FROM HOWARD M. ZARITSKY

Stranger-Originated Annuity Transactions—Not Quite Ready for Prime Time?

Annuity contracts are often issued by life insurance companies, and they involve a different set of assumptions and relationships from those involved in life insurance policies. The issuer of a life insurance policy has an economic interest in the insured living as long as possible; the issuer of an annuity desires that the insured live for as short a time as possible. Nonetheless, in both instances, public policy arguably requires that the contract owner, if not the insured or annuitant, has a reason to desire that the insured or annuitant live as long as possible, to avoid the purchase of mere wagering contracts.

Some investors appear now to be financing the purchase of variable annuities in a manner that resembles the stranger-originated life insurance (STOLI) arrangements.[1] These stranger-initiated annuity transactions (STATs) involve financing the purchase of variable annuities by individuals who are chronically or terminally ill. An individual buys an annuity policy that guarantees a lifetime annuity payment, that the annuitant will receive the cash value of the policy, based on its directed internal investments, and that if the annuitant dies within a relatively short time, the premiums will be returned, often with interest. The investors pay the premiums.

The annuitant assigns the policy death benefits to the investors or names them the beneficiaries. If the market value of the investments grows significantly, the investors benefit when the annuitant dies. If the market value of the investments does not grow, the investors recover the premium payments, sometimes with interest. The annuitant receives a cash payment for entering into the transaction.

The validity of this arrangement turns on whether the insurable interest rules apply to variable annuity contracts. This issue was examined by the U.S. District Court for Rhode Island, and now the Court of Appeals for the First Circuit has certified two key issues to the Rhode Island Supreme Court.[2]

Background

It was alleged at trial that the defendant, an attorney, devised a program to enable unrelated investors to profit or reduce investment risks by indirectly buying variable annuities on the lives of terminally ill individuals. A terminally ill person would buy a variable annuity and receive a cash payment from the investors, who then pay the premiums and are named the beneficiaries of the guaranteed death benefit.

The investors paid larger premiums than required and directed that the premiums be allocated to highly risky investments. In one instance, investors paid $750,000 into an annuity policy within eight days of its issuance. The investors also elected an "enhanced death benefit rider," that guaranteed them the greater of (1) the premiums paid, increased by 5% per year (less partial surrenders); and (2) the largest policy value on any annual anniversary date, plus premiums and less any adjusted partial surrenders after that highest anniversary date. The contracts with the investors also had an incontestability clause that appeared to bar from its inception any challenge, including one based on the lack of an insurable interest.

The issuer of the annuities sought to rescind those policies as to which the annuitants were still alive, or a declaratory judgment that the annuities were void, because they were

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procured on the basis of fraud by owners who lacked an insurable interest. The defendants filed a motion to dismiss for failure to state a claim upon which relief could be granted, arguing, among other things, that the insurable interest requirement did not apply to annuities and the incontestability clause precluded the insurers' claims. Viewing the factual allegations in the manner most favorable to the insurers, for purposes of the motion to dismiss, the U.S. District Court for Rhode Island granted the motion to dismiss.

The court explained that state law (Rhode Island) statutorily requires that the person who procures an insurance contract must have an insurable interest in the life of the insured.[3] The annuities in this case were not insurance contracts, however, because the death benefit was only a secondary feature.

The insurers also claimed, in the alternative, that annuities may be "'hybrid products,' possessing characteristics of both insurance products and investment securities."[4] The insurers also argued that Rhode Island courts will look beneath the surface to expose life insurance cloaked under different names. The court held that a hybrid policy, if such can exist under Rhode Island state law, must have life insurance at its core, which was not the case here.

Appellate certification

The U.S. Court of Appeals for the First Circuit certified to the Rhode Island Supreme Court two questions, to assist in its deliberations. The First Circuit asked for an opinion whether:

1. If the owner and beneficiary of an annuity with a death benefit was a stranger to the annuitant, the annuity was infirm for want of an insurable interest.
2. A clause in an annuity contract that purported to make the annuity incontestable from the date of its issuance precludes the maintenance of an action based on lack of an insurable interest.

The court raised three questions regarding the insurable interest issue. The court asked:

1. How best to classify the policy (as an annuity, a life insurance contract, or a hybrid).
2. Whether the absence of an insurable interest renders the policy infirm.
3. Whether the policy is an unenforceable wagering contract.

With respect to the first issue, the court stated that the question of whether the investors' status as a stranger to its annuitant invalidated the policy was clearly fundamental to determining the correct holding. The court noted that the Rhode Island Supreme Court has long treated "a purely speculative contract on the life of another" procured by one without an insurable interest as voidable, because it is contrary to public policy.[5] Similarly, Rhode Island statutes require relatives named as beneficiaries to have "a substantial interest" in an insured's life "engendered by love and affection," and other beneficiaries to have "a lawful and substantial economic interest in having the life, health, or bodily safety of the individual insured continue."[6] The investor conceded that it did not have an insurable interest in the life of its annuitant, but the question remained whether the annuity policy is the kind of contract that Rhode Island's insurable interest requirement renders infirm.

The court stated that the answer may depend on whether the policy should be classified as an "insurance contract" or as an "annuity." If the death benefit makes the policy an insurance contract, the want of an insurable interest would defeat it. The document designated itself as a variable annuity, rather than an insurance contract, but "labels can be misleading, and the Rhode Island courts have sometimes looked beyond the title of a document to deem its substance to be insurance."[7] Here, the court noted, the insurer was obligated to pay at least the aggregate premiums invested in the annuity (plus interest) upon the annuitant's death. To this extent, the policy, at least in part, was functionally equivalent to a life insurance policy.

Unlike a traditional life insurance policy, however, the death benefit did not promise a defined sum at death, but only the greater of the market value of the policy or the

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1 On STOLI arrangements generally, see Leimberg and Zaritsky, *Tax Planning With Life Insurance*, ¶ 12.11[3] (Thomson Reuters/WG&L, 2d ed.); Beers, "Trends and Developments in Investor-Owned Life Insurance," 37 Tax Mgmt. Estates, Gifts & Tr. J. 325 (11/8/2012); Fleisher, "Stranger Originated Life Insurance: Finding a Modern Cure for an Age-Old Problem," 41 Cumb. L. Rev. 567 (2010/2011); Leimberg, "Planners Must Be Aware of the Danger Signals of 'Free' Insurance," 34 ETPL 20 (February 2007); Leimberg, "Stranger-Owned Life Insurance (SOLI): Killing the Goose That Lays Golden Eggs," 32 ETPL 43 (January 2005); Leimberg, "'Free' Life Insurance: Really a Free Lunch, or a Prelude to Acid Indigestion?" 41st U. Miami Est. Plan. Inst. ch. 3 (2007).

2 Western Reserve Life Assurance Co. of Ohio v. Conreal, LLC, 715 F. Supp. 2d 270 (DC R.I., 2010), *on app. sub nom.* Western Reserve Life Assurance Co. of Ohio v. Adm Associates, LLC, 2013 WL 6498968 (CA-1, 2013).

3 R.I. Gen. Laws § 27-4-27(a).

4 Citing Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101 (CA-2,. 2001).

5 Cronin v. Vt. Life Ins. Co., 20 RI 570, 40 A. 497 (R.I., 1898).

6 R.I. Gen. Laws § 27-4-27(c).

7 Citing Sisson ex rel. Nardolillo v. Prata Undertaking Co., 49 RI 132, 141 A. 76 (R.I., 1928) (Rhode Island Supreme Court went beyond the "burial contract[ ]" designation attached to certain agreements and held that the agreements actually comprised burial insurance).

8 Cronin v. Vt. Life Ins. Co., *supra* note 5.

9 R.I. Gen. Laws § § 27-72-1 to 27-72-18.

10 R.I. Gen. laws. § § 27-72-2(26), 27-72-2(9)(i)(A)(X), 27-72-14(a)(1).

11 See 16 Lord, *Williston on Contracts* § 49:95 (4th ed., 2013).

12 22 RI 524, 48 A. 800 (R.I., 1901).

13 Citing, e.g., Reagan v. Union Mut. Life Ins. Co., 189 Mass. 555, 76 NE 217 (Mass., 1905).

aggregate premiums paid for it. Moreover, the insurer made no effort to verify that the owner of the policy had any relationship with the annuitant, and it did not engage in the sort of medical underwriting that might have enabled it to calculate the annuitant's mortality risk.

As to the second issue, the court noted that the insurer chose to structure and market the transaction as an annuity, and annuities are not normally deemed to violate public policy for want of an insurable interest.[8] This type of annuity, however, differs substantially from the 19th century annuities that produced the current law, both because of its variable nature and its death benefit. The court believed that the Rhode Island Supreme Court should consider whether these changes are enough to remove the policy from Rhode Island's historic exclusion of annuities from the insurable interest requirement.

The court also asked the Rhode Island Supreme Court to consider how the state's Life Settlements Act affects this case.[9] The Rhode Island Life Settlements Act expressly forbids STOLI arrangements—"a practice or plan to initiate a life insurance policy for the benefit of a third-party investor who, at the time of policy origination, has no insurable interest in the insured."[10] This proscription expresses hostility to certain classes of transactions that are different than, but similar to, the transaction in this case, and the court believed that it required guidance regarding the possible impact of this legislation on the case in point.

Third, the court noted that whether an insurable interest was required for the policy may depend on whether it can be fairly characterized as a contract wagering on life. An argument can be made that, without an insurable interest, the policy is a wager on life, because the owner/beneficiary, a stranger to the annuitant, will receive money when the annuitant dies and, thus, cash in on what amounts to a wager. On the other hand, the court recognized a strong counterargument that a rule requiring an insurable interest for the policy could also cover any contract with a death benefit, propelling the insurable interest requirement far beyond the traditional province of life insurance.

The court also certified to the Rhode Island Supreme Court the operation of the policy's incontestability clause. The court noted that the incontestability clause, on its face, appears to bar any challenge, including one based on the lack of an insurable interest, but that interpretation presents two potential obstacles to such an unconditional reading.

First, Rhode Island public policy could refuse to countenance an incontestability clause that denies any contestability period. The Rhode Island Supreme Court has not addressed this question, and courts elsewhere are divided.[11] In the present case, the court pointed out that in Murray v. State Mutual Life Ins. Co.,[12] the Rhode Island Supreme Court observed, albeit in dictum, that a two-year incontestability clause is "not an absolute stipulation to waive all defenses and to condone fraud." The fear of condoning fraud has led some other courts to refuse to enforce incontestability clauses analogous to the clause at issue in this case.[13] That same case, however, also emphasized the importance of holding the underwriter of a policy to its duty "to fulfill its plain and deliberately assumed obligation," which arguably favors the literal enforcement of incontesta-

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bility clauses, particularly those that operate in favor of the insured.

Also, the court noted, the special risk of fraud associated with immediate incontestability clauses may be offset by a built-in protection. Thus, some courts have upheld immediate incontestability clauses, noting that the insurer had an unlimited time, prior to issuing the policy, to investigate the incidence of fraud.[14]

The court also explained that, even if the potential obstacle presented by the immediacy of an incontestability clause can be overcome, an issue remains as to the force of such a clause with regard to a defense premised on the lack of an insurable interest. This issue is largely unaddressed in Rhode Island case law, and the other jurisdictions that have addressed it have been unable to reach a consensus.[15]

Conclusion

It remains uncertain whether the law in most states requires an insurable interest in an annuitant's life similar to that required to buy a life insurance contract. Differences in various annuity products and riders and in state law complicate the issue, as do differences between common and statutory insurable interest requirements, and regulatory jurisdiction. It may also be argued that the insurable interest requirements for annuities with life insurance elements are substantially similar to those for life insurance contracts. The public policy should be the same regarding investors originating annuities for speculative value profit if the annuitant purchasing such a contract does not live long enough to begin collecting annuity payments, and for insureds on life insurance policies. On the other hand, given the investment nature of such contracts, there is some incentive for investors to want the annuitant to live for at least some relatively short period of time if the investments inside the annuity are performing well.

Using a stranger's life to prompt a transaction that, by design, will ultimately cause an investor to have more to gain from the stranger's death than his or her continued life raises enough of an insurable interest concern to justify judicial and regulatory concern, and practitioners should await at least the opinion of the Rhode Island Supreme Court and the U.S. Court of Appeals for the First Circuit, before advising clients to enter into these transactions. ■

[14] See, e.g., Pac. Mut. Life Ins. Co. v. Strange, 223 Ala. 226, 135 So. 477 (Ala., 1931).

[15] A majority of courts hold that a life insurance policy lacking an insurable interest is void as against public policy and thus the incontestability provision cannot apply. Citing PHL Var. Ins. Co. v. Price Dawe 2006 Ins. Trust ex rel. Christiana Bank and Trust Co., 28 A.3d 1059 (Del., 2011) (collecting cases); and Cronin v. Vt. Life Ins. Co., 20 RI 570, 40 A. 497 (R.I., 1898) (court did not specifically address the insurable interest requirement in the context of an incontestability clause, but it hinted that Rhode Island might align itself with this view). Some courts, however, have held that an insurable interest defense cannot trump an incontestability clause, because the policy is voidable, rather than void. See, e.g., Bogacki v. Great-West Life Assurance Co., 253 Mich. 253, 234 N.W. 865 (Mich., 1931); New Eng. Mut. Life Ins. Co. v. Caruso, 73 N.Y.2d 74, 538 N.Y.S.2d 217, 535 N.E.2d 270 (N.Y., 1989); cf. Monast v. Manhattan Life Ins. Co., 32 R.I. 557, 79 A. 932 (R.I., 1911) (deeming it "clear both upon principle and authority that a life insurance policy is not void because the premiums have been paid ... by one having no insurable interest in the life of the assured"). This minority position arose after the Cronin dictum.

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MARCH 2014
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