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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

The 4th Circ. Stance In First Penn V. Evans

Law360, New York (May 15, 2009) -- One of the many challenging issues currently facing the life insurance industry is the increasing prevalence of stranger-originated life insurance transactions, commonly referred to as STOLI.

In the typical STOLI transaction, an elderly individual obtains life insurance on his own life by financing the premiums through a third party, with the understanding or agreement that the policy will later be sold to an entity lacking an insurable interest — usually following the policy's two-year contestability period.

STOLI has become a big business, and it is having a significant impact on the bottom lines of many life insurance companies.

First Penn v. Evans

Increasingly, life insurers are fighting back against STOLI by instituting lawsuits to rescind STOLI policies on grounds that they are void due to a lack of an insurable interest in the life of the insured and/or based on material misrepresentations in the application. The results of this litigation have been mixed.

In First Penn-Pacific Life Insurance Co. v. Evans, 2009 WL 497394 (4th Cir. Feb. 26, 2009) (unpublished), the Fourth Circuit Court of Appeals recently held that an insurable interest existed in a STOLI transaction, even though the insured intended to assign the policy when he submitted the application.

The insured in Evans fraudulently obtained seven life insurance policies that provided $8.5 million in coverage. The insured then falsely represented to a viatical settlement broker that he was terminally ill and sold six of the seven policies. One of the policies he sold was issued by First Penn-Pacific Life Insurance Company ("First Penn").

First Penn filed a lawsuit in federal court seeking to rescind the policy due to the lack of an insurable interest. The district court entered summary judgment in favor of the defendants, and First Penn appealed to the U.S. Court of Appeals for the Fourth Circuit.

The primary issue presented on appeal to the Fourth Circuit was whether an insurable interest existed under Arizona law at the time the policy was issued.

The Fourth Circuit found that it did and affirmed the order granting summary judgment in favor of the

defendants. The court held that even though the insured planned to sell the policy at the time he applied for it, an insurable interest existed because an individual clearly has an insurable interest in his own life.

The court rejected First Penn's argument that it should consider the insured's intent, reasoning that "evaluating insurable interest on the basis of the subjective intent of the insured at the time the policy issues, as First Penn would have us do, would be unworkable and would inject uncertainty into the secondary market for insurance."

On its face, the bright-line test employed by the Evans court (i.e., whether an insurable interest existed at the time of application) would seemingly result in approval of all STOLI transactions. Policies could even be assigned within the two-year contestability period (which was arguably the case in Evans) because an insurable interest would always exist at the time of application.

Read more closely, however, the Evans opinion is not necessarily the panacea the STOLI community would like for it to be.

Although the court rejected the evaluation of insurable interest based on the subjective intent of the applicant, the court also noted that there was "no evidence that anyone other than [the insured] was a participant in the scheme at the time [he] obtained the First Penn policy."

In other words, "[n]o third party participated in the procurement of [the] policy and therefore no one was 'wagering' on [the insured's] life in violation of public policy."

The court seems to be implying here that if a third party had been involved from the beginning, and if there had been objective evidence of an agreement to assign the policy after issuance, then the court may have sided with the insurer and found that the insurable interest requirement was lacking.

In fact, the court even went so far as to cite in a footnote a Minnesota case that reached that very holding.

In Sun Life Assurance Co. of Canada v. Paulson, 2008 WL 5120953 (D. Minn. Dec. 3, 2008), the court dismissed Sun Life's claims on the basis that Sun Life had not adequately alleged that the applicant and a third party shared a "mutual intent" at the time of application to subsequently assign the policy.

The court held that under Minnesota law, an insurer must be able to show that there was a mutual intent between the applicant and a third party in order to establish that the insurable interest requirement is lacking.

The Evans court also cited Life Product Clearing LLC v. Angel, 530 F. Supp. 2d 646 (S.D.N.Y. 2008). Although the court cited Angel for the proposition that "a third party must be involved in the procurement of the policy to eliminate the insurable interest," the court apparently read more into the Angel decision than was there.

In fact, the court in Angel specifically explained that the insurable interest analysis requires courts to consider "the intent of the insured ... at the time the policy is procured."

The court did not specifically require the involvement of a third party as suggested in Evans, though evidence of such involvement certainly helps in establishing the applicant's intent to subsequently assign the policy.

In fact, Angel could just as easily be cited for the proposition that insurable interest is determined by the subjective intent of the applicant, which, ironically, is the very holding that the Evans court rejected.

Nevertheless, ample evidence that a third party was complicit in a STOLI transaction at the time of application will almost always bolster an insurer's argument that the policy should be declared void for lack of an insurable interest.

Practical Considerations

Although Evans leaves as many questions as answers, it offers some important practice tips, particularly when read in conjunction with Paulson and Angel. First and foremost, specifically pleading the involvement of a third party is critical.

Before asserting a claim for rescission, insurers should muster all the evidence they can obtain in order to show that the insured and a third party mutually intended, at the time of application, to subsequently assign the policy to a party lacking an insurable interest.

This information will be helpful regardless of what the applicable law requires. These facts should then be specifically set forth in the complaint (or counterclaim) in sufficient detail to survive the inevitable motion to dismiss.

To the extent the insurer lacks such evidence, but can in good faith and in compliance with Rule 11 allege the involvement of a specific third party, the insurer should do so in as much detail as possible.

This will allow the insurer to get beyond the pleading stage and develop facts during discovery to support its argument that an insurable interest was lacking and that the policy should be rescinded.

--By Jason A. Walters, Bradley Arant Boult Cummings LLP

Jason Walters is a partner with Bradley Arant in the firm's Birmingham, Ala., office.

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