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Looking Back At The Life Settlements Industry In 2018

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The U.S. life settlements industry, an alternative asset investment industry in which investors purchase and trade in-force life insurance policies, experienced a 2018 that was very similar to 2017. Last year saw only a few legislative changes, but there were further developments in the areas of stranger-originated life insurance cases, progression of cost of insurance litigation, further implementation of key Internal Revenue Code changes and new privacy and data security laws.

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Stranger Originated Life Insurance/Insurable Interest Litigation

While the number of newly filed stranger-originated life insurance, or STOLI, cases, challenging the validity of investor-financed life insurance policies on the basis of lack of insurable interest in the life of insureds at the time of policy issuance, continued to decline in 2018, the courts decided a few important STOLI cases last year.

In Sun Life Assurance Company of Canada v. Wells Fargo Bank,[1] the Third Circuit Court of Appeals was presented with an appeal of the New Jersey district court's 2016 grant of summary judgment to Sun Life finding that a $5 million policy issued in 2009 that matured in 2014, was void for lack of a valid insurable interest. The Third Circuit certified to the New Jersey Supreme Court two questions: (1) does a life insurance policy that is procured with the intent to benefit persons without an insurable interest in the life of the insured violate the public policy of New Jersey, and if so, is that policy void ab initio, and (2) if such a policy is void ab initio, is a later purchaser of the policy, who was not involved in the illegal conduct, entitled to a refund of any premium payments that it made on the policy. Currently, there is a split of judicial authority on these issues, and the New Jersey Supreme Court has not yet issued its advisory opinion.

The Second Circuit Court of Appeals made an important choice of law decision in AEI Life LLC v. Lincoln Benefit Life Insurance Company.[2] this case presented a choice of law dispute between the substantive laws of New York and New Jersey. The court held that New York's center of gravity test applied to a life insurance policy issued pursuant to a fraudulent life insurance application in which the insured's net worth was grossly overstated and that, under New York's insurance law, namely New Eng. Mut. Life Insurance Co. v. Caruso,[3] the policy could not be contested after the expiration of its two-year contestability period. The court rejected the argument that the policy's New Jersey life insurance application's conformity of law clause acted as a choice of law provision to apply New Jersey insurable interest law, which, had it applied, would have allowed an insurable interest challenge to the policy to be made by the issuer of the life insurance policy any time after the policy's contestability period had expired..

In Sun Life Assur. Co. v. Conestoga Trust Services LLC,[4] a federal district court in 2017 had concluded that a life insurance policy was originated for an investor without an insurable interest in the life of the insured. Therefore, the court found that the policy constituted an illegal STOLI scheme that violated Tennessee public policy. The court concluded that the policy was void ab initio and that Sun Life did not have to pay the death benefit to the owner of the policy at the time of the insured's death, but that Sun Life was required to refund the premiums paid by that owner. The Sixth Circuit affirmed the district court decision in May 2018, in a short three page opinion, and in October 2018, the United States Supreme Court declined to review the case.

Last year saw the emergence of a relatively new theory of liability with respect to defendants that may be loosely referred to as "STOLI promoters." A STOLI promoter can best be described as a designer and marketer of STOLI programs for the benefit of third party investors that lack an insurable interest in the life of the insureds. The plaintiffs in these suits might be the STOLI investors who lose their investment when a court voids the underlying policy or the estates of the insureds when the life insurance company that issued the STOLI policy pays the death benefit proceeds to the investors or to a court in an interpleader action rather than to the natural beneficiaries of the insured.[5] Also, in United States of America v. David Quatrella,[6] the Second Circuit concluded that a federal district court in Connecticut properly found that investors in three STOLI policies were victims under the federal Mandatory Victim Restitution Act (18 U.S. Code § 3663A) and ordered a man who pleaded guilty to insurance fraud to pay $1.9 million in restitution. The Second Circuit explained that investors would not have given the defendant their money if they were aware of the promoter's unlawful scheme.

Last year we also noticed some life insurance companies were pursuing insurance producers to recover commissions paid and other damages in connection with voided STOLI policies. For example, Sun Life Insurance Company of Canada v. Wells Fargo Bank and Frank Nelson,[7] involved a STOLI policy in which the trial court concluded that Wells Fargo may bring an action under Illinois law to recover premiums it innocently paid (but not premiums paid by any other person) on a voided STOLI policy. The court also concluded that the issuing life insurance company may sue the producer to whom the life insurance company had paid commissions with respect to the sale of the policy and that the producer may not defend the claim on the basis that the contestability period has expired and, in any event, the incontestability clause is not enforceable under Illinois law with respect to a STOLI policy that is void ab initio.

The Imperial Premium Finance LLC litigation with Sun Life Insurance Company of Canada continued into 2018. In September 2018, the Eleventh Circuit issued an opinion in Sun Life Assurance Company of Canada, v. Imperial Premium Finance LLC.[8] These cases arose in connection with Sun Life's action against Imperial (now known as Emergent Capital Inc.) relating to what Sun Life alleged was a STOLI origination program which resulted in Imperial holding a portfolio of STOLI policies, the original owners of which had all defaulted on nonrecourse premium finance arrangements.

Imperial, for its part, contended in a separate action that its acquisition and ownership of the policies was lawful, and alleged that Sun Life's attempts to interfere with its ownership of and rights under the policies, including Sun Life's filing of its lawsuit, was itself part of Sun Life's own fraudulent scheme and in breach of the life insurance policy contracts. In a series of rulings in the consolidated cases, the U.S. District Court for the Southern District of Florida dismissed all claims of the parties. The Court of Appeals vacated in part and affirmed in part and remanded the case for further proceedings. Imperial has petitioned for an en banc review or, in the alternative, the certification of questions to the Florida Supreme Court. On appeal, Sun Life had argued, for apparently the first time, that the trial court should have conducted a fact-intensive analysis of which states' laws applied to the dispute before applying Florida law to the case. That is often a significant and outcome-determinative issue in STOLI litigation.

However, the appellate court concluded that "Sun Life waived its opportunity for the district court to apply non-Florida law to the policies at issue." The district court had dismissed Sun Life's Racketeer Influenced and Corrupt Organizations Act and fraud claims based on the alleged Imperial fraudulent scheme, concluding that those claims were time-barred by operation of the two-year incontestability clause in the policies. On appeal, the appellate court concluded that the expiration of the incontestability period does not apply to the RICO and fraud claims and vacated the district court decision to the contrary. The appellate court reversal could be interpreted as a method by which a life insurance company could easily circumvent the incontestability clauses in policies in actions against a STOLI promoter — see above.

Sun Life also alleged that Imperial tortuously interfered with Sun Life's producer contracts with its sales agents by directing the producers to submit fraudulent life insurance applications to Sun Life. The district court had dismissed that claim, but the appellate court reinstated it. Sun Life also sought a declaratory judgment that "each of the policies procured through the Imperial scheme lacked an insurable interest at its inception and should be declared void ab initio." The premise of the claim is that the policies owned by Imperial were unlawful in light of state law prohibiting the procurement of life insurance policies in which the beneficiary lacks an "insurable interest" in the insured individual at the time the policy is issued. The district court dismissed the claim under Rule 12(b)(6) and the appellate court affirmed because Sun Life effectively conceded that its declaratory judgment claim was foreclosed under controlling Florida law by Wells Fargo Bank N.A. v. Pruco Life Insurance Co.[9]

On the Imperial side of the ledger, Imperial alleged that Sun Life's efforts to obstruct Imperial's ownership rights separately breached two provisions of the life insurance policy agreements: (1) the incontestability clause and (2) the rights-and-privileges clause. The Court of Appeals reversed the trial court's dismissal of Imperial's claim holding that "Unlike Sun Life's fraud-based claims, Sun Life's claim for a declaratory judgment that the policies are void ab initio plainly 'contest[ed]' the policies under controlling Florida law. … And, having filed its declaratory judgment claim more than two years after issuance of the policies, [Imperial] has plausibly alleged that Sun Life breached the terms of the incontestability clause." Sun Life had also successfully argued below that Florida law does not allow damages suits for the breach of an incontestability clause. The district court accepted this argument, concluding that the incontestability clause may be raised only as a shield, not as a sword, but the Court of Appeals disagreed and reversed.

Tax Cuts and Jobs Act

IRS Reporting of Acquisitions of Direct and Indirect Interests in Life Insurance Contracts

The Tax Cuts and Jobs Act created new Section 6050Y under the Internal Revenue Code that, among other things, imposes reporting obligations on most acquirers of life insurance policies in secondary market transactions after Dec. 31, 2017. Reporting is required for "reportable policy sales" which are defined as the acquisition of an interest in a life insurance contract [policy] if the acquirer has no substantial family, business or financial relationship with the insured [i.e., no insurable interest]. The term "indirectly" applies to the acquisition of an interest in a partnership, trust or other entity that holds an interest in a life insurance contract.

In April 2018, the U.S. Department of the Treasury and the Internal Revenue Service published Notice 2018-41 in which they announced that they intended to issue proposed regulations providing guidance to assist taxpayers in complying with their information reporting obligations for reportable policy sales. In the notice, the DOT and IRS requested public comment and also stated that reporting would not be required until final regulations are issued. The notice provided that the final regulations would allow for additional time after the date the final regulations are published to file reports for post 2017 reportable policy sales. Numerous organizations submitted comments to the DOT and IRS to assist in the development of proposed regulations, including the Life Insurance Settlement Association and the American Council of Life Insurers. In September 2018, the IRS published one proposed reporting form (Form 1099-LS) for comment. However, as of the date of this writing, no proposed regulations have been published by the DOT or the IRS. The impact of the federal government shutdown may delay even further the publication of proposed regulations.

Global Intangible Low-Taxed Income

The new Global Intangible Low-Taxed Income, or GILTI, tax affected many types of controlled foreign corporations, or CFCs, subject to income tax on phantom income imposed by Subpart F of the IRC. Now offshore life settlement investment funds that are viewed as corporations for U.S. income tax purposes must also contend with the GILTI tax and avoid having U.S. shareholders that trigger CFC status. Before the TCJA, offshore life settlement investment funds generally avoided taxation as a CFC because death benefit income is not Subpart F income, but GILTI represents a new type of passive investment income that is separate from Subpart F income and can now apply to these funds.

Carried Interest Three-Year Holding Period for Capital Gains Treatment

For most general partners or investment managers of hedge funds and private equity funds, in order to receive capital gains treatment on the carried interests in such funds, they must now hold their carried interests for a minimum of three years under new IRC Section 1061. However, investment funds subject to IRC Section 1061 are defined by reference to making investments in “specified assets,” which include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts. Because life insurance policies do not constitute a “specified asset,” fund managers of life settlements investment funds should remain subject to the pre-TCJA one-year holding period for capital gains treatment on their carried interests.

Cost of Insurance Litigation and Regulation

Last year saw notable settlements in pending cost of insurance, or COI, cases, together with some newly filed cases. We can expect more of the same in 2019. These cases are relevant to the life settlement industry because COI increases adversely impact expected investment returns for life settlements portfolios and new investor interest in this asset class. The settlements involve COI litigation against John Hancock Life Insurance Company, 37 Besen Parkway LLC v. John Hancock Life Insurance Company,[10] that involved a settlement fund in excess of $90,000,000, and Transamerica [Gordon and Mary Feller et al., v. Transamerica Life Insurance Company,[11] in which Transamerica agreed to pay $195,000,000 relating to 2015 COI increases on approximately 70,000 universal life insurance policies. The Transamerica settlement payments will automatically increase the account values of the existing policies owned by class members, and owners of terminated policies will receive cash payments. Transamerica has also agreed not to impose any additional increases in the monthly deduction rate schedules applicable to the class members' policies for a period of five years unless the company is ordered to do so by regulatory authorities.

The John Hancock case is interesting because the core allegation in that case was that COI charges should have decreased due to improved mortality for the class of policyholders. In another John Hancock settlement, Larson v. John Hancock Life Insurance Co.,[12] John Hancock agreed to pay a settlement class approximately $60,000,000. In that case, the Larson class action plaintiff argued that the company failed to decrease the cost of insurance charges on one particular policy, Flex V Premium Variable Whole Life Insurance — despite improved mortality rates across the country. In Vogt v. State Farm Insurance,[13] on June 6, 2018, a federal jury in the Western District of Missouri awarded $34.3 million in compensatory damages to a class of approximately 43,000 current and former State Farm Life Insurance Company universal life policyholders. The complaint alleged that State Farm systematically deducted cost of insurance and expense charges from each policy owner's policy's account value in amounts greater than those authorized by the policy. The case has been appealed by both parties.

New cases involve Voya Retirement Insurance and Annuity Company and Lincoln Financial Group, the administrative agent and reinsurer on the policies (United States District Court — Southern District of New York). The core allegation of these cases is that Voya "breached the standardized, form insurance policies owned by all members of the proposed Class by raising COI rates," and whether Aetna's (the original issuer of several classes of the universal life insurance policies) reinsurer, Lincoln, was unjustly enriched as a result. The complaint pointed to language in the policies to the effect that any changes in COI on the policies in question were to be based on "estimates for future cost factors." The complaint alleged that Aetna breached these contractual provisions, and that Lincoln was "unjustly enriched."

Security Life of Denver faces a class action lawsuit filed in July 2018 in Colorado, which alleges that policyholders of the Strategic Accumulator Universal Life and Life Design Guarantee Universal Life policies have paid unlawful and excessive premiums as a result of cost of insurance increases announced in September of 2015 and that these increases are designed to increase the company's profitability and further its goal of inducing policy lapses and relieving itself of payments of potential death claims. The company has acknowledged that increased premium amounts may impact persistency of the policies but has denied that the COI increases were intended to induce higher than average lapse rates.[14]

On the regulatory front, in March 2018 the New York Department of Financial Services' Regulation 210 (11 NYCRR 48) became effective. This regulation requires life insurance companies transacting business in New York to (1) establish criteria approved by the company's board of directors for determining nonguaranteed charges and benefits for life insurance policies, including how policies are assigned to different "classes" of insured, (2) follow specified requirements and procedures for revising a scale of nonguaranteed elements of life insurance policies, (3) file with the NYDFS certain actuarially supported information regarding any adverse change in a policy's current scale of nonguaranteed elements at least 120 days before its implementation and (4) provide written disclosures to policyholders at policy issuance regarding the policy's current scale of nonguaranteed elements and at least 60 days prior notice of any subsequent adverse change thereto.

Legislative and Regulatory Developments

Life Settlement Laws

Life settlement transactions are now regulated in 44 states through their insurance codes. In 2018, there were few legislative developments for this industry. Delaware eliminated the licensure requirement that a life settlement broker maintain a bond or other qualified financial security in the amount of $250,000, which requirement is based on model life settlements acts. This should increase the number of life settlement brokers transacting business in Delaware. Rhode Island adopted a consumer disclosure law, which the life settlements industry has pushed in other states, requiring the life insurance companies to deliver written notice to policyholders that a life settlement may be an option for them in lieu of a lapse or surrender of a life insurance policy.

NAIC Life Insurance Online Guide's Addition of Life Settlements

The National Association of Insurance Commissioner's Life Insurance Online Guide (A) Working Group began developing an online version of the NAIC's Life Insurance Buyer's Guide which would be hosted on the NAIC's website and will likely include consumer information about a life settlement transaction. Specifically, the online guide is likely to provide information about what a life settlement transaction is, the primary reasons for a policyholder to sell a life insurance policy, the characteristics of a typical seller and insured, the amount a seller may expect to receive and how the sales process usually works.

Fiduciary and Best Interest Laws and Regulations

Although the Fifth Circuit's 2018 vacatur of the federal U.S. Department of Labor's fiduciary rule was a significant victory for the life insurance industry, its application would have had little impact on the life settlement industry because very few life settlement investment structures use ERISA/IRA assets. Furthermore, life settlement brokers are (and were prior to the promulgation of the DOL's fiduciary rule) subject to a statutorily imposed fiduciary obligation under state life settlement laws to original owners of life insurance policies selling their policies.

On April 27, 2018, the New York Department of Financial Services issued a revised "Suitability in Life Insurance and Annuity Transactions" (commonly referred to as the "best interest" rule) that expressly removed the mandate in the regulation as initially proposed that would have required life insurance producers (and life insurance companies) to inform inquiring consumers that a life settlement transaction was an available alternative to the lapse or surrender of their life insurance policy to the issuing company. The revised regulation now expressly provides that the best interest rule shall not apply to transactions involving any life settlement contract. The rule goes into effect on March 1, 2019. The Life Insurance Settlement Association submitted a letter to the NYDFS requesting that the NYDFS reconsider certain portions of the proposed rule so that life insurance producers would be required to inform consumers who seek a recommendation about their policies of the availability of a sale of their policies as an alternative to lapse or surrender.

The U.S. Securities and Exchange Commission is also studying its own best interest rule that is expected to be finalized in some form during 2019. The proposed rule, known as Regulation Best Interest, Release 34-83062, was published for comment by the SEC in April 2018. After the DOL fiduciary rule was invalidated, renewed interest in an expanded SEC rule surfaced. The rule would apply to registered investment advisers and broker dealers. Precisely how this new rule might impact the life settlements industry at this time is difficult to predict.

Cybersecurity and Privacy Laws and Regulations

While the European Union's new General Data Protection Regulation became effective in May 2018, the

GDPR did not impact either U.S. or European-based institutional life settlement investments funds because they do not invest in life insurance policies insuring lives of, or sell retail investments to, European citizens or residents.

However, most of the New York Department of Financial Services' Cybersecurity Regulation's phased-in provisions became applicable in 2018. These provisions affect life settlement providers and brokers holding licenses from the NYDFS. In March 2019, all aspects of the NYDFS's Cybersecurity Regulation will become applicable. Similarly, in 2018 South Carolina became the first state to adopt the National Association of Insurance Commissioner's Insurance Data Security Model Law, which contains many concepts found in the NYDFS Cybersecurity Regulation and applies to life settlement provider and broker licensees in South Carolina. Ohio became the second state to adopt this model law on December 19, 2018. Earlier in the year, Ohio enacted a first-of-its-kind statute that provides an affirmative defense to any cause of action sounding in tort that is brought under the laws of Ohio or in the courts of Ohio that alleges that the failure to implement reasonable information security controls resulted in a data breach concerning personal information. Companies that comply with Ohio's Insurance Data Security laws will be entitled to assert this new affirmative defense in applicable litigation.

On the west coast, the California Consumer Privacy Act of 2018, which contains a few GDPR-like elements but is not effective until Jan. 1, 2020, became law in June 2018 but was quickly amended in August 2018 for clarifications and other cleanup fixes and is likely to undergo further amendment. One of the key August 2018 amendments included a change to the exemption for consumer information protected under the Gramm-Leach-Bliley Act, which, through its implementation via state insurance laws and regulations, applies to financial institutions, including life insurance companies, life insurance agents and life settlement providers and brokers. The originally passed version of the CCPA exempted persons governed by the GLB act to the extent that the act did not conflict with the CCPA. Because of industry concerns that there were no such conflicts in the first instance, arguably making the GLB act exemption a nullity, the CCPA was amended to make what most think is a full exemption for GLB act regulated persons from the CCPA, although even the effect of that amendment is not entirely clear.

The bottom line for the life settlements industry is that life settlement providers and brokers transacting business in California will benefit from whatever GLB act relief ultimately results. Furthermore, most life settlement providers and brokers would otherwise not be a covered person under the CCPA because they do not (1) have at least $25 million of annual revenue, (2) annually receive personal information of at least 50,000 California resident consumers or (3) derive at least 50 percent of their annual revenues from sales of consumer personal information, which are the three triggers for being subject to the CCPA.

Securities Law Litigation

Howey Test Applied to Nonfractionalized Life Insurance Policies

Fractionalized investments in life insurance policies generally are deemed to be securities under the Supreme Court's Howey test for what constitutes an investment contract under the Securities Act of 1933.[15] In 2018, the District Court for the Northern District of Texas, arguably misapplying this test, affirmed a decision of the U.S. Bankruptcy Court for the Northern District of Texas which held that a consulting agreement between a consultant that agreed to source whole, nonvariable life insurance policies for purchase by a proposed investment fund that desired to use life insurance policies as collateral for project debt financing was unenforceable because the policies, although not contemplated to be fractionalized, were investment contract securities for purposes of the Securities Act of 1933, as amended, and the consultant was not registered as an investment adviser under the Investment

Advisers Act of 1940.[16]

The Texas District Court rejected Living Benefits' argument that sales of whole (nonfractionalized) life insurance policies are not investment contracts based on a Securities and Exchange Commission's Life Settlement Task Force 2010 report noting that it was unclear whether the sale of a whole policy constitutes the sale of a security under federal law and held that this report was not persuasive in the absence of subsequent guidance on the issue from either the Fifth Circuit Court of Appeals or the Supreme Court. This case has been appealed to the Fifth Circuit Court of appeals.[17]

No Private Right of Action Under California's Life Settlement Act

In KKMB v. Khader,[18] the trial court concluded that there is no express or implied private right of action for a fraudulent life settlement act under California's life settlement act. The crux of the complaint was a fraudulent medical report stating the insured had cancer. The court also dismissed without discussion a securities fraud claim. The case is ongoing. A first amended complaint was filed on Dec. 6, 2018, and answers were filed on Dec. 20, 2018.

Sales of Major Life Settlements Asset Servicers

Three of the major life settlement asset servicers were acquired in 2018, indicating some maturity in the market. Stone Point Capital, a large private equity firm participant in the insurance industry, acquired ITM 21st, a long-time industry provider of life expectancies and life insurance policy services. NorthStar Life Services, which is a subsidiary of North Channel Bank, a private German bank, purchased the operating assets of Torrey Pines Life Services. Finally, Asset Servicing Group, also a veteran servicer of life settlement assets, was sold to an established German life settlement investor.

Life Expectancy Extensions

Two of the three major U.S. life expectancy providers updated their older age mortality tables used to render life expectancies for insureds, extending prior issued life expectancies for some life insurance policies owned by investors. ITM 21st announced its revised mortality tables in November 2018, updating its last revisions done in 2013 and lengthening life expectancies for older-age mortality by an average of approximately 9 percent. AVS Underwriting followed suit just a few weeks later, increasing its older age life expectancies by an average of approximately 13 percent. The American Academy of Actuaries and the Society of Actuaries also published various revised life expectancy tables to the same effect in 2018. The life settlements investment market is currently digesting these changes and their potential effects on existing life settlements investment portfolios and future pricing methodologies.

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[1] No. 16-04337 (Jan. 30, 2018)

[2] Docket No. 17-224 (June 8, 2018)

[3] 73 N.Y.2d 74, 78, 535 N.E.2d 270, 272, 538 N.Y.S.2d 217,219 (1989)

[4] 263 F. Supp. 3d 695 (E.D. Tenn. 2017), aff'd, 717 Fed. Appx. 600 (6th Cir. 2018)

[5] See, for example, the pleadings in Estate of Phyllis Malken v. Wells Fargo v. Coventry [US DC Florida case No. 1:17-cv-23136]

[6] No. 17-1786-cr, 2nd Cir., 2018 U.S. App. LEXIS 3189

[7] USDC for the Northern District of Illinois Case No. 1:17-cv-06588 (May 2018)

[8] Consolidated cases No. 17-10189 and 17-104150

[9] 200 So.3d 1202 (Fla. 2016).

[10] United States District Court, Southern District of New York, Case # 15-CV-9924 (PGG)(HBP), July, 2018

[11] USDC, Central District of California, Case No. 2:16-cv-01378-CAS-GJSx

[12] No. RG16813803 (Cal. Superior Ct. of Alameda County, May 8, 2018.

[13] No. 2:16-cv-04170, USDC for the Western district of Missouri

[14] Advance Trust & Life Escrow Services, LTA, as securities intermediary for Life Partners Holder Trust on behalf of itself and all others similarly situated v. Security life of Denver Insurance Company, 1:18-cv- 01897, USDC for the District of Colorado.

[15] SEC v. Mutual Benefit Corp., 408 F.3d 737 (U.S. App. 11th 2005).

[16] Living Benefits Asset Management LLC v. Kestrel Aircraft Co., Inc., Civil Action No. 4:1-cv-00486-O in the USDC for the Northern District of Texas, March 26, 2018.

[17] Case no. 18-10510.

[18] Case No. CV 18-5170-GW(JPRx), USDC for the Central District of California, October 4, 2018