Aaron seemed particularly hostile toward the investors. "Some might say it's a scam from beginning to end," she told Sklaver at one point. She echoed the concerns of U.S. Supreme Court Justice Oliver Wendell Holmes Jr., who warned more than a century ago against using a life insurance contract as "a cloak to what is in its inception a wager." (*Grigsby v. Russell*, 222 U.S. 149, 156 (1911).)

In the balance hung not only the more than $2 million in premiums that the investors had already paid, but also millions in potential profits depending on the timing of Teren's death. The odds appeared to be against Sklaver and cocounsel Ryan C. Kirkpatrick, another Susman Godfrey partner. After all, if something walks like STOLI and talks like STOLI, then surely it must be STOLI.

Search
Search

Matthew Bender® Practice Guide: California E-Discovery and Evidence, the only practice guide exclusively devoted to e-discovery and electronically stored information issues in California.
Now available in eBook format
Order Now: 800.223.1940

WE KNOW OUR CLEAR SAILING AGREEMENT FROM OUR COMMON FUND CLASS.
GO WEST.
Learn more »
BANK OF THE WEST COMMERCIAL BANKING | BNP PARIBAS GROUP
Member FDIC

When it comes to making money - lots of money - the insurance industry and Wall Street usually work together. During the housing boom of 2000-06, for example, they made complex deals involving mortgage-backed securities and then covered those bets with credit default swaps. But the crash of '08 split their interests - someone had to pay for those soured deals. One giant insurer, American International Group (AIG), teetered at the edge of bankruptcy before its $182.3 billion bailout by the federal government. Goldman Sachs, which had hedged its derivatives investments through AIG, collected $8.1 billion from the bailout to cover its losses.

Life settlements are another exotic product that has divided the financial industry. In recent years they boomed, growing from $5.5 billion in transferred death benefits in 2005 to $11.8 billion in 2008, according to the Financial Industry Regulatory Authority. Research firm Conning & Company estimated that by 2009 about $35 billion in U.S. life settlements were in effect. Major investment firms - including Goldman Sachs, Credit Suisse, and Deutsche Bank - set up life settlement trading desks, servicing clients that included hedge funds, pension funds, and charitable organizations.

There was plenty of money to be made. As a rule of thumb, an ideal candidate would be at least 70 years old and qualify for at least $2 million in coverage. With a base of aging high-net-worth individuals, investors were typically making estimated rates of return between 10 and 14 percent. And carriers were collecting hefty premiums - as Lincoln Life did from the Teren investors.

But what might have been another lucrative form of financial partnership turned into something else - a pitched battle between putative allies, fought in a series of high-stakes lawsuits. "This is big-ticket litigation for both sides," says Rene L. Siemens, a partner in the Los Angeles office of Pillsbury Winthrop Shaw Pittman who has represented investors in such cases. "What this is really about is a struggle between insurance companies and big investment banks and investors."

The insurers' field army includes attorneys at Drinker Biddle & Reath, Dorsey & Whitney, and Edison McDowell. In the past few years they have filed declaratory relief suits seeking the rescission of alleged STOLI policies in at least eight states. The top general in the campaign is Michael Lovendusky, vice president and associate general counsel at the American Council of Life Insurers (ACLI) in Washington, D.C. The enemy is not life settlements per se, he says, but "manufactured" STOLI or other illicit policies supported by no insurable interest, a category that experts estimate accounts for about half the life settlement market.

Lovendusky makes STOLI sound like a biblical pestilence. "There's a tremendous amount of it," he fumes in an interview. "What is bedeviling the insurance industry is how much STOLI exists."

Conceding that the ACLI "recognizes there is a legitimate life settlement" product, he nonetheless recently urged the U.S. Securities and Exchange Commission to scuttle a proposal supported by private investors and financial firms to permit securitization of such policies. "[A]s evidenced by the persistent reports by officials and media of abusive investment schemes involving life settlements, the secondary market for insurance products is dangerous," he wrote.

Investors and their attorneys, however, claim this is something of a phony war, a dispute driven not so much by lofty notions of insurable interest as by a standard investment practice known as "lapse rate arbitrage."

Life insurers anticipate that a certain percentage of insureds will stop paying premiums, causing their policies to lapse and precluding any payments. Using this assumption, insurers can price policies so that premiums total less than the death benefit. Underpricing makes the policies more affordable to consumers - and attractive to investors, who are guaranteed a profit even if the policy goes to term. The reason insurers dislike life settlements, attorneys representing investors argue, is that their clients don't miss premium payments - thereby preventing insurers from capturing arbitrage profits.

Pillsbury's Siemens says, "What's motivating the insurance industry is the dirty little secret about how they underwrite life insurance policies." Investors, Sklaver contends, are being targeted by insurers simply because they pay their bills on time.

This business combat has spilled over into court. Insurers have recently won significant rulings at trial and appellate courts, often by citing *Grigsby* and the common law policy against wagering contracts. In some cases, the insurers have been awarded damages, allowing them to keep all or part of the premiums they collected on a rescinded policy. Last year a Florida appeals court ruled, "Where a party wrongfully procures a life insurance policy on an individual in whom it has no insurable interest, the party is not entitled to a return of premiums paid for the void policy." (*TTSI Irrevocable Trust v. Reliastar Life Ins. Co.*, 60 So. 3d 1148, 1149 (2011).)

But much to the chagrin of insurers, the life settlement industry also has won notable court rulings in key markets, including New York and California. Some judges have accepted investors' arguments that alleged STOLI transactions are perfectly legal under the express language of state insurance statutes. In November 2010, for instance, New York's highest court found that a life insurance policy is valid even if the insured immediately assigns it to a stranger (*Kramer v. Phoenix Life Ins. Co.*, 15 N.Y. 3d 539 (2010)).

State insurance regulators have reluctantly been drawn into the fray. In Florida and New York, they have brought charges against individual insurance brokers for selling STOLI policies. But with scant resources for enforcement, most regulators have stayed on the sidelines. That leaves millions of dollars in existing life settlement policies unchallenged.

"There is no wager here," Pillsbury's Siemens insists. "These are financial transactions in which both parties are getting consideration. They're done by business people, not by hit men." Referring to Billy Wilder's classic 1944 film noir, he adds, "This is not *Double Indemnity*."

The deadly insurance fraud that drives *Double Indemnity* resonates through English and American insurance law. The British Parliament passed the Life Assurance Act of 1774 to prevent the use of life insurance for nefarious purposes. The act proclaimed, "Whereas it hath been found by experience that the making of insurance on lives ... wherein the insured shall have no interest hath introduced a mischievous kind of gaming[,] no insurance shall be made ... on the life ... of any person ... wherein the person ... for whose ... benefit ... such policy shall be made shall have no interest."

The insurable interest doctrine was originally intended to discourage the murder of the insured. But when the doctrine was incorporated into mid-20th-century insurance statutes, "[n]obody writing the laws anticipated you would just go out and sell your policy," says Stephan R. Leimberg, an expert on life settlements and publisher of Leimberg Information Services Inc. in Amelia Island, Florida. "There was no life settlement community, there was no secondary market."

The idea of third-party investment in life insurance policies surfaced in the 1980s during the U.S. AIDS epidemic. Companies offered to buy the policies of HIV/AIDS patients who needed cash for medical and living expenses. California statutes permitted these so-called viatical settlements, though critics found the transactions ghoulish and macabre. To protect buyers, the Legislature in 1990 required that anyone selling the agreements be licensed. The market declined as the survival rate for HIV patients improved, but there was now an option for people with terminal illnesses and others to cash out their life insurance.

By 1998, life insurance policies worth $200 million were sold to investors - up from just $5 million in 1989. The California Department of Insurance cited an estimated $13 billion in policies less than a decade later, driven by well-funded corporate entities that transformed the life settlement concept into a wealth-management tool. Investors targeted the wealthy, offering signing bonuses, ship cruises, and even luxury cars to entice them to sell their life insurance policies. One of those who saw an opportunity in managing life settlement portfolios was Martin E. Fleisher, a New York City attorney who founded Life Product Clearing LLC (LPC) in 2005. "We figured out the economics of it," he recalls. "We thought we could raise money to do it."

In structuring the deals, Fleisher used the beneficial interest trust. If an insured wished to sell a policy directly to an investor, the transaction would have to be approved by the carrier that issued the policy. But if the policy was held in a beneficial interest trust, the investor could avoid any carrier review. Technically, the trust still owned the policy, but the investor owned the death benefit.

Jonathan S. Berck, another New York attorney, was the trustee for many of the trusts created by Fleisher's deals. Life settlements traditionally were delayed for two years to coincide with the statutory period during which insurers can contest a policy because of fraud. But amid the life settlement boom, some policyholders didn't have to wait that long to get their money. In May 2006, for instance, LPC added two $10 million policies to its portfolio through a beneficial interest transfer: the freshly issued policies on the life of Jack Teren.

After reading a *Wall Street Journal* article about billionaire Warren Buffett's purchase of beneficial interests in life insurance, Elliott Teren, Jack's son, suggested the idea to his father. Elliott testified later that he asked a cousin who was a life insurance agent to help him "do something like this."

Jack Teren signed some documents before a notary in San Diego, and in March 2006 the application for two policies was submitted to Lincoln Life. By that time, Judge Meyer noted in his ruling, "everything was in place for LPC's acquisition of the beneficial interest in the Teren Policies." The Teren Trust had been established, and LPC had solicited investors.

Lincoln Life issued the policies the following month. Less than three weeks later LPC paid Elliott Teren $600,000: $500,000 for Jack, a finder's fee of $50,000 to Elliott, and $50,000 to another son, Darren. Lincoln's underwriting department was suspicious that the policies were STOLI, but Jack signed an amendment to his application stating that he was receiving no compensation for the policies.

LPC provided the trust with the funds to pay the premiums. Two years later, in May 2008, Lincoln filed a declaratory relief action in San Diego against Teren and his trust. Why it waited so long isn't clear; it challenged other LPC deals during the interim. Four months earlier a federal judge in New York had denied LPC's motion for judgment on the pleadings to enforce its beneficial interest in another trust, finding it plausible that the insured had "obtained the policy with the prior intent to transfer it to a stranger with no 'insurable interest' in his life." The court concluded, "The law prohibits gaming the system to procure wager policies, regardless of the creativity of form." (*Life Product Clearing, LLC v. Angel*, 530 F. Supp. 2d 646 (S.D.N.Y. 2008).)

By the time Lincoln filed, the two-year contestability period on the Teren policies had expired, but the carrier nonetheless asked Judge Meyer to rescind them as STOLI polices that were void *ab initio*, for lack of insurable interest. As counsel for his investors Fleisher hired Sklaver, who had previously represented hedge funds that owned beneficial interests in life insurance trusts. Sklaver could see that insurers were scoring public relations points about death-bet investments. "I think that they have succeeded in having it out there that this is stranger-originated life insurance," he says. But Sklaver was convinced the law supported his clients.

"If someone took out insurance on your life and you have no idea, that's totally illegal," he says. "But in all these [alleged STOLI] cases, the insured ... has a major role in the transaction. They gave their permission for it."

The strategy, cocounsel Kirkpatrick says, was "to get the courts to follow the black-letter law" and "show the involvement [of the insured] - that this is a deliberate decision and there's no manipulation of the insured."

Judge Meyer, at least, didn't buy it. Although Jack Teren and his sons had insurable interests in Jack's life, he wrote in his August 2009 order, "the Teren policies lack an insurable interest because, in fact, the Teren Trust took out and procured the insurance policies on the life of Jack Teren for the benefit of [LPC] and its investors."

Meyer made no mention, however, of a federal court decision in Los Angeles the previous month that had denied Lincoln's challenge to three $10 million policies it alleged were STOLI. U.S. District Judge Stephen G. Larson found that the insured had followed insurance law "formalities" in applying for the policies, and despite Lincoln's "valiant attempts" to characterize the deal as a "charade," "the simple fact remains that the law, as it is currently structured, allows for [such] an arrangement." (*Lincoln Nat'l Life Ins. Co. v. Fishman Irrevocable Life Trust*, 638 F. Supp. 2d 1170, 1178 (C.D. Cal. 2009).)

Judge Meyer's ruling also coincided with a successful lobbying campaign by insurers to regulate the life settlement industry in California. In October 2009, Gov. Arnold Schwarzenegger signed a new law (SB 98; Cal. Ins. Code §§ 10113.1.3) that repealed existing viatical settlement statutes and replaced them with one that defines STOLI as any "act, practice, or arrangement to initiate the issuance of a life insurance policy in this state for the benefit of a third-party investor who, at the time of policy origination, has no insurable interest, under the laws of this state, in the life of the insured." The new statute also declares that entering into STOLI is a fraudulent act.

Provisions of the law require life settlement brokers to obtain a state license and to comply with consumer disclosure requirements. But the statute also forbids insurers from restricting lawful transfers of policy ownership, and it specifically exempts any life settlement contract entered into on or before July 1, 2010. Lincoln Life - one of the country's ten largest stock life insurers - claims it issued more than 29,000 life insurance policies in California or on the lives of California residents prior to the effective date of the statute.

Late in 2010, two more rulings in Los Angeles federal court indicated that the Central District would carefully review suspected STOLI transactions under SB 98. In the first, the court let litigation against a private equity firm proceed after finding that an insurer had a "colorable claim" challenging the validity of an insurance policy the firm had purchased (*SEC v. Private Equity Mgm't Group, LLC* 2010 WL 4794701 at *3 (C.D. Cal.)). In the second, the court held that allegations regarding two $1 million policies held in trust for the benefit of the insureds' wives "strongly support inferences that the Policies were indeed STOLIs" and prohibited under sections of the recently enacted statutes (*Ohio Nat'l Life Assurance Corp. v. Davis*, 2010 WL 4916643 at *3 (C.D. Cal.).)

The court in *Private Equity*, however, acknowledged the defendant's opposing reliance on *Fishman*, which had held that an insurable interest must exist at the time the policies are issued "but need not exist thereafter or when the loss occurs." (*Fishman*, 638 F. Supp. 2d at 1177.) Section 10113.1(w) of the new insurance code also appeared to permit policy transfers so long as an insurable interest existed at the time the policy was issued.

During oral argument in *Teren* last April, Sklaver relied on the *Fishman* opinion. "You can't pierce the corporate formalities of these contracts to figure out what's going on," he told the appellate justices. "If you look at the contract, the way it was structured, the insured was the applicant, an insured has an unlimited insurable interest in his or her own life, [and] he or she can do whatever he wants with the policy."

Sklaver convinced a bare 2-1 majority of the panel; in May the Fourth District reversed the lower court, reinstating Jack Teren's insurance policies. Writing for the majority, Justice Alex C. McDonald found that the intent to sell the beneficial interest in the policies "does not negate the fact that when the trust acquired the policies, they were supported by an insurable interest" and that "California law allowed the beneficial interest in the policies to be transferred to a transferee without an insurable interest." (*Lincoln Life v. Berck*, 2011 WL 1878855, *7 (Cal. Ct. App.).)

The ruling was a triumph for the life settlement industry, giving it a West Coast bookend to the 2010 *Kramer* decision in New York. In effect, an appellate court in a second key state - California has the nation's largest population of seniors - had shrugged its shoulders at STOLI transactions. "It was a very gratifying result," says Fleisher. In August, the California Supreme Court denied Lincoln's petition for review.

But the Fourth District also mitigated Sklaver's victory. For one thing, it marked the opinion nonpublished and noncitable. For another, Justice Aaron - who had grilled Sklaver during oral argument - wrote a blistering dissent. "The trial court's findings establish that Jack Teren was, in reality, merely a 'shill' who fit the needs of the investors in that he was 79 years old and willing to participate in the sham transaction in exchange for significant personal monetary gain," she wrote.

Skewering the formalistic view of the majority, she argued that courts should "look beyond the signature on an insurance application to the true nature of the transaction." The majority's failure to do so, she concluded, was "in derogation of public policy and rewards those who, in the trial court's words, have perpetrated an 'astounding fraud.' "

The ACLI's Lovendusky insists that carriers are fighting an honorable fight based on the principles of insurable interest. Referring to lapse rate arbitrage, he says, "We do not underwrite policies for our customers with the expectation that premiums are going to lapse." And though Lovendusky complains that in some instances "[c]ourts have recognized the cloak of the wager rather than the reality of the transaction," some important cases have gone the carriers' way since the *Teren* decision.

Last September, for instance, the Delaware Supreme Court ruled that the insurable interest requirement is not satisfied if the insured is a "straw purchaser." To determine whether a policy is bona fide, the justices advised, courts should look at whether the insured paid the premiums "as

opposed to someone with no insurable interest in the insured's life." (*PHL Variable Ins. Co. v. Price Dawe 2006 Ins. Trust*, 28 A.3d 1059, 1076 (Del. 2011).)

In November, a Florida judge found a STOLI policy to be an illegal wagering contract because it was procured "with the intention that it would be assigned or otherwise transferred to a person or entity with no insurable interest in the insured's life." (*Pruco Life Ins. Co. v. Brasner*, No. 10-CV-80804 (S.D. Fla. order issued Nov. 14, 2011 ECF No. 246).)

"The difference," according to Leimberg, "is in how you apply the law - whether you look for the substance and spirit of the law, or base decisions on black-letter law."

Sklaver still represents investors in alleged STOLI trusts, and he contends that insurers have been disingenuous, to say the least. "They issued these policies knowing they would be sold in the secondary market," he says. "You've got folks at these companies who get paid commissions based on the number of policies they are able to issue." At one large insurer, he claims, the third- or fourth-highest-paid employee "was just a middle manager helping to write all these policies."

"For our clients," Sklaver stresses, "the worst thing is to find out there's financial fraud. There's a whole basket of [other] things they can buy. They want to buy the policies that are clean, so they know they have a predictable business model."

Sklaver admits to feeling a bit apologetic when he speaks at legal conferences. "I've joked that it's almost like being at an AA meeting - 'My name is Steven, and I represent alleged STOLI investors,' " he says. "But these are people who were involved in transactions to help people monetize an asset. Carriers think that's a bad thing, and we think it's not."

As for Jack Teren's case, Justice Aaron of the Fourth District highlighted the macabre in her dissent when she said that the investors in his $20 million life insurance policies "are betting that Jack Teren will die within the term of the policies, and sooner rather than later." (2011 WL 1878855 at 14.)

Teren is now 85 and, Sklaver reports, still very much alive.

Matthew Heller is a Los Angeles-based freelance writer and the editor of On Point, a legal news website.

Reader Comments

Comment by Colleen - April 5, 2012

Interesting read

Add your Comment

California Lawyer reserves the right to delete any letter at its discretion; we may remove letters that are off-topic, crude or vulgar, are of low quality or that violate the law or common decency. California Lawyer also reserves the right to edit any letter for use in its print publication. By posting a comment, California Lawyer does not necessarily endorse the views expressed.

---

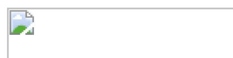
* *Indicates required field*

**Please enter your name:*

**Please enter your E-mail: (will not be published)*

**Comment*

☐ *I have read and understand this disclaimer.*



*Enter the Text you see on the left: