Life Insurance Update: Rescission and STOLI

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Speaker Biography

Jason Walters is a litigation partner with Bradley Arant Boult Cummings LLP and serves as national and regional counsel for life and health insurance companies. His practice encompasses both individual and class action litigation, with particular emphasis in the area of fraudulent sales practices and the bad faith denial of benefits for life insurance, annuities, and health insurance products. Jason also has extensive experience defending insurers in litigation filed by agents and independent marketing organizations in cases that typically involve damages for lost profits. In addition to his litigation experience, Jason has counseled clients on managing risk and reducing legal expenses through the use of alternative fee agreements. Jason has structured significant alternative fee agreements for both individual and class action litigation and has been published on the topic. Jason is a member of the Association of Life Insurance Counsel, the ABA Life Insurance Law Committee, and the DRI Life, Health and Disability Committee. He frequently lectures and publishes on issues of importance to the life and health insurance industry.

I. Introduction

This presentation discusses recent case law involving policy rescission and the sometimes related issue of stranger-originated life insurance ("STOLI").

II. Rescission

A. Risk Posed by Rescission

Although policy rescission is a relatively common occurrence in the life insurance industry, the practice can present significant exposure when pursued improvidently. In *Mitchell v. Fortis Insurance Co.*, 686 S.E.2d 176 (S.C. 2009), for example, the defendant's rescission of a health insurance policy resulted in a punitive damages verdict of more than $15 million. The South Carolina Supreme Court ultimately remitted the verdict to $10 million.

B. Choice of Law

When deciding whether to rescind a policy, insurers must first determine which state's law applies. Because a proper rescission in one state may create bad faith liability in another, this determination should be made carefully and without making assumptions.

Two recent cases illustrate the choice of law analysis in rescission cases. In *Gomez-Silva v. Jackson National Life Insurance Co.*, No. CV09-2120, 2011 WL 1656507 (D. Ariz. May 3, 2011), the court analyzed whether Arizona or California law applied. The court followed § 192 of the Restatement (Second) of Conflict of Laws, which provides as follows:

> The validity of a life insurance contract issued to the insured upon his application and the rights created thereby are determined, in the absence of an effective choice of law by the insured in his application, by the local law of the state where the insured was domiciled at the time the policy was applied for, unless, with respect to the particular issue, some other state has a more significant relationship under the principles stated in § 6 to the transaction and the parties, in which event the local law of the other state will be applied.

Even though the policy in *Gomez-Silva* provided that California law applied, the court held that the choice of law provision in the policy was not dispositive since the provision was not contained in the *application*, as stated in § 192. The court then concluded that Arizona law applied because the insured was domiciled in Arizona when he submitted the application and because California did not have a

more significant relationship to the parties or the transaction, as provided in § 6 of the Restatement. As a result, the court denied the insurer's motion for summary judgment, which was based on California law.

In *American General Life Insurance Co. v. Billard*, No. C10-1012, 2011 WL 797675 (N.D. Iowa March 1, 2011), the court applied § 192 of the Restatement to determine the applicable state law. Since the policy application did not contain a choice of law provision, the court looked to the insured's state of domicile at the time he applied for the policy, which was Florida. Because the court concluded that neither Texas nor Iowa had a more significant relationship to the transaction than Florida, it ruled that Florida law governed.

It is also important to remember that federal law may apply to the rescission of ERISA policies. In *Garcia v. American United Life Insurance Co*., No. 10-40388, 2011 WL 1409222 (5th Cir. Tex. April 13, 2011), for example, the court held that Texas law did not apply to the insurer's decision to rescind the policy because the plaintiff brought suit under ERISA. As a result, federal law governed.

C. Ambiguity in Application

When an insured contests rescission, one of the first arguments he or she typically makes is that the response provided on the application was not a misrepresentation. When the questions on an application are not clear or when they can be construed as subjective questions that seek an opinion answer, courts may preclude the insurer from rescinding the policy.

In *Loza v. American Heritage Life Insurance Co*., No. 10-15651, 2011 WL 2066549 (9th Cir. May 26, 2011), for example, the plaintiff argued that a prostate-specific antigen test ("PSA test") did not constitute a "diagnostic test for cancer,"—a term contained in the defendant's application—because the test could not identify or rule out the presence of cancer. The Ninth Circuit agreed, holding that the term was ambiguous and that the defendant was not entitled to rescission. The court reversed summary judgment in favor of the defendant on the insured's breach of contract claim, as well as his tort claims for bad faith, negligent infliction of emotional distress and intentional infliction of emotional distress.

In *Brondon v. Prudential Insurance Co.*, No. 09-CV-6166T, 2010 WL 4486333 (W.D.N.Y. Nov. 9, 2010), the court found that the term "heart trouble" as used in the defendant's application was ambiguous. As a result, the insurer could not rely on the alleged misrepresentation of the insured's health condition to rescind her policy. The court also awarded the insured attorneys' fees, costs, and prejudgment interest under ERISA.

In *Barry v. United States Life*, No. 2:09-cv-1790, 2011 WL 1832995 (D.N.J. May 12, 2011), the insured died one month after the policy was issued. On the

application, the insured failed to disclose that he had a "disease or disorder" of the liver, despite the fact that his prior blood tests had evidenced abnormal liver function and that his doctor had recommended an ultrasound test. Importantly, the court concluded that this question was subjective, not objective, and that as a result, the insurer was required to prove an intentional misrepresentation. The court then held that there was no evidence that the insured had actually known the details of his health condition, precluding the inference that he intentionally misrepresented his health status on the application. *Barry* illustrates the difficulty in intentional misrepresentation states of establishing the intent of a deceased insured.

D. Knowledge of Agent Imputed to Insurer

Another argument commonly made by insureds who contest policy rescission is that the agent knew the true facts and that his knowledge is imputed to the insurer.

In *O'Riordan v. Federal Kemper Life Assurance*, 114 P.3d 753 (Cal. 2005), for example, the insurer rescinded the policy after the plaintiff's wife died of breast cancer on that basis that the insured failed to disclose her smoking habit. The insured's medical records indicated that she had requested a nicotine patch less than a year before she applied for the policy, although no nicotine was found in her system during the medical exam. During the application process, the insured had told her agent that she might have had a couple cigarettes during the preceding two years. The court held that this knowledge was imputed to the insurer. In light of the dispute over the insured's cigarette use, it reversed the summary judgment in favor of the insurer.

While an agent's knowledge may be imputed to the principal, insurers can also argue that the agent did not have full knowledge of the facts. In *Northwestern Mutual Life Insurance Co. v. Gil*, No. 3:07-cv-00303, 2009 WL 276086 (D. Conn. Feb. 5, 2009), for example, the insured's estate argued that the insurer was charged with the agent's knowledge of the insured's marijuana use. But the court found that even if the agent had known the insured used marijuana, there was no evidence that he knew of the insured's cocaine use or his psychiatric treatment. As a result, the court held that rescission should be granted.

An exception to the rule of imputed knowledge arises when the agent was acting in a manner that was adverse to the principal. A STOLI transaction is a good example. In *Penn Mutual Life Insurance Co. v. Norma Espinosa 2007-1 Trust Co.*, No. 09-300-JJF, 2010 WL 3023402 (D. Del. July 30, 2010), a STOLI case, the court held that the agent's knowledge was not imputed to the insurer because the agent's own interests became adverse to the insurer's interests.

E. Other Positive Rescission Cases

In *Park v. Metropolitan Life Insurance Co.*, No. 10-481, 2011 WL 1226273 (3rd Cir. March 30, 2011), the Third Circuit affirmed the rescission of a life insurance policy where the insured misrepresented his medical history.

Similarly, in *Adam v. Stonebridge Life Insurance Co.*, 612 F.3d 967 (8th Cir. 2010), the Eighth Circuit affirmed summary judgment in favor of the insurer where the insured falsely answered "no" to the health questions on a simplified issue policy application.

In *Harper v. Fidelity and Guaranty Life Insurance Co.*, 234 P.3d 1211 (Wyo. 2010), the court affirmed summary judgment in favor of the insurer where the insured failed to disclose a history of heart problems and alcohol abuse. Importantly, the court found that the insurer did not have a duty to investigate the truthfulness of the insured's application responses.

In *Massachusetts Mutual Life Insurance Co. v. Jordan*, No. 3:10-0016, 2011 WL 1770535 (S.D.W. Va. May 9, 2011), the court granted summary judgment in favor of the plaintiff insurance company where the insured failed to disclose a heroin overdose less than one year before he applied for the policy. The court rejected the argument that the question in the application was ambiguous.

III. STOLI

A. Insurable Interest and the Contestability Clause

Two issues predominate in STOLI litigation. The first is whether a STOLI policy is void *ab initio* for lack of an insurable interest. The second is whether an insurer is entitled to rescind a STOLI policy due to lack of an insurable interest after expiration of the two-year contestability period.

Perhaps the most notable STOLI decision handed down within the last year is *Kramer v. Phoenix Life Insurance Co.*, 940 N.E.2d 535 (N.Y. 2010). In *Kramer*, the New York Court of Appeals held that STOLI policies are valid under New York law. More specifically, the court concluded that New York Law permits a person to procure an insurance policy on his or her own life and immediately transfer it to one without an insurable interest in that life, even where the policy was obtained for just such a purpose. Fortunately, the impact of the *Kramer* holding is limited because New York passed anti-STOLI legislation in 2009, with an effective of May 18, 2010.

The California Fourth District Court of Appeal reached a similar decision in *Lincoln Life and Annuity Co. v. Berck*, No. D056373, 2011 WL 1878855 (Cal. Ct. App. May 17, 2011 (unpublished). The court held that two STOLI policies with a combined death benefit of $20 million could not be declared void *ab initio*

because an insurable interest existed at their inception. The court ruled that the subsequent assignment of the policies was permissible under California law. The court further held that California's anti-STOLI legislation, which took effect July 1, 2010, did not apply.

The opposite conclusion was reached under Illinois law in *Ohio National Life Assurance Corp. v. Davis*, No. 10 C 2386, 2011 WL 2680500 (N.D. Ill. July 6, 2011). Distinguishing *Kramer* (albeit in a footnote), the court denied the defendant's motion to dismiss the insurer's claims arising out of a STOLI transaction, holding that the insurer sufficiently alleged that the policy lacked an insurable interest. The court further concluded that the two-year contestability clause did not bar the insurer's claims because the policy was a wagering contract.

A similar decision was reached in *Pruco Life Insurance Co. v. Brasner*, No. 10-80804, 2011 WL 134056 (S.D. Fla. Jan. 7, 2011). Here the court denied the defendant's motion to dismiss because the insurer's allegations, if proven, would establish that there was an agreement in place before the policy was issued to assign the policy to a third party with no insurable interest. Although the contestability period had expired, the court followed what it considered to be the "majority view … that incontestability clauses have no effect where a policy is void *ab initio* for lack of an insurable interest."

In *Sun Life Assurance Company of Canada v. Berck*, No. 09-498-SLR, 2011 WL 922289 (D. Del. March 16, 2011), the court reached the same decision as did the courts in *Davis* and *Brasner*. Applying Delaware law, the court denied the defendants' motions to dismiss, holding that the insurer sufficiently alleged that the policies were void for lack of an insurable interest. The court further concluded that the contestability clause did not bar the insurer's claims.

B. Return of Premiums

Another prevalent issue in STOLI litigation is whether the insurer is entitled to retain some or all of the premiums paid on a STOLI policy in addition to obtaining a declaration that the policy is void for lack of an insurable interest. Increasingly, courts are permitting insurers to proceed with such claims.

In *PHL Variable Insurance Co. v. Lucille E. Morello 2007 Irrevocable Trust*, No. 10-1696, 2011 WL 2717950 (8th Cir. July 14, 2011) (applying Minnesota law), the court held that the insurer was permitted to retain the premiums paid on a STOLI policy due to the intentional fraud that was perpetrated by the participants in the STOLI scheme.

In *Pruco Life Insurance Co. v. Brasner*, No. 10-80804, 2011 WL 134056 (S.D. Fla. Jan. 7, 2011), the insurer requested that the defendants be estopped from seeking a return of premiums. One of the defendants moved to dismiss this

request, and the court denied the motion, noting that "some courts have allowed insurers to seek to retain premiums."

In *Principal Life Insurance Co. v. Lawrence Rucker 2007 Insurance Trust*, No. 08-488-MPT, 2011 WL 1195878 (D. Del. March 30, 2011), the court held that the insurer could not retain the premiums paid on the policy, but that it could seek to recover damages for the expenses it incurred issuing the policy.

In *TTSI Irrevocable Trust v. Reliastar Life Insurance Co*., 60 So. 3d 1148 (Fla. Dist. Ct. App. 2011), the court held that under Florida law the insurer was entitled to retain the premiums paid on a policy that was void *ab initio* for lack of an insurable interest.

In *Hartford Life & Annuity Insurance Co. v. Doris Barnes Family 2008 Irrevocable Trust*, No. CV 10-7560, 2011 WL 759554 (C.D. Cal. Feb. 22, 2011), the court denied the defendant's motion to dismiss the insurer's request for a declaration that it was entitled to retain some or all of the premiums paid on a STOLI policy. The court held that it would be premature to dismiss the insurer's claim and also cited authority supporting the argument that the insurer was entitled to such relief.