STRANGER-INITIATED ANNUITY TRANSACTIONS AND THE CASE FOR INSURABLE INTEREST

KENDALL J. BURR
THOMAS F.A. HETHERINGTON
DAVID T. MCDOWELL

***

This article addresses the issue of whether insurable interest requirements similar to those which have already been enacted in many states to prohibit the practice of Stranger-Originated Life Insurance policies (STOLIs) should also be made applicable to Stranger-Originated Annuity Transactions, or 'STATs.' The article makes the case that they should by highlighting the inherent similarities that exist between STATs and STOLIs while also analyzing the flawed reasoning behind the lone case to hold that insurable interest requirements are not applicable to STATs. The authors then discuss various state insurance statutes and advance the argument that many of them may already prohibit STAT contracts from being entered into. In other words, the statutory framework for criminalizing STAT schemes may already be in place, in which case, the issue becomes the charge of the courts whose job it will be to interpret these statutes.

***

I. INTRODUCTION

Variable annuities have traditionally been viewed as long-term investment vehicles that offer a number of desirable benefits, including a guaranteed future income stream, favorable tax treatment, and standard or enhanced death benefits paid to a beneficiary in the event of untimely death. Savvy investors, however, claim to have discovered a "loophole" in these products, exploiting them to invest aggressively in the securities markets with the assurance that any short-term losses will be borne by the insurance company. To implement their strategy, they recruit terminally ill individuals to serve as the measuring lives for annuities with built-in death benefits, which provide a full and prompt refund of the investors' premiums if their high-risk investments go awry. This predation on sick individuals—who often claim not to have understood that their poor health was being exploited as a hedge against market losses by a total stranger—raises a significant legal question: should these "Stranger-Originated Annuity Transactions," or "STATs,"[1] be rescinded as unlawful wagers on human lives, violating the well-established "insurable interest" requirement applied in life insurance cases? Examining the pertinent laws applicable to annuities and life insurance, persuasive arguments can be made that insurable interest laws apply to annuity products, and that stranger investors may not use the products to profit from the deaths of other human beings.

II. THE PRODUCT: VARIABLE ANNUITIES

A variable annuity is a product, primarily sold by life insurance companies, that incorporates certain features of an investment account and life insurance. Fundamentally, an annuity is a contract pursuant to which a purchaser agrees to make one or more premium payments to the issuer up front, during an "accumulation phase," and the issuer agrees to make a series of payments thereafter, either to the purchaser or to a designated beneficiary, during a "payout phase." Thus, an annuity is essentially a loan from the purchaser that the insurer pays back over time. An annuity may be "fixed," meaning the insurance company promises to pay a minimum rate of interest or a set dollar amount for each periodic payment, or "variable," allowing the premiums to be invested in mutual funds or other options in the bond and equity markets.[2] Variable annuity products offer a range of benefits that make them appealing to individuals interested in both preparing for retirement and safeguarding against untimely death. Variable annuities typically offer three major categories of benefits: guaranteed income distribution, favorable tax treatment, and death benefits.[3]

First, variable annuities provide a guaranteed distribution of periodic income. An annuity may be structured so as to make payments for a period certain, but is more commonly structured as a "life annuity," made payable for the duration of the lifetime of a designated "annuitant." The

---

[1] Also sometimes referred to as "Stranger-Originated Annuities" ("STOAs") or "Stranger Originated Life Annuities" ("STOLAs" or "STOAs").

[2] Variable annuities are regulated by the Securities and Exchange Commission, whereas fixed annuities are not considered securities and are therefore not regulated by the SEC. *Annuities*, SEC, http://www.sec.gov /answers/annuity.htm (modified Apr. 6, 2011).

[3] *See Variable Annuities: What You Should Know*, SEC, http://www.sec.gov/ investor/pubs/varannty.htm#vch (modified Apr. 18, 2011).

income distribution schedule and amounts are typically fixed at the time of annuitization, the point at which the contract owner agrees to freeze all or some of the funds invested in the accumulation phase and use them to commence distributions in a payout phase. Thus, a fundamental characteristic of a life annuity is its ability to provide a guaranteed source of income lasting as long as the uncertain lifetime of the annuitant. This offers a form of "longevity insurance," protecting the designated beneficiary against the possibility that the annuitant will outlive the assets available from the accumulated value of the investment at the point of annuitization. Given this framework, a purchaser of a variable annuity will often name the same person as both annuitant and beneficiary, or will designate one person as the annuitant and his or her spouse, child, or other family member as the beneficiary.

The second attractive feature of a variable annuity is its favorable tax treatment. Under the Internal Revenue Code, variable annuities owned by individuals may be invested during the accumulation phase in a tax-deferred manner,[4] much like a Roth 401(k). As a variable annuity is funded during the accumulation phase with after-tax dollars, any internal accumulation remains tax free. Once annuitized, any amounts withdrawn from the annuity during the payout phase over and above the amounts contributed are taxable. These market profits are taxed at ordinary income tax rates rather than capital gains rates. As such, the utility of the variable annuity is maximized if used as a long-term investment vehicle.

Third, a variable annuity typically includes a "Guaranteed Minimum Death Benefit" ("GMDB") to be provided to the beneficiary upon the annuitant's death. Usually, the life insurer offers a standard death benefit provision already built in to the base contract, generally guaranteeing the beneficiary an amount no less than the greater of (1) the total face value of the account, or (2) the total of all premiums paid, minus any adjusted withdrawals from the account. Enhanced or "stepped-up" GMDB options are often available à la carte for additional fees, either as part of the annuity contract or as a contract rider. A stepped-up GMDB option may, for example, allow the customer to "lock in" the account's face value as of a specified date, if the account's investments have been performing well. The issuer may also offer a "high water mark" or "anniversary ratchet" option, which looks at the account face value on each contract anniversary date and guarantees a minimum GMDB based on the highest account value as of any of those dates. Or the company might offer a "roll-up" option, guaranteeing a minimum rate of return on the invested

---

[4] *See generally* I.R.C. § 72 (2012).

funds. Various combinations of these enhanced options may also be available.

While other elective features may also be available for additional fees,[5] these three main advantages—guaranteed income distribution, tax-deferred investment, and death benefits—are frequently the defining features of a variable annuity product. Because these products incorporate death benefits, as well as lifetime benefits whose duration is tied to the date of the annuitant's death, it is often treated as an insurance contract, or as a hybrid product combining features of an investment product and life insurance. Whether a variable annuity is actually *legally* defined as life insurance varies from state to state, as discussed in further detail below.

III. THE BACKDROP: STOLI

Before examining how the death benefit component of variable annuities has been recently exploited to pursue risk-free investment opportunities by third-party investors, it is first necessary to examine recent developments in the life insurance industry.

Over the past decade, investors and agents have developed a gray market in life insurance known as Stranger Originated Life Insurance ("STOLI").[6] STOLI refers to any transaction or arrangement by which an investor seeks to purchase a life insurance policy on the life of an individual, typically an elderly insured, even though the investor does not have an insurable interest in the insured's life. The investor typically pays the premiums and structures the transaction so that the investor obtains ownership of the policy, the beneficial interest of a trust holding the policy, or otherwise secures control of the policy through a variety of clandestine transactions, enabling it to re-sell the policy or its controlling interest on the life settlement market. STOLI promoters use various methods to acquire interests in life insurance policies. The investor might agree to buy the

---

[5] Insurers may, for example, offer various guaranteed *lifetime* benefits for an additional charge, such as a guaranteed minimum income benefit ("GMIB"), promising a minimum income stream during the payout phase, or a guaranteed minimum accumulation benefit ("GMAB"), which, after a set period of time (usually 10 or 20 years), resets the account's value to a guaranteed accumulation amount. Insurers also sometimes offer "bonus credit" features, such as a promise to add a bonus contribution to the accumulated value based on a specified percentage of purchase payments, typically ranging from 1% to 5%.

[6] Also referred to as Investor-Owned or Stranger-Owned Life Insurance ("SOLI" or "IOLI").

policy outright from the insured on a pre-determined date, or purchase a beneficial interest in a trust holding the policy.[7] Or the policy might be funded by premium financing for a period of two years (the typical statutory contestability period of a life insurance policy), after which the insured is given the option of either paying off the loan, which typically has large administrative fees and a high interest rate, or surrendering the policy to the investor in full satisfaction of the loan.[8]

STOLI practices pose significant problems for the life insurance industry. STOLI often promotes fraud, incentivizing investors and agents to encourage exaggeration of the insured's net worth and income in order to qualify for larger death benefits,[9] and sometimes takes place even without the knowledge or complicity of the insured.[10]

The most significant problem posed by STOLI, however, is its noncompliance with the well-established requirement that a life insurance policy's initial owner, beneficiary, or both must possess an insurable interest in the life of the insured. This requirement is based on public policy and is designed to prevent wagering on human lives, which creates perverse economic incentives to hasten the insured's death.[11] As discussed in further detail below, nearly all states impose insurable interest

---

[7] *See* Life Prod. Clearing LLC v. Angel, 530 F. Supp. 2d 646, 649 (S.D.N.Y. 2008) (describing STOLI scheme whereby policy was owned by an irrevocable trust and the insured, who had initially named himself as trust beneficiary, sold his beneficial interest to a funding third-party investor shortly after policy issuance).

[8] *See* Lincoln Nat'l Life Ins. Co. v. Calhoun, 596 F. Supp. 2d 882, 885 (D.N.J. 2009) (describing a "typical STOLI transaction" as involving an up-front cash payment in exchange for a promise of a future sale of the policy, use of a trust to hold the policy, and funding of premiums through non-recourse premium financing).

[9] *See*, *e.g.*, Settlement Funding, LLC v. AXA Equitable Life Ins. Co., No. 06 CV 5743(HB), 2010 WL 3825735, at *1 (S.D.N.Y. Sept. 30, 2010) (STOLI policy on life of elderly insured was based on application claiming that she had a net worth in excess of $12 million, even though she lived in an apartment and had assets of less than $100,000).

[10] *E.g.*, *id.* (evidence showed that insured's signature was forged on trust agreement, insured was not in the same state as where the agreement was purportedly signed, and notary had never met the insured or notarized the trust agreement).

[11] *See*, Warnock v. Davis, 104 U.S. 775, 779 (1881) (insurable interest required as a matter of public policy to avoid the issuance of life insurance "by which the party taking the policy is directly interested in the early death of the assured").

requirements in a life insurance transaction. Due to the proliferation of STOLI practices in the last decade, many states have also recently enacted additional statutes specifically targeting STOLI transactions and clarifying that they violate the insurable interest requirement. For example, the California Insurance Code, as amended in 2009, defines entering into a STOLI arrangement as a "fraudulent life settlement act,"[12] and defines "STOLI" to include any arrangement designed 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."[13] A majority of states have already enacted legislation specifically targeting STOLI practices just in the past few years,[14] with additional legislation in other states likely to follow.

---

[12] CAL. INS. CODE § 10113.1(g)(1)(B) (West 2012).

[13] *Id.* § 10113.1(w) (adding, "Trusts that are created to give the appearance of insurable interest and that are used to initiate policies for investors violate insurable interest laws and the prohibition against wagering on life."); *see also id.* § 10110.1(e) (same).

[14] At least twenty-seven states thus far have enacted statutes specifically defining and prohibiting STOLI practices, nearly all since 2008, including Arizona, Arkansas, California, Connecticut, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Minnesota, New Hampshire, New York, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, Tennessee, Utah, Vermont, Washington, West Virginia, and Wisconsin. *See* ARIZ. REV. STAT. ANN. § 20-443.02 (West 2002 & Supp. 2011-2012) (prohibiting STOLI); ARK. CODE ANN. § 23-81-802(24) (LexisNexis 2005 & Supp. 2011-2012) (defining STOLI as unlawful practice); CAL. INS. CODE § 10113.1(g)(1)(B), (w) (West 2005 & Supp. 2012) (describing STOLI as fraudulent life settlement act); CONN. GEN. STAT. §§ 38a-465 (defining STOLI), -465j (2011) (entry into any practice or plan that involves STOLI constitutes fraud); GA. CODE ANN. § 33-59-2(24) (West 2003 & Supp. 2011) (defining STOLI as unlawful practice); HAW. REV. STAT. §§ 431E-2 (defining STOLI), -24 (2005 & Supp. 2009) (prohibiting entering into any practice or plan that involves STOLI); IDAHO CODE ANN. §§ 41-1951(15) (defining STOLI), 1962(1) (2010) (prohibiting any act that constitutes or promotes STOLI); 215 ILL. COMP. STAT. ANN. 159/5 (defining STOLI), 159/50 (prohibiting entering into STOLI), and 159/72 (West 2008 & Supp. 2011-2012) (crime of life settlement fraud includes entering into any arrangement which involves STOLI); IND. CODE ANN. §§ 27-8-19.8-7.8 (defining STOLI), 27-8-19.8-20.1 (LexisNexis 2008) (prohibiting the issuance, solicitation, or promotion of STOLI); IOWA CODE ANN. § 508E.2(12) (West 2007 & Supp. 2011-2012) (defining STOLI as unlawful practice); KAN. STAT. ANN. § 40-5002(f)(5) (K.S.A 2011 Supp.) (same); KY. REV. STAT. ANN. § 304.15-020(15) (West 2006) (same); ME. REV. STAT. ANN. tit. 24-A, § 6802-A(12-A) (West 2000 & Supp. 2011) (same); MINN. STAT. ANN. §§

Thus, the past few years have witnessed a flurry of legislation and an industry-wide spotlight on the STOLI issue. Legislators and life insurers, focusing their efforts solely on life insurance policies owned by strangers, apparently did not foresee that despite these tightened restrictions, some opportunistic investors would move on to exploit variable annuities in an analogous but unanticipated manner.

IV. STATs

The life insurance industry is now facing a new challenge from brokers and investors orchestrating the purchase of variable annuities offered by life insurance companies, referred to as "Stranger-Originated Annuity Transactions," or "STATs." STATs are the subject of a well-publicized lawsuit currently pending in federal court in the District of

---

60A.0782(12) (defining "STOLI practices"), 60A.0784 (making it "unlawful" to "engage in STOLI practices or otherwise wager on life"), 60A.0786(1) (creating presumption of STOLI practices where, *inter alia*, the premiums are financed by means other the assets of the insured or someone "closely related to the insured by blood or law"), and 60A.0789 (West 2005 & Supp. 2011-2012) (insurer may bring declaratory judgment action to declare STOLI policies void); N.H. REV. STAT. ANN. 408-D:2(XVI) (defining STOLI), D:12(I) (LexisNexis 2011) (prohibiting the solicitation, promotion, or knowing participation in any STOLI activities); N.Y. INS. LAW § 7815 (McKinney 2000 & Supp. 2012) (defining STOLI as prohibited practice); N.D. CENT. CODE § 26.1-33.4-01(23) (2010) (same); OHIO REV. CODE ANN. §§ 3916.01(W) (defining STOLI), and 3916.171 (any contract, arrangement or transaction entered into in furtherance of STOLI act is "void and unenforceable"), 3916.172 (West 2005 & Supp. 2011-2012) (promoting STOLI constitutes fraud); OKLA. STAT. ANN. tit. 36, § 4055.2(13) (West, Westlaw through 2012) (defining STOLI as unlawful practice); OR. REV. STAT. §§ 744.318(18) (defining STOLI), 744.369 (2011) (prohibiting entering into any practice or plan involving STOLI); R.I. GEN. LAWS ANN. § 27-72-2(26) (West, Westlaw through 2012) (defining STOLI as unlawful practice); TENN. CODE ANN. § 56-50-102(12) (2011) (same); UTAH CODE ANN. §§ 31A-36-102(18) (defining STOLI), 31A-36-113(2)(a)(iii) (LexisNexis 2010) (prohibiting the entering into any practice involving stranger-originated life insurance); VT. STAT. ANN. tit. 8, §§ 3835(18) (defining STOLI), 3844(a)(2) (2009) (prohibiting any activities resulting in or intending to result in the issuance of STOLI); WASH. REV. CODE ANN. § 48.102.006 (West, Westlaw through 2012) (defining STOLI as unlawful practice); W. VA. CODE ANN. § 33-13C-2(18) (LexisNexis 2011) (same); WISC. STAT. ANN. 632.69(w) (West 2004 & Supp. 2011-2012) (same).

Rhode Island,[15] in which two life insurance companies, Transamerica Life Insurance Company and Western Reserve Life Assurance Company of Ohio, claim to have been defrauded by STAT arrangements masterminded by Rhode Island attorney Joseph Caramadre and carried out with the collaboration of investors and brokerage firms.[16]

Caramadre, a real-estate specialist, believed he had discovered a "loophole" in the variable annuity product that allowed their use to facilitate aggressive short-term investments.[17] By locating individuals with extremely poor health and a short life expectancy who would be willing to act as "annuitants" for variable annuities with GDMBs, Caramadre realized that one could engage in high-risk, short-term investments with the expectation that any potential losses would be borne by the insurance company upon the individual's death.

To implement their strategy, STAT originators like Caramadre first seek out potential annuitants with terminal illnesses, recruiting such individuals through a number of unsavory methods that have drawn national attention. Caramadre, for example, published advertisements in the Rhode Island Catholic, an official diocese publication, stating "Terminal Illness? $2,000 in CASH, Immediately Available."[18] The ads further promised that the funds were offered by a "compassionate organization" hoping to provide "financial assistance" to those near death.[19] STAT originators also target church patrons and workers and patients in nursing homes, hospices, and hospitals, circulating flyers or through direct solicitation[20] and generally offering between $2,000 and $5,000 for their participation.[21]

---

[15] *See* W. Reserve Life Assurance Co. of Ohio v. Conreal LLC, 715 F. Supp. 2d 270 (D.R.I. 2010) *on reconsideration in part sub nom.* W. Reserve Life Assurance Co. of Ohio v. Caramadre, 847 F. Supp. 2d 329 (D.R.I. 2012).

[16] *See generally* W. Reserve's Amended Complaint, W. Reserve Life Assurance Co. of Ohio v. Conreal LLC, 715 F. Supp. 2d 270 (D.R.I. 2010) (No. 09-564S).

[17] *Id*. at ¶¶ 12-13, 20; *see also* Mark Maremont & Leslie Scism, *Investors Recruit Terminally Ill to Outwit Insurers on Annuities*, WALL ST. J., Feb. 16, 2010, http://online.wsj.com/article/SB10001424052748704479704575061392800740492.html.

[18] Maremont & Scism, *supra* note 17.

[19] *Id*.

[20] *See*, *e.g.*, Amended Complaint, *supra* note 16, at ¶ 17; Jim Connolly, *Senior Recounts Brush with STOA as Commissioners Determine Tools to Fight It*, THE INS. BELLWETHER BLOG (May 21, 2010, 12:57 AM),

Once a terminally ill individual is identified, the STAT originator arranges for a licensed agent of an annuities brokerage firm to provide and sign an application for a variable annuity, designating an investor as the owner and beneficiary and having the terminally ill individual serve as the annuitant. The annuitization date is usually far enough in the future that a terminally ill annuitant will likely never receive an annuity payment. STAT sponsors opt on the application for either a standard or stepped-up GMDB, guaranteeing that the beneficiaries will receive a death benefit totaling at least the amount of premiums paid, and in some cases also purchasing additional enhanced benefits.[22] The GMDB acts as a safety net, allowing the investor to make aggressive investments within the variable annuity with the expectation that, if they do not perform well, the insurance company will pay out at least the total of all premiums paid upon the annuitant's death.

V. THE NATIONAL RESPONSE

STATs have been widely criticized since coming to national attention over the past two years, with particular focus on the disturbing manner in which terminally ill annuitants are recruited. Often, the individuals or their families claim to have been misled about the nature of the arrangement, believing that the solicitors were simply offering charity.[23] As one such individual later testified to the National Association of Insurance Commissioners ("NAIC"), "What if I die now? He's going to collect. I don't want to see him get that kind of money. Not for bodies. I'm not going to sell my body."[24] Another individual testified to a federal grand jury that Caramadre and his associates never mentioned annuities at

---

http://www.theinsurancebellwether.com/2010/05/senior-recounts-brush-with-stoa-as.html.

[21] Linda Koco, *Testimony Rips into Stranger-Originated Annuities in Different Ways,* NAT'L UNDERWRITER LIFE & HEALTH (June 14, 2010), http://www.lifehealthpro.com/2010/06/14/feature-testimony-rips-into-strangeroriginated-ann.

[22] *See* Amended Complaint, *supra* note 16, at ¶¶ 19, 28, 45, 62.

[23] *See* Koco, *supra* note 21 (noting testimony from Rhode Island's Superintendent of Insurance that the annuitants "are unclear on their participation in the annuity contract" and believe that they are receiving a charitable gift); *see also Olsen Testifies to NAIC: Annuity Transactions Raise Regulatory Questions*, ACTUARIAL UPDATE, July, 2010, at 1, *available at* http://www.actuary.org/files/publications/Actuarial_Update_July_2010.pdf.

[24] Connolly, *supra* note 20.

all, and never told him that someone would profit from his wife's death, saying, "They preyed on the sick and the weak at a vulnerable time."[25] The plaintiffs in the Rhode Island cases have even alleged that some of the annuitants' signatures may have been forged.[26]

However unsavory and exploitative STAT tactics may appear, questions still remain regarding their legality. The similarities between STATs and STOLI practices are obvious, particularly their exploitation of elderly or ill individuals for the profit of investors with no genuine interest in the continued life of those individuals. But despite the flurry of recent statutory enactments relating to STOLI, legislatures have yet to expressly tackle STATs. The NAIC held hearings in May 2010 at which numerous groups, including the Life Insurance Settlement Association ("LISA"), the National Association of Insurance and Financial Advisors ("NAIFA"), and the American Council of Life Insurers ("ACLI"), testified in condemnation of STATs and described them as sharing many of the same troubling characteristics of STOLI practices, but not all groups were yet prepared to announce their support of implementing new regulation or legislation to directly address STATs.[27] Several state insurance departments have issued bulletins regarding the potential harms of STATs, but they have not openly condemned them as illegal *per se*, instead opting to merely warn life insurers and recommend the implementation of safeguards.[28]

Courts have yet to resolve open questions regarding the legality of STATs. The Securities and Exchange Commission is investigating Caramadre and his associates for possible violations of the securities

---

[25] Katie Mulvaney, *Philanthropist Accused of Profiting from Terminally Ill*, PROVIDENCE J.-BULL. (Mar. 7, 2010).

[26] *See*, *e.g.*, Amended Complaint, *supra* note 16, at ¶ 24.

[27] *See* Gary A. Sanders, Vice President of Securities and State Government Relations, National Association of Insurance and Financial Advisors, Statements before NAIC Life Insurance and Annuities Committee Public Hearing on Stranger Originated/Owned Annuities (May 20, 2010), *available at*: http://www.naifa.org/advocacy/documents/naifatestimonyfornaichearing.pdf; Doug Head on behalf of LISA and the ACLI at the May 20, 2010 NAIC hearing, a*vailable at* http://www.naic.org/committees_a.htm.

[28] *See*, *e.g.*, *Companies Encouraged to Have Safeguards in Place to Limit Potential Exposure to Stranger Originated Annuity Transactions*, OH. DEPT. OF INS. (Apr. 6, 2009), http://www.insurance.ohio.gov/Consumer/Documents/Stranger%20Originated%20Annuity%20Transactions.pdf; *Bulletin No. 2010-02*, LA. DEPT. OF INS. (July 6, 2010), http://www.ldi.state.la.us/docs/CommissionersOffice/legal/Bulletins/Bul2010-02_cur_StrangerOriginatedAn.pdf (bulletins issued by the Departments of Insurance of the states of Ohio and Louisiana).

laws,[29] but that investigation is still ongoing. Caramadre and his colleague were also indicted by a grand jury on charges including conspiracy, mail fraud, wire fraud, identity theft, aggravated identity theft, and money laundering.[30] Outside of Rhode Island, several other lawsuits have been filed involving disputes regarding the validity and enforceability of stranger-initiated annuities, and whether insurance companies must remain bound to those contracts.[31] However, only one court, the District of Rhode Island in dealing with Caramadre's scheme, has thus far rendered a substantive decision directly addressing the validity of STATs, *Western Reserve Life Assurance Co. of Ohio v. Conreal LLC* (hereinafter "*Conreal*").[32] Moreover, that court's conclusion, that the contracts were *not* voidable for lack of insurable interest nor contestable on fraud grounds, is based on a tenuous interpretation of Rhode Island statutes and, as discussed further below, raises more questions than it answers. Regardless, in at least forty-nine states, the question as to whether STATs should be viewed as analogous to STOLI policies, and potentially subject to rescission under existing insurable interest laws, remains a matter of first impression.

---

[29] *See generally* Indictment, Securities and Exchange Commission v. Caramadre et al., No. 1:10-mc-00052-S (DLM) (D.R.I. 2010).

[30] *See* Katie Mulvaney, *Two Men Plead Not Guilty to Defrauding Elderly, Dying*, PROVIDENCE J., Dec. 1, 2011, at 5.

[31] For example, in *MetLife Investors USA Insurance Co. v. Zeidman*, 734 F. Supp. 2d 304 (E.D.N.Y. 2010), a STAT was issued and the terminally ill annuitant, Sherry Pratt, died twelve days later. MetLife later investigated and then rescinded the annuity, and the contract owner, the Zeidman Trust, did not contest rescission; it sought only the return of the $975,000 purchase price for the annuity. *Id.* at 308. MetLife thereafter interpleaded those funds with the court, citing competing claims to the funds by the Zeidman Trust and the estate of Ms. Pratt. *Id.* The court issued an opinion addressing various claims asserted by Ms. Pratt's estate against the Zeidman Trust and MetLife, ultimately holding that the estate had failed to adequately allege its claims. The only claim by the estate against MetLife was an alleged violation of the Illinois Right of Publicity Act, claiming that MetLife had used Ms. Pratt's identity for an annuity without her consent, but the court dismissed the claim because the statute required a "public" use of one's identity to be actionable. *Id.* at 311-12. The court then granted MetLife's petition for discharge. *Id.* at 316. The decision did not involve any discussion regarding the validity or enforceability of the annuity itself, however, given the Zeidman Trust's concession to rescission.

[32] *See* W. Reserve Life Assurance Co. of Ohio v. Conreal LLC, 715 F. Supp. 2d 270 (D.R.I. 2010).

VI. COMPARING AND CONTRASTING STATs AND STOLI

STATs and STOLI arrangements share several key elements. For both types of transactions, a third-party investor is the real party in interest acquiring the product, despite having no familial relationship or other interest in the life of the individual insured or annuitant. Both also involve the exploitation of a product offered by life insurance companies, and both involve products that guarantee a death benefit. But obvious distinctions between life insurance policies and variable annuities are worth consideration before addressing whether STATs should be subject to insurable interest requirements.

First, life insurance policies and variable annuities trigger different financial obligations on the part of the issuing insurer during the named individual's lifetime and after his or her death, and thus implicate different interests for the insurer with respect to that individual's longevity. In the case of life insurance, the insurer hopes to benefit by continuing to receive premium payments for the duration of the insured's life. As such, insurance companies have a clear interest in obtaining more thorough information from applicants seeking life insurance that will enable them to more accurately assess the mortality risk of persons and determine proper risk classes for each policy, so as to maximize average expected profits.

By contrast, issuers of variable life annuities only continue to receive premium payments during the accumulation phase, but not after the contracts are annuitized. Moreover, before STAT exploitation, the only perceived profitable use of variable annuities was for long-term investments. Customers who purchase annuities were therefore viewed as self-selecting, being highly unlikely to commit large proportions of their funds to a long-term investment if their health was poor.[33] Thus, for a typical non-STAT annuity with a GMDB, the initial mortality rate is roughly 1%.[34] Based on this risk assessment, most insurers did not see a need to engage in extensive underwriting, and structured their variable annuity applications and contracts accordingly, unaware that the mortality risk for a STAT, by definition, would approach 100%.[35] Thus, insurance

---

[33] *See* ACLI, *supra* note 27, at 4.

[34] Nancy Bennett, Senior Life Fellow, American Academy of Actuaries, Actuarial Considerations of Stranger Initiated Annuity Transactions 5 (July 9, 2010), *available at* http://www.actuary.org/pdf/life/AAA%20Comments%20to%20NCOIL%20on%20Stranger%20Originated%20Annuities%20final%207-9-2010.pdf.

[35] *Id.*

companies have historically had comparatively few financial incentives to examine a prospective annuitant's health or life expectancy, and thus do not engage in the same degree of underwriting they ordinarily require of prospective insureds.

These different underwriting requirements may make it more difficult for an insurer to prove fraud in a STAT case than in a STOLI case. STOLI disputes are likely to involve more clear evidence of fraud and misrepresentation, given that an applicant must answer direct questions on the policy applications regarding their medical condition and finances. Annuity applications often do not ask such questions. Of course, the evidence in a particular STAT case may still show express misrepresentations, or a failure to disclose the annuitant's failing health or the fact that the beneficiary and the annuitant are total strangers, despite a duty to do so. The Rhode Island plaintiffs, for example, allege that Caramadre set up a relatively low initial premium on the application, invested conservatively, to avoid arousing the suspicions of the insurer, and then, after issuance, dramatically increased the premium payments and transferred the funds into riskier investment options.[36] Caramadre and his associates, however, respond that the insurer does not request medical information or inquire about the relationship between the annuitant and the beneficiary, and argue that the application, contract, or prospectus are silent on such issues.[37]

Another key difference between life insurance policies and variable annuities relates to the duration of the contract's contestability period. Life insurance policies typically have clauses providing that they are contestable on grounds of material misrepresentation for a period of two years, and most states have enacted statutes requiring insurers to promise no more than two years of contestability in life insurance contracts.[38] But although state statutes sometime allow insurers to provide for up to two years of contestability for annuity contracts,[39] some insurers still opt for a shorter contestability period and choose to make their annuity contracts

[36] *See* Amended Complaint, *supra* note 16, at ¶ 21.

[37] *See generally* Answer and Counterclaim, Transamerica Life Ins. Co. v. Caramadre, No. 09-471 S (D.R.I. Apr. 8, 2011).

[38] *See*, *e.g.*, CAL. INS. CODE § 10113.5 (West 2006); 215 ILL. COMP. STAT 5/224(c) (West 2000); N.Y. INS. LAW § 3203(a)(3) (McKinney 2008); FLA. STAT. ANN. § 627.455 (West 2011); TEX. INS. CODE ANN. § 1101.006(a) (West 2009).

[39] *See*, *e.g.*, ALA. CODE § 27-15-18 (LexisNexis 2007); FLA. STAT. ANN. § 627.466 (West 2011).

incontestable from the date of contract issuance.[40] Again, such business decisions reflect the perceived self-selective nature of annuity applicants, and demonstrate how insurers simply did not foresee how variable annuity products might be exploited by stranger investors.

The *Conreal* opinion shows that such business decisions may come back to haunt the insurer. There, the court determined that the fact that the insurers drafted their annuity contracts as incontestable from the "policy date" foreclosed any argument by the insurers that the policies should be rescinded due to fraud.[41] Notably, the court still allowed the insurers to pursue fraud claims seeking damages from Caramadre and his associated sponsors, agents, and brokers, noting that "unlike Harry Potter's 'Invisibility Cloak,' which could conceal not only Harry, but anyone who wore it," the incontestability clauses could not be invoked by third parties to the contract.[42] But as to the owners of the annuities, and the validity of the contracts themselves, the court dismissed all fraud claims as incontestable.[43]

Still, despite these varied distinctions, a key functional similarity between a life insurance policy and a variable annuity with a GMDB remains: both products provide a death benefit, and if purchased by a stranger investor, can therefore be exploited to provide a significant monetary payout upon the death of an individual in which the purchaser has no insurable interest.

---

[40] For example, the Rhode Island STATs cases all appear to have involved contracts providing that they were incontestable from the "policy date." *See* W. Reserve Life Assurance Co. of Ohio v. Conreal LLC, 715 F. Supp. 2d 270, 279-80 (D.R.I. 2010).

[41] *Id.* at 279-80.

[42] *Id*. at 281.

[43] *Id*. at 280. Insurable interest claims, however, would in most states survive the contract's contestability period. Most state laws provide, at least in the insurance context, that insurable interest is an issue that goes to contract formation, rendering the contract void *ab initio*, and thus may be raised at any time regardless of any contestability clause therein. *See* 1 LEE R. RUSS, COUCH ON INSURANCE 3D § 240:82 (2009) ("The majority of jurisdictions follow the view that an incontestable clause does not prohibit insurers from resisting payment on the ground that the policy was issued to one having no insurable interest—such a defense may be raised despite the fact that the period of contestability has expired.").

VII. LEGAL DISTINCTIONS BETWEEN "INSURANCE" AND "ANNUITIES"

Before addressing whether insurable interest rules should apply to annuity products, it must be noted that courts have long recognized various legal similarities and distinctions between life insurance policies and variable annuities in various contexts. Courts have treated the two types of products differently for such varied purposes as to compel issuers of variable annuities to comply with securities laws,[44] to allow national banks to sell annuities,[45] or to address their tax treatment.[46] But as the Seventh Circuit noted after examining numerous cases and treatises addressing the similarities and differences between insurance and annuity products, "The most we can conclude from these long lists of cases and treatises is that annuities are not *exactly* insurance policies, but that the two have multiple similarities. Thus courts and treatise writers have stated that the two products are different in some situations, and the same in others."[47] The court then concluded that "none of the cases or treatises authoritatively answers the question that we must decide."[48] While the issue before that court is not pertinent here,[49] it demonstrates that given the numerous

---

[44] *See* SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959) (discussing the differences between life insurance and variable annuities and concluding that the latter had to be registered under the Securities Act of 1933). Interestingly, a key reason for the Supreme Court's conclusion was its understanding that a variable annuity "places all of the investment risk on the annuitant, not on the company. . . . The companies that issue these annuities take the risk of failure. But they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities -- an interest that has a ceiling but no floor." *Id.* at 71-72. STATs, however, do not follow these conventions; the investor is guaranteed a floor in the form of a GMDB, and the insurer is misled into unwittingly assuming all of the risks in the investment portfolio.

[45] *See* NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 263-64 (1995) (noting various similarities and distinctions between annuities and insurance, and deferring to the Comptroller of the Currency's decision to treat them as distinct products for purposes of the National Bank Act, noting that his conclusion was "at least reasonable").

[46] *See* Helvering v. Le Gierse, 312 U.S. 531 (1941) (focusing on the differences between insurance risks and investment risks in examining estate tax dispute).

[47] Am. Deposit Corp. v. Schacht, 84 F.3d 834, 840 n.4 (7th Cir. 1996).

[48] *Id.*

[49] *See id.* (examining the specific question as to whether annuities should be considered to be "insurance" for purposes of the McCarran Ferguson Act).

similarities and differences between the two types of products, any analysis of whether they should be treated similarly or differently depends entirely upon the nature of the legal issue being considered. Here, the salient question is whether insurable interest requirements should apply to both products.

VIII. PUBLIC POLICY REASONS FOR REQUIRING INSURABLE INTEREST FOR VARIABLE ANNUITIES

A review of the historical development of the insurable interest requirement suggests that it should apply equally to variable annuities with GMDBs for the same reasons it applies to life insurance policies. The requirement was first imposed in eighteenth-century Great Britain in an effort to combat the so-called "dead pools" or "death pools" popular at the time, in which aristocratic gamblers wagered on when royals and other celebrities would die first.[50] Prior to 1750, the common law had only condemned wagers on human life when accompanied by a criminal act, such as murder to collect on a policy.[51] In the third quarter of the eighteenth century, however, gambling on human life began to be seen as an independent moral hazard, a concern plausibly related to growing unease over slavery and the concept of trafficking in the commerce of human lives.[52] Thus, Parliament enacted the Life Assurance Act in 1774, holding that any insurance policy made to benefit a person who had "no interest" in the life of the person insured would be deemed "null and void."[53]

This insurable interest requirement was reinforced in the common law of the United States as a matter of public policy. For example, the United States Supreme Court recognized this public policy requirement in 1881 in *Warnock v. Davis*, explaining that without such an interest, "the contract is a mere wager, by which the party taking the policy is directly interested in the early death of the assured. Such policies have a tendency to create a desire for the event."[54] The Supreme Court reiterated the same concerns in *Grigsby v. Russell*, a 1911 opinion rendered by Justice Oliver

---

[50] *See* Timothy Alborn, *A License to Bet: Life Insurance and the Gambling Act in the British Courts*, 14 CONN. INS. L.J. 1, 1 (2007).

[51] *Id.* at 2.

[52] *Id.* (citing GEOFFREY CLARK, BETTING ON LIVES: THE CULTURE OF LIFE INSURANCE IN ENGLAND 1695-1775, 62-63 (Manchester University Press 1999).

[53] Life Assurance Act 1774, 14 Geo. 3 c. 48, § 1 (1774).

[54] Warnock v. Davis, 104 U.S. 775, 779 (1881).

Wendell Holmes: "A contract of insurance upon a life in which the insured has no interest is a pure wager that gives the insured a sinister counter interest in having the life come to an end."[55] The "very meaning" of insurable interest, Justice Holmes explained, "is an interest in having the life continue."[56] Recent court decisions addressing STOLI disputes have reiterated these principles in holding that modern statutes imposing insurable interest requirements are based on these fundamental public policy concerns.[57]

Thus, although the insurable interest requirement has since been incorporated into the insurance codes of nearly every state,[58] the

---

[55] Grigsby v. Russell, 222 U.S. 149, 154-55 (1911) (adding, "although that counter interest always exists . . . the chance that in some cases it may prove a sufficient motive for crime is greatly enhanced if the whole world of the unscrupulous are free to bet on what life they choose.").

[56] *Id*. *Warnock* and *Grigsby* also address a key issue more applicable to STOLI policies than to STATs -- the alienation of the contract to one with no insurable interest. While *Warnock* invalidated an assignment of ninety percent of a policy's proceeds executed contemporaneously with the application for the policy, *see Warnock,* 104 U.S. at 781, *Grigsby* clarified that a lack of insurable interest on the part of a prospective assignee does not bar the sale of an in-force life insurance policy, *see Grigsby*, 222 U.S. at 156-57. *Grigsby* clarified that this freedom to alienate only applies to policies that are issued with a valid insurable interest in the first instance and there is no pre-existing agreement to assign, noting an important distinction: "And cases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith." *Id.* at 156. While assignment or some other method of alienation is frequently a key component of a STOLI transaction, however, STATs often involve no alienation at all. The application typically just names the third-party investor as owner and beneficiary, and the annuitant signs the application as the annuitant only. *See*, *e.g.*, W. Reserve Life Assurance Co. of Ohio v. Conreal LLC, 715 F. Supp. 2d 270, 274 (D.R.I. 2010).

[57] *See*, *e.g.*, Life Prod. Clearing LLC v. Angel, 530 F. Supp. 2d 646, 652-55 (S.D.N.Y. 2008) (analyzing rationales given in *Warnock* and *Grigsby,* as well as a December 19, 2005 opinion by the Office of General Counsel on behalf of the New York State Insurance Department noting that STOLI activities seeking to procure a policy "solely as a speculative investment for the ultimate benefit of a disinterested third party . . . is contrary to the long established public policy against 'gaming' through life insurance purchases." (internal quotation marks omitted)); Lincoln Nat'l Life Ins. Co. v. Calhoun, 596 F. Supp. 2d 882, 888-89 (D.N.J. 2009); Lincoln Nat'l Life Ins. Co. v. Schwarz, No. 09-03361, 2010 WL 3283550, at *7 (D.N.J. Aug. 18, 2010).

[58] *See* discussion *infra* Part X.

requirement is not a creature of statute. As the Supreme Court recognized in *Warnock*, the prohibition of the wagering on human lives is founded in public policy "independently of any statute on the subject."[59] This distinction is reflected in recent statutory amendments addressing STOLI cases, which are typically worded so as to reflect that insurable interest statutes recognize and apply pre-existing insurable interest requirements, which are based on public policy and common law.

California's new 2009 legislation, for example, added a subsection providing that certain STOLI arrangements, through the use of trusts or special purpose entities, "violate the insurable interest laws and the prohibition against wagering on life,"[60] plainly recognizing and referring to pre-existing legal standards. Another provision in the same section, which existed both before and after the 2009 amendment, adds, "[t]his section shall not be interpreted to define all instances in which an insurable interest exists."[61] In other words, the California legislature recognized that the contours of the insurable interest laws were incapable of being precisely defined by statute. To expect otherwise of state legislators is unreasonable, particularly in a modern world where investors continue to invent new and unanticipated ways to exploit human lives for profit. Thus, by specifically prohibiting certain STOLI practices in 2009, the California legislature was not trying to fix a pre-existing statutory loophole or create a new rule of law, but to confirm that a new, previously unforeseen type of transaction was of a nature that violated existing laws.

When examining the scope of state laws on insurable interest, courts should therefore be mindful not only of pertinent statutes and case law, but also of the fundamental public policy interests underlying those statutes and judicial opinions. Such interests are implicated no differently by STATs than by STOLI policies, both of which are structured to provide a death benefit to a third-party investor who stands to gain financially from the death of a human being. Indeed, STAT investors are essentially using variable annuities *as* life insurance policies; the product is being used in such a manner as to use it almost entirely for its life insurance feature, in conjunction with a short-term market play. STAT investors who purchase annuity products for that purpose should be viewed as subjecting

---

[59] *Warnock*, 104 U.S. at 779; *see also Schwarz*, 2010 WL 3283550, at *7 (citing *Warnock,* 104 U.S. at 779) (holding that the original public policy interest in precluding insurance absent an insurable interest "is the law in New York").

[60] CAL. INS. CODE § 10110.1(d) (West 2010).

[61] CAL. INS. CODE § 10110.1(i) (West 2010) (amending CAL. INS. CODE §10110.1(g) (2004)).

themselves to a contract that public policy dictates to be of the type that must have insurable interest to be valid and enforceable.

The twin public policy rationales historically given for the insurable interest requirement—prohibiting the morbid practice of gambling on human lives and eliminating a perverse incentive to commit murder (sometimes called the "moral hazard" rationale)—have in some circles been attacked as no longer being compelling concerns in a modern world.[62] However, as demonstrated by the eagerness of modern legislatures to enact laws prohibiting STOLI practices,[63] modern societies do apparently continue to believe that wagers on human lives by disinterested investors still pose a legitimate threat to the public interest. Indeed, at least one recent case suggests that the moral hazard concern, while it may appear to be implausible in modern times, may not be a simple paranoia of the past. In September 2008, 74-year-old Germaine Tomlinson was mysteriously found having drowned in her bathtub in Indiana, fully clothed and wearing high heels. The last person to see her alive was her son-in-law, the beneficiary of a $15 million insurance policy on her life, who had been with Ms. Tomlinson at a bar the night of her death, drove her home, and escorted her into the house. Police first concluded that the death was accidental, but reopened their investigation after learning that Ms. Tomlinson died the day before her son-in-law's deadline to either repay a $1.3 million loan he had taken out to finance the policy premiums or risk surrendering the policy to the lender.[64] Police were unable to find clear evidence of foul play, but courts allowed civil suits to proceed.[65] Even if such incidents are unlikely or rare today, the mere threat thereof is not too far-fetched, which helps explain why the moral hazard concern played a part in supporting the recent wave of anti-STOLI legislation nationwide.

---

[62] *See*, *e.g.*, Roy Kreitner, *Speculations of Contract, or How Contract Law Stopped Worrying and Learned to Love Risk*, 100 COLUM. L. REV. 1096, 1123 (2000) (arguing that the gambling rationale has only been paid "lip service" in court decisions like *Grigsby*, and that courts instead relied more heavily on the moral hazard concern implicated by an incentive to hasten another's death); Jacob Loshin, *Insurance Law's Hapless Busybody: A Case Against the Insurable Interest Requirement*, 117 YALE L.J. 474, 483-90 (2007) (arguing that even the moral hazard rationale is too imprecise to justify an insurable interest requirement).

[63] *See supra* note 14.

[64] *See* Mark Maremont & Leslie Scism, *Inquiry Into Death in Indiana Reopened*, WALL ST. J., May 13, 2010, at A7.

[65] *See* K. McLaughlin, *Drama Builds in Hilbert Suit*, 31 INDIANAPOLIS BUS. J., November 6, 2010, at A3.

STAT cases create similar moral hazard risks; indeed, at least one STAT plaintiff has alleged that the annuitant had voiced fears that STAT originators sought to kill her.[66] Although it may arguably be difficult to imagine a white-collar STAT investor carrying out or orchestrating a calculated killing for profit, the moral hazard public policy rationale has never targeted a specific demographic of suspected would-be murderers. Indeed, such temptations could theoretically be exacerbated in STAT cases, given the volatility of the stock market. One might imagine, for example, a sudden downturn decimating the investor's high-risk portfolio, and an urgent need for cash flow that a GMDB payout might provide. Although STAT annuitants are selected with the expectation that they will pass away soon, the uncertainty as to the timing of that passing may prove frustrating for an investor with substantial sums invested in a fluctuating market. A STAT investor might even have fewer qualms about orchestrating the carrying out of such a deed given the individual's terminal illness. The objective of the public policy is simply to eliminate such incentives that could conceivably result in disastrous consequences.

Another public policy concern that supports an insurable interest requirement for STATs is their negative impact on the market itself. The other parties to a STAT investor's high-risk speculation do not know that the investor is not actually undertaking such risks, given its concealed knowledge of the GMDB safety net. Such conduct may expose the investor to liability to such third parties, and, as in Caramadre's case, may also invite investigation by the S.E.C. But it can also be seen as sufficiently damaging to the market to justify another public policy rationale for preventing STATs. The securities laws themselves, and related doctrines such as the fraud-on-the-market theory, are based on similar public policy concerns that the integrity of the securities markets requires a "philosophy of full disclosure."[67] The imposition of an insurable interest requirement for STATs would be an effective way to reduce such risks.

STATs also negatively impact the market by disrupting the economics in the annuity industry. Annuity providers are faced with a

---

[66] *See*, *e.g.*, Complaint in Eouity [sic] and Law at 44-45, Pratt v. Flowers., No. 2010-L-002155, 2010 WL 687509 (Ill. Ct. Cl. 2010) (alleging that annuitant had stated her fear that "these people are trying to kill me.").

[67] Tad E. Thompson, *Messin' with Texas: How the Fifth Circuit's Decision in* Oscar Private Equity *Misinterprets the Fraud-on-the-Market Theory*, 86 N.C. L. REV. 1086, 1093 (2008) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 230, (1988)) (discussing public policy interests underlying Rule 10b-5 and the fraud-on-the-market theory).

problematic choice – either they must invest in additional underwriting, or, if they choose not to do so, they must increase the prices charged to the public to account for the market losses that STAT investors will pass on to the company. Either way, the annuity providers would have to pass on these additional costs to the customers who buy their annuity products, and may have already done so.[68]

With the exception of the last two market-based justifications for barring STATs, the other public policy interests noted above are well-established and provide the basis for current statutes codifying insurable interest requirements. As examined below, these public policy concerns are not in conflict with such statutes. These concerns, however, were inexplicably ignored by the Rhode Island District Court in *Conreal*.

IX. THE FLAWED ANALYSIS IN *CONREAL*

Conreal is the sole judicial opinion thus far rendered addressing the applicability of the insurable interest requirement to stranger-originated variable annuities. The justification for that conclusion, however, is flawed in several respects.

First, the court assumed that the insurable interest requirement only applied to products fitting statutory definitions of "insurance."[69] The court presupposed that the sole basis for the requirement was statutory, citing a provision in the state insurance code prohibiting the procurement of an "insurance contract" without an insurable interest.[70] Thus, the court's entire discussion is framed exclusively within the limited confines of an analysis of whether annuities can be considered "insurance products" or as "hybrid products" under statutory definitions.[71] But the court did not seriously consider the possibility that other non-statutory bases for an insurable interest requirement existed based on common law and public policy.[72]

---

[68] A similar argument has been made regarding STOLI transactions, which caused a reduction in lapse rates due to the fact that investors do not typically allow policies to lapse. This forces insurers to increase premium rates for their products, further harming ordinary consumers.

[69] W. Reserve Life Assurance Co. v. Conreal LLC, 715 F. Supp. 2d 270, 276 (D.R.I. 2010).

[70] *Id*. (citing R.I. GEN. LAWS § 27-4-27(a) (2010)).

[71] *Conreal*, 715 F. Supp. 2d. at 276-79.

[72] The court even quoted language from an older Rhode Island case that arguably supported a common-law argument for applying the doctrine outside the context of insurance, holding that "a purely speculative *contract* on the life of another is . . . objectionable on the grounds of public policy." *Id*. at 276 (quoting

The court did briefly examine state cases in seeking to differentiate annuities from life insurance, quoting an 1877 Rhode Island Supreme Court decision noting that other transactions resulting in "speculation upon the chances of human life," such as "when a man takes a transfer of an annuity," have not been held void.[73] But a "transfer of an annuity" is an entirely different type of transaction from a STAT. An annuity purchaser buys the right to receive annuity payments lasting as long as the duration of the annuitant's life, and thus has every hope that the annuitant stays alive. STAT originators, by contrast, set up the transaction from its inception so as to benefit the investor when the annuitant dies. Not until recently, and certainly not in 1877, could the Rhode Island Supreme Court have anticipated that annuities could be exploited in a manner giving a stranger a contractual right to benefit from another's death.

In fact, the *Conreal* court went out of its way to deliberately skirt the question regarding the pertinence of the moral hazard rationale. The court did briefly acknowledge the possibility that STATs may create a "temptation to shorten life,"[74] but did not go on to consider whether such a danger was of public concern. Instead, the court focused its discussion solely on a critique of the plaintiff insurers for their failure to ensure that their application procedures screened for insurable interest.[75] Thus, by censuring the insurers for the fact that they did not foresee how variable annuity products might be exploited by investors recruiting terminally ill annuitants,[76] the court sidestepped the more important question of whether there existed a valid *public* interest in eliminating an incentive to shorten life.

Further, the *Conreal* opinion is based on a tenuous interpretation of the pertinent state statutes. It noted that the Rhode Island Insurance Code

---

Cronin v. Vt. Life Ins. Co., 40 A. 497, 497 (R.I. 1898)). This language, unlike the statute cited above, is not constrained to life insurance contracts.

[73] *Id.* at 278 (citing Clark v. Allen, 11 R.I. 439, 444 (1877)).

[74] *Id.* at 279 (quoting *Cronin*, 40 A. at 497).

[75] *Id.*

[76] *Id.* Interestingly, the court also appears to recognize that these novel schemes were unanticipated, describing Caramadre as having "discovered" a loophole in the product itself, and describing his strategy as based on his "insight" regarding how the product could be exploited. *Id.* at 273-74. The court later describes the STAT originators as having "figured out how to game a flaw in the product." *Id.* at 278. The court almost appears to be praising Caramadre for his ingenuity, but condemning the insurers for failing to come to the same realization first.

had separately defined the terms "life insurance" and "annuities,"[77] but failed to examine why that distinction mattered in the STAT context. As noted above, although treatises and cases alike conclude that the products are similar in numerous respects, various reasons exist for distinguishing between the two products in certain contexts, such as for purposes of taxation or securities registration. Thus, while many states define "life insurance" as including annuities, others, like Rhode Island, have defined them differently.[78] The key question, then, is not whether annuities *are* insurance products, but whether certain rules historically applied to insurance policies should also apply to annuity contracts that have only recently begun to be used in a similar manner. There is no evidence that the Rhode Island General Assembly defined the terms "life insurance" and "annuity" for the purpose of excluding annuities from insurable interest requirements.

The *Conreal* court, however, asserts that the General Assembly "reinforced the statutory distinction" between the two when it failed to mention annuities in the Life Settlements Act ("LSA"), which addressed STOLI practices.[79] But as noted above,[80] Rhode Island is but one of many states to recently enact STOLI legislation. Like many other states, the General Assembly based the LSA on a model act recommended by the National Conference of Insurance Legislators.[81] The model act and the LSA were both drafted well before STATs came to national attention in the past two years. Thus, it is likely that the omission of any reference to STATs in the LSA was not a conscious exclusion, but a reflection of the fact that the legislature was simply unaware that variable annuities could similarly be exploited by stranger investors.

Moreover, the language of the LSA itself again indicates that insurable interest legislation is designed to codify pre-existing insurable interest requirements. Like the California anti-STOLI legislation cited above, Rhode Island's LSA provides that STOLI arrangements through the use of trusts "violate insurable interest laws and the prohibition against

---

77 *Conreal*, 715 F. Supp. 2d at 276-77 (citing R.I. GEN. LAWS § 27-4-0.1 (2010)).

78 *See* discussion *infra* Part X.

79 *Conreal*, 715 F. Supp. 2d at 277 (citing R.I. GEN. LAWS ANN. § 27-72-2 (West 2010)).

80 R.I. GEN. LAWS ANN. § 27-72-2(26) (West 2010).

81 Trevor Thomas, *Rhode Island Enacts Settlements Law*, LIFEHEALTHPRO.COM (Nov. 11, 2009), http://www.lifeandhealthinsurancenews.com/News/2009/11/Pages/Rhode-Island-Enacts-Settlements-Law.aspx.

wagering on life."[82] Thus, the statute sought to clarify that STOLI arrangements violate existing laws, not to announce that all other hitherto-unknown schemes to wager on human life were fair game.

Further, even if it were true that the court was constrained by the statutory language to restrict insurable interest requirements to "insurance" or "hybrid" products, the court still erred in concluding that they were *not* hybrid products, contending that GMDBs merely "sweeten the deal."[83] While that might be the case for non-STAT annuities, where the purchaser expects the annuitant to live long enough to justify pursuing a traditional investment strategy, the GMDB is a fundamental component of a STAT transaction. By placing a wager on whether aggressive investments will turn a profit before a stranger dies, and putting the entire risk of loss on the insurance company, STAT promoters have certainly made the life insurance component of the scam more than a mere "ancillary perk."[84]

X. A SURVERY OF STATE LAWS RELATING TO ANNUITIES AND INSURABLE INTEREST

Conreal is the sole judicial opinion thus far rendered that examines whether insurable interest requirements might apply to variable annuities. But even if later Rhode Island courts or statutes do not overrule or contradict its holding, *Conreal* does not necessarily spell disaster for insurers or annuitants wishing to declare STATs void under the laws of other states. An examination of other statutory schemes and related caselaw reveals that the framework underlying *Conreal*'s conclusion is not at all typical, and that in each state, sufficient statutory or common-law authority may already exist to support contrary conclusions.

Two considerations are important in this analysis. First, how states define the terms "life insurance" and "annuities" may or may not indicate whether the legislature intended that the latter should be treated as insurance products. Thirteen states, encompassing California,[85] Colorado,[86]

---

[82] R.I. GEN. LAWS § 27-72-2(26) (2010).

[83] *Conreal*, 715 F. Supp. 2d at 278.

[84] *Id.* at 278-79.

[85] CAL. INS. CODE § 101 (West 2005) ("Life insurance includes insurance upon the lives of persons or appertaining thereto, and the granting, purchasing, or disposing of annuities.").

[86] COLO. REV. STAT. ANN. § 10-1-102(12) (West 2011) ("'Insurance' means a contract whereby one, for consideration, undertakes to indemnify another or to pay a specified or ascertainable amount or benefit upon determinable risk contingencies, and includes annuities.").

Florida,[87] Illinois,[88] Michigan,[89] Mississippi,[90] Nebraska,[91] New Mexico,[92] North Dakota,[93] South Carolina,[94] Tennessee,[95] Texas,[96] and West Virginia,[97] have statutes or case law that expressly define annuities as

---

[87] FLA. STAT. ANN. § 624.602(1) (West 2011) ("The transaction of life insurance includes also the granting of annuity contracts, including, but not limited to, fixed or variable annuity contracts").

[88] 215 ILL. COMP. STAT. ANN. § 5/4 (West 2000) (defining "classes of insurance" — "Life. Insurance on the lives of persons and every insurance appertaining thereto or connected therewith and granting, purchasing or disposing of annuities.").

[89] MICH. COMP. LAWS SERV. § 500.602(1) (LexisNexis 2008) ("'Life' insurance is insurance upon the lives and health of persons and every insurance pertaining thereto, and to grant, purchase, or dispose of annuities.").

[90] Hamilton v. Penn Mut. Life Ins. Co., 17 So. 2d 278, 280 (Miss. 1944) (annuities not technically life insurance policies but are subject to provisions of insurance code regulating life insurance); State *ex rel.* Gully v. Mut. Life Ins. Co. of N.Y., 196 So. 796, 799 (Miss. 1940), *overruled in part on other grounds*, United Gas Corp. v. Leggett, 198 So. 763 (1940).

[91] NEB. REV. STAT. § 44-704 (2010) (requiring benefits of any "policy of insurance" to be payable to person with insurable interest in person's life, and expressly providing that the term "policy of insurance" includes annuity contracts).

[92] N.M. STAT. ANN. § 59A-7-2 (2000) ("'Life' insurance is insurance of human lives and every insurance appertaining thereto, and the granting, purchasing or disposing of annuities. . . ").

[93] N.D. CENT. CODE § 26.1-26-11 (2010) (variable annuities categorized along with variable life insurance contracts as "insurance coverage"); *id* § 26.1-05-02 (same); *id.* § 26.1-34.2-02 (definitions section relating to annuities includes definitions referring to "insurance, including annuities" and "insurance products, including annuities").

[94] S.C. CODE ANN. § 38-1-20(19) (2002) ("The term 'insurance' includes annuities.").

[95] TENN. CODE ANN. § 56-2-201(4) (2008 & Supp. 2011) ("For the purposes of this title, the transacting of life insurance includes the granting of annuities, both with and without a life or mortality contingency or element . . . ."); *see also* H & R Block E. Tax Serv., Inc. v. State Dep't of Commerce & Ins., Div. of Ins., 267 S.W.3d 848, 858 (Tenn. Ct. App. 2008) (noting that statutory definitions of "contract of insurance" and "insurable interest" were circular and ambiguous, and that the broad definition could cover various types of contracts).

[96] TEX. INS. CODE ANN. § 1102.001(1)(A) (West 2009) (definition of "insurance policy" includes annuity contracts).

[97] W. VA. CODE ANN. § 33-1-10(a) (LexisNexis 2011) ("*Life insurance*. -- Life insurance is insurance on human lives including endowment benefits, additional benefits in the event of death or dismemberment by accident or accidental means, additional benefits for disability and annuities.").

insurance products. Further, their rules relating to insurable interest do not seek to carve out annuities or other specific types of insurance products.[98] Nebraska even expressly *includes* annuity contracts in its insurable interest statute.[99] Other states are not quite so explicit as Nebraska—which is not surprising, given the very recent advent of STATs—but the fact that these thirteen states define annuities as insurance suggests that courts confronted with STAT disputes in those states would have little choice but to distinguish *Conreal*.

But the second consideration in examining state statutes is far more important: regardless of whether a state legislature or court has chosen to define the products separately, the language of the state's insurable interest laws may already be broad enough to cover annuities. Many states do not expressly define annuities as insurance, and sometimes even define them as separate products, but their insurance codes still make clear that insurable interest requirements apply to annuities. For example, New Jersey's insurable interest statute, like Nebraska's, *explicitly* applies to annuities[100] even though the code elsewhere defines them as separate from insurance products.[101] In other states, it is clear from the structure of the code that the insurable interest requirement applies to annuities. For example, Arizona's insurance code provides, "Except as exemption or other provision is made, all provisions in this title applicable to life insurance shall be deemed applicable also to annuities."[102] That title includes an insurable interest statute that does not make any "exemption or other provision" excluding

---

[98] *See*, *e.g.*, CAL. INS. CODE § 10110.1 (West 2005) (insurable interest requirement does not carve out annuities); FLA. STAT. ANN. § 627.404 (West 2011) (same); MICH. COMP. LAWS SERV. § 500.2207 (LexisNexis 2008) (same); N.M. STAT. ANN. §§ 59A-18-4, 59A-18-5 (2000) (setting forth insurable interest requirements), and § 59A-18-1 (chapter applies as to all insurance policies and annuity contracts); TEX. INS. CODE ANN. § 1103.052 (West 2009) (subchapter relating to insurable interest for life insurance policies "shall be liberally construed to implement the purposes of this subchapter"); W. VA. CODE ANN. § 33-6-2 (LexisNexis 2011) (insurable interest statute with no carve-out for annuities).

[99] NEB. REV. STAT. § 44-704 (2010).

[100] N.J. STAT. ANN. § 17B:24-1.1 (West 2006) (setting forth insurable interest requirement and providing that it applies to life insurance, health insurance, and annuities).

[101] *Id.* § 17B:17-5 (defining "annuity" and noting that a contract that includes life insurance death benefits is still deemed to be an annuity "if such extra benefits constitute a subsidiary or incidental part of the entire contract").

[102] ARIZ. REV. STAT. ANN. § 20-254 (2002).

annuities from the requirement.[103] This type of statutory framework is especially common. Eighteen states, comprising Alabama,[104] Alaska,[105] Arizona,[106] Arkansas,[107] Delaware,[108] Georgia,[109] Idaho,[110] Indiana,[111] Kentucky,[112] Louisiana,[113] Maine,[114] Maryland,[115] Nevada,[116] New

---

[103] ARIZ. REV. STAT. ANN. § 20-1104 (2010); *see also id.* § 20-1101 (clarifying scope of article that includes insurable interest requirement and excluding certain products, but not annuities).

[104] ALA. CODE § 27-14-2 (LexisNexis 2007) ("[T]his chapter applies as to all insurance contracts and annuity contracts"); § 27-14-3 (very next section, stating insurable interest requirement without any carve-out for annuities). Alabama thus makes its insurable interest requirement applicable to annuities even though it defines them as separate products elsewhere in the code. See § 27-5-3 (defining "annuity" as a separate type of contract from a life insurance policy as defined in § 27-5-2, and noting that a contract that includes certain life insurance death benefits is still deemed to be an annuity "if such extra benefits constitute a subsidiary or incidental part of the entire contract").

[105] ALASKA STAT. § 21.42.020(d) (2010) (defining insurable interest requirement as referring to "life, annuity, or health insurance").

[106] ARIZ. REV. STAT. ANN. § 20-1101 (2010) (clarifying scope of article that includes insurable interest requirement and excluding certain products, but not annuities).

[107] ARK. CODE ANN. § 23-79-103 (2004) (defining insurable interest requirement); ARK. CODE ANN. § 23-79-102 (Supp. 2011) (clarifying scope of chapter and excluding certain products, but not annuities).

[108] DEL. CODE ANN. tit. 18, § 2701 (1999) (explaining "this chapter applies to all insurance contracts and annuity contracts"); DEL. CODE ANN. tit. 18, § 2704 (1999) (describing insurable interest requirement with no carve-out for annuities).

[109] GA. CODE ANN. § 33-24-3 (West Supp. 2011) (defining insurable interest requirement); GA. CODE ANN. § 33-24-2 (West 2003) (clarifying scope of chapter and excluding certain products, but not annuities).

[110] IDAHO CODE ANN. § 41-1804 (2010) (defining insurable interest requirement); IDAHO CODE ANN. § 41-1801 (2010) (chapter of code applies "as to all insurance contracts and annuity contracts").

[111] IND. CODE ANN. § 27-1-15.6-31 (LexisNexis Supp. 2012) (insurable interest law applies to annuities in context of requiring producer to have an insurable interest in life of annuitant in order to have an interest therein); *see also In re* Estate of Powers, 849 N.E.2d 1212 (Ind. Ct. App. 2006).

[112] KY. REV. STAT. ANN. § 304.14-040 (West 2012) (defining insurable interest requirement); KY. REV. STAT. ANN. § 304.15-010 (West 2012) (subtitle in code applies to annuities as well as life insurance). Like Alabama, Kentucky has this framework despite explicitly defining annuities as separate products from life insurance. *See* KY. REV. STAT. ANN. § 304.5-030 (West 2012).

Jersey,[117] Oklahoma,[118] South Dakota,[119] Utah,[120] and Wyoming,[121] have similarly enacted statutes that either expressly state, or whose structure and

[113] LA. REV. STAT. ANN. § 22:914 (2009) (stating provisions of insurance code apply to variable annuity contracts); LA. REV. STAT. ANN. § 22:901 (2009) (defining insurable interest requirement); *see also* bulletin issued by the state insurance department taking the position that STATs would violate insurable interest laws, *see supra* note 28.

[114] ME. REV. STAT. ANN. tit. 24-A, § 2404 (2000) (defining insurable interest requirement); ME. REV. STAT. ANN. tit. 24-A, § 2401 (2000) (chapter of code "applies as to all insurance contracts and annuity contracts"). Maine has this framework despite some arguable inconsistencies in its code relating to whether annuities are deemed insurance products. *Compare* ME. REV. STAT. ANN. tit. 24-A, § 3 (2000) (defining "insurance" broadly to include annuities), *with* ME. REV. STAT. ANN. tit. 24-A, § 703 (2000) (defining "annuity" as a separate type of contract from a life insurance policy per § 702).

[115] MD. CODE ANN., INS. § 12-201 (LexisNexis 2011) (defining insurable interest requirement); MD. CODE ANN., INS. § 12-102 (LexisNexis 2011) (article applies to insurance and annuity contracts). This framework applies even though annuities are not defined in the code as life insurance products. MD. CODE ANN., INS. § 1-101(d)(3) (LexisNexis 2011) (definition of "annuity" provides that it "does not include life insurance); *see also* Matthews v. Matthews, 647 A.2d 812, 817 (Md. Ct. App. 1994) (annuity contracts are not technically life insurance).

[116] NEV. REV. STAT. ANN. § 687B.040 (LexisNexis Supp. 2011) (defining insurable interest requirement); NEV. REV. STAT. ANN. § 687B.010 (LexisNexis Supp. 2011) (scope of chapter of code "applies to all insurance contracts and annuity contracts"). The statutes so provide despite having defined annuities as separate from insurance. *See* NEV. REV. STAT. ANN. § 688A.020 (LexisNexis Supp. 2011).

[117] *See* N.J. STAT. ANN. § 17B:24-1.1 (West 2006); N.J. STAT. ANN. § 17B:17-5 (West 2006).

[118] OKLA. STAT. ANN. tit. 36, § 3604 (West 2001) (defining insurable interest requirement); OKLA. STAT. ANN. tit. 36, § 3601 (West 2001) (clarifying scope of chapter and excluding certain products, but not annuities); *see also* Baird v. Wainwright, 260 P.2d 1060, 1064 (Okla. 1953) (holding where annuity certificate provided a monthly annuity for insured during his lifetime, and at his death if aggregate of annuities was less than the premium paid the difference was payable to the beneficiary named in the policy, the contract was a combination life and annuity policy authorized to be executed by an insurance company).

[119] S.D. CODIFIED LAWS § 58-10-4 (2004) (defining insurable interest requirement); S.D. CODIFIED LAWS § 58-10-1 (2004) ("Chapters 58-10 to 58-12, inclusive, apply as to all insurance contracts and annuity contracts.").

[120] UTAH CODE ANN. § 31A-21-104 (LexisNexis 2010) (defining insurable interest requirement); UTAH CODE ANN. § 31A-21-101 (Supp. 2012) (defining scope of chapter and not carving out annuities); *see also* UTAH CODE ANN. § 31A-

placement in the code imply, that annuities are subject to the same insurable interest requirements as life insurance policies.

Altogether, this review indicates that thirty-one of the fifty states either expressly define annuities as insurance products or otherwise indicate that insurable interest requirements apply to annuities. In each of these states, strong arguments could be made that insurable interest requirements already apply to STATs under existing law.

Such arguments might also be made as to *some* variable annuities in Hawaii and Washington, which have developed an interesting approach to the definitional question that is of direct relevance to STATs. Both states have enacted statutes providing that whether life insurance rules apply to annuities depends on the nature of the death benefit. If the GMDB is "not in excess of the greater of the sum of the premiums or stipulated payments paid under the contract or the value of the contract at time of death," the provision "shall not be deemed to be life insurance and therefore not subject to the provisions of this code governing life insurance carriers."[122] But "[a] provision for any other benefit on death during the deferred period *shall* be subject to such insurance provisions."[123] Presumably, that would include being subject to insurable interest laws.[124] Thus, in these states, a STAT that is limited to a standard GMDB allowing it to pursue risk-free investment, with a safety net promising only a premium refund, would arguably *not* be subject to insurable interest requirements, whereas a STAT with an enhanced or "stepped-up" death benefit, such as the "lock in," "anniversary ratchet," or "roll-up" options

1-301 (Supp. 2012) (including various definitions of terms that include annuities, including "business of life insurance" and "insurance business"); *but see In re* Estate of Clark, 354 P.2d 112, 117 (Utah Ct. App. 1960) (analyzing statutory definitions of life insurance and annuities in context of tax dispute, and holding, "We find nothing in these sections to justify the claim that an annuity contract such as herein involved should be classified as life insurance either for the purpose of estate tax or otherwise.").

[121] WYO. STAT. ANN. § 26-15-102 (2011) (setting forth insurable interest requirement); WYO. STAT. ANN. § 26-15-101 (2011) ("This chapter applies to all insurance contracts and annuity contracts.").

[122] HAW. REV. STAT. § 431:10D-118(b)(2) (2005); *see also* WASH. REV. CODE ANN. § 48.18A.030 (West 2010).

[123] HAW. REV. STAT. § 431:10D-118(b)(2) (2005) (emphasis added); *see also* WASH. REV. CODE ANN. § 48.18A.030 (West 2010).

[124] *E.g.*, WASH. REV. CODE ANN. § 48.18.030 (West 2010) (imposing insurable interest statute as applying to life insurance).

described above, would more clearly run afoul of insurable interest requirements.

Insurers seeking to rescind STATs in the remaining seventeen states will have to deal with a variety of statutes and cases—or, in some states, an absence thereof—that may make it more difficult to establish that insurable interest is required for variable annuities. Eight of these states—consisting of Connecticut,[125] Minnesota,[126] Missouri,[127] Montana,[128] New York,[129] North Carolina,[130] Vermont,[131] and of course, Rhode Island—present a statutory framework similar to that considered in *Conreal*. In those states, statutes define annuities as separate products from life insurance, but do not explicitly speak to the issue of whether insurable interest laws apply to those separately defined annuities. But again, that fact does not necessarily suggest that the legislatures in those seventeen states meant to *exclude* STATs. Rather, it suggests only that those

---

[125] CONN. GEN. STAT. ANN. § 38a-1 (West 2012) ("This definition of 'annuities' does not apply to payments made under a policy of life insurance.").

[126] MINN. STAT. ANN. § 61A.021 (West 2005) (sale of life insurance and annuity as a single product, e.g. with a rider or otherwise, expressly prohibited in Minnesota).

[127] MO. ANN. STAT. § 376.671 (West Supp. 2012) (where annuity contracts also provide death benefits by rider, the annuity and life insurance portions of the benefits shall be calculated separately as though it were a separate contract); *see also* Carroll v. Equitable Life Assurance Soc'y of U.S., 9 F. Supp. 223, 224 (W.D. Mo. 1934) (emphasizing distinct characteristics between annuities and life insurance contracts).

[128] MONT. CODE ANN. § 33-1-208 (2011) (defining life insurance without referencing annuities); *see also* Estate of Miles v. Miles, 994 P.2d 1139, 1144 (Mont. 2000) (analyzing code in detail and noting that legislature could have, but did not, define annuities as life insurance or provide that they should be similarly treated).

[129] N.Y. INS. LAW § 1113(a)(1-2) (McKinney 2006) (defining annuities and life insurance policies as separate types of contracts); *see also* N.Y. INS. LAW § 3205 (McKinney 2006) (insurable interest requirement only refers to life insurance contracts).

[130] N.C. GEN. STAT. § 58-7-15 (2001) (defining life insurance and annuities as separate products); *see also* N.C. GEN. STAT. §§ 58-58-70 to -86 (2001) (relating to insurable interest without speaking to which types of contracts require such an interest).

[131] VT. STAT. ANN. tit. 8, § 3717 (2009) (stating an annuity with death benefits of the kind provided by life insurance "shall nevertheless be deemed to be an annuity if such extra benefits constitute a subsidiary or incidental part of the entire contract.").

legislatures have not yet been confronted with the possibility that strangers lacking insurable interests in the lives of terminally ill annuitants might exploit variable annuities.[132] Four other states—Massachusetts,[133] Oregon,[134] Virginia,[135] and Wisconsin[136]—have insurable interest statutes whose phrasing or placement in the code suggests that the legislature did not intend them to apply to annuities. And finally, as to the last five states—Iowa,[137] Kansas,[138] New Hampshire,[139] Ohio,[140] and

---

[132] As argued above, if these states later enact legislation making insurable interest a requirement for annuities, such enactments would arguably not reflect a "change" to state law, but a recognition that STATs violate existing common-law and public policy grounds prohibiting the procurement of contracts by total strangers who stand to gain from another's death. *See supra* p. 136.

[133] MASS. GEN. LAWS ANN. ch. 175, § 123 (West 2011) (requiring assent of insured not applicable to "contracts based upon the continuance of life, such as annuity or pure endowment contract . . . .").

[134] OR. REV. STAT. ANN. § 743.024 (West 2011) (setting forth insurable interest requirement for personal insurance but then stating, "[t]his section does not apply to annuity policies."). This statute does so despite the fact that the Oregon code defines insurance to include annuities. OR. REV. STAT. ANN. § 731.102 (West 2011) ("'Insurance' so defined includes annuities."); OR. REV. STAT. ANN. § 731.170 (West 2011) ("For convenience, reference to 'life insurance' in the Insurance Code includes life insurance as defined in subsection (1) of this section and annuities as defined in ORS 731.154, except if the inclusion of annuities obviously is inapplicable or if the context requires, or the Insurance Code provides, otherwise.").

[135] VA. CODE ANN. § 38.2-301 (2007) (setting forth insurable interest requirement); *id.* § 38.2-300 (2007) (chapter does not apply to annuities). This carve-out for annuities is made despite the fact that other statutes define annuities as insurance. *See* VA. CODE ANN. § 38.2-602 (2007) ("'Life insurance' includes annuities."); *id.* § 38.2-501 (2007) ("'Insurance policy' or 'insurance contract' includes annuities . . . .").

[136] WIS. STAT. ANN. § 631.01 (West 2004) (chapters addressing life insurance, which include provisions relating to insurable interest, "do not apply to annuities").

[137] *See*, *e.g.*, Hult v. Home Life Ins. Co. of N.Y., 240 N.W. 218, 227 (Iowa 1932) ("[A] life insurance contract must be based upon an insurable interest, in the absence of which it becomes a wager contract."). *Hult* involved claims by an executor seeking to rescind annuity contracts that the deceased had purchased on her own life. Although the court declined to apply the insurable interest rule to rescind the contracts at bar, its rationale for doing so arguably suggests that it would have reached a different result in a STAT case:

> If a person takes out a life insurance policy on the life of one in whom he has no insurable interest, there are three parties involved: First, the party who procures the insurance; second, the

Pennsylvania[141]—the statutory framework and case law does not provide a concrete answer.

While this review does not exhaustively examine every potentially pertinent statute or case in each state, it at least suggests that *Conreal* should not necessarily be viewed as a dangerous precedent or as an invitation to STAT promoters to target other markets. Because Rhode Island's statutory scheme is unlike those of most other states, *Conreal* is easily distinguishable.[142]

XI. OTHER POTENTIAL ISSUES IN STAT DISPUTES

Even if a STAT dispute does not result in judicial rescission of the annuity contract on insurable interest grounds, other potential arguments

---

> insurance company; third, the party insured. Not so in this case. Here there are but the two parties, the one to whom the contract runs and the insurance company, which makes the contract. There is here no disinterested third party, *whether viewed as an annuity contract or an insurance contract*.

Id. (emphasis added).

[138] Kansas has a statute prohibiting a "life insurance contract" without insurable interest, KAN. STAT. ANN. § 40-450 (West 2000), but the insurance code does not purport to define that term or to distinguish it from annuity contracts.

[139] New Hampshire law requires insurable interest for a "policy of life or endowment insurance," N.H. REV. STAT. ANN. § 408:2 (LexisNexis 2009), but the insurance code does not define that term or to distinguish it from annuity contracts. *But see* Frederick v. Frederick, 687 A.2d 711, 714 (N.H. 1996) (noting a "long history of cases" viewing annuity beneficiaries with the same analysis used in the life insurance context).

[140] Ohio's code does not define insurance or annuities, and its insurable interest rules are primarily based on common law, with uncertain applicability to annuities. *See*, *e.g.*, Donahue v. Carpenter, No. 91WD057, 1992 WL 66564 (Ohio Ct. App. Mar. 31, 1992) (sustaining appeal of judgment on interpleaded proceeds of annuity contract, but not directly addressing the parties' dispute regarding whether insurable interest rules applied to annuities).

[141] Pennsylvania's insurable interest requirement only applies to a "policy of life insurance," 40 PA. STAT. ANN. § 512 (West 1999), but the code does not define that term or distinguish it from annuities. Some case law exists distinguishing the two types of products, but not in the context of insurable interest. *E.g.*, *In re* Estate of Bayer, 26 A.2d 202, 205 (Pa. 1942) (noting "obvious differences" between annuities and life insurance contracts and finding that they are to be treated differently for taxation purposes).

[142] *See* W. Reserve Life Assurance Co. of Ohio v. Conreal, 715 F. Supp. 2d 270, 276-78, 280 (D.R.I. 2010).

might be made by insurers seeking to recover market losses paid to the investors in the form of GMDBs, such as by bringing causes of action for fraud or material misrepresentations. The annuity contract's contestability clause may bar such claims against the contract owner. However, courts may, as in *Conreal*, still allow insurers to seek fraud damages from the other various sponsors, agents, and other collaborators in STAT schemes.[143] An insurer might also claim that conduct by participating agents breached brokerage service agreements with the company,[144] or a covenant of good faith and fair dealing implied in such contracts.[145] STAT promoters might also be subject to criminal liability and potential civil actions relating thereto, such as for forging annuitant signatures,[146] paying money in exchange for such signatures,[147] or insurance fraud.[148]

Insurance companies should be well-prepared for the possibility that courts and juries may be skeptical of insurers' claims because of companies' failure to eliminate the potential risks of STATs. Insurers draft the annuity applications, contracts, and prospectuses. They do not request additional information or engage in thorough underwriting before issuing a variable annuity. They control the assumptions used to set prices for the annuity fees, and have decided that the annuitant's health is not a relevant factor. Yet, none of these arguments should have any impact on whether a court is willing to enforce the public policy that is part and parcel of an insurable interest analysis. Further, insurers might contend that they had no way of knowing that their annuity products would be exploited in this manner, and that their business decisions regarding the degree of underwriting needed were reasonable in light of historically low mortality rates for annuity applicants. Even *Conreal*, after condemning the insurers for their lack of foresight in declining to recognize an insurable interest

---

143 *Id.* at 281-82.

144 Such contracts, for example, often require the brokerage firm to train and supervise its agents, to indemnify the insurer for its agents' wrongful acts, *see*, *e.g.*, Complaint and Jury Demand at 16-17, W. Reserve Life Assurance Co. of Ohio v. Conreal, 715 F. Supp. 2d 270 (2009) (No. 09-564-S), and might also obligate agents to use only approved materials to market the insurer's products (which, presumably, do not include flyers distributed at hospices and churches).

145 *E.g.*, *id.* at 16.

146 *E.g.*, *id.* at 18.

147 *See* Consolidated Memorandum in Response to Defendants' Motions to Dismiss at 45, Transamerica Life Ins. Co. v. Lifemark Sec. Corp., No. 09-549/S (D. R.I. Feb. 1, 2010).

148 *E.g.*, Complaint, *supra* note 144, at 18.

requirement,[149] still allowed the insurers to proceed with their fraud claims against the non-owner defendants despite not having specifically asked for the information withheld.[150]

Conreal also acknowledged additional arguments for voiding the contracts that, like insurable interest, could "rope the owners back into the lawsuits" despite the contestability clauses.[151] The plaintiff insurers raised arguments that the contracts might be void due to forgery of the annuitant's signatures and fraud in the factum, based on the theory that the annuitants were tricked into signing without knowing the contracts' true nature or contents. The court declined to address the merits of such arguments, noting that the complaints had failed to adequately plead such claims, but it did grant them leave to amend.[152] Importantly, the court recognized that such forgery or fraud in the factum could render the annuity contracts "void and not merely voidable," thus depriving the owners of their incontestability defense because the pertinent clauses "never would have come into effect."[153] Thus, depending on the facts of a particular STAT case, such arguments could certainly be made to suggest that the annuity contracts were not validly formed and should be held void.

One other potential argument relating to valid contract formation is also worth discussing, that there was no meeting of the minds between the owner and the insurer. In other words, the insurer might contend that there was a mistake of fact—that the insurer reasonably believed that the selected annuitant was a typical, self-selecting individual whose life expectancy would be of sufficient duration to justify the long-term investment strategy ordinarily expected of the variable annuity product. Mistake arguments, however, have historically been rejected in cases involving annuitants whose health problems were unknown at the time of the annuity purchase.[154] Such cases might theoretically be distinguished based on the

---

[149] *Conreal*, 715 F. Supp. 2d at 278-79.

[150] *Id.* at 281-82.

[151] *Id.* at 287 n.16.

[152] *Id.*

[153] *Id.* (citing R.I. Depositors Econ. Protection Corp. v. Bowen Court Assocs., 763 A.2d 1005, 1009 (R.I. 2001); Giannone v. Ayne Inst., 290 F. Supp. 2d 553, 563 (E.D. Pa. 2003)).

[154] *See*, *e.g.*, Aldrich v. Travelers Ins. Co., 56 N.E.2d 888, 889 (Mass. 1944) ("It is difficult to see how any company could carry on an annuity business if the estate of an annuitant could rescind whenever it turned out that the condition of his health did not 'warrant a reasonable expectation of life.'"); Am. State Bank of Bloomington v. Nat'l Life Ins. Co., 17 N.E.2d 256 (Ill. App. Ct. 1938); Woodworth v. Conn. Mut. Life Ins. Co., 27 F. Supp. 732 (S.D.N.Y. 1939).

fact that they were *mutual* mistake cases brought by unknowingly ill annuitants,[155] while STATs involve a *unilateral* mistake on the insurer's part. But the problem with a unilateral mistake argument, again, is the insurer's typical decision not to inquire as to the annuitant's health. The Restatement of Contracts, for example, holds that the mistake of one party makes a contract voidable only when the mistaken party does not "bear the risk of the mistake."[156] It further explains that a party *does* bear the risk of a mistake—and thus, is not entitled to rescission—if "he is aware, at the time the contract is made, that he has only limited knowledge with respect to the facts to which the mistake relates but treats his limited knowledge as sufficient."[157] An insurer invoking the "meeting of the minds" argument should be prepared to address these considerations.

In sum, various remedies might be sought from collaborators in STAT schemes. Insurers may even in some cases be able to establish that the contracts should be held void for fraud vis-à-vis the annuitant. But if the annuitant did participate knowingly, or there is not enough evidence to prove otherwise, rescission of a STAT contract will likely hinge on whether the insurable interest requirement applies to variable annuities under applicable state laws.

XII. CONCLUSION

STAT investors exploit a *practical* loophole in the variable annuity product, but it is far from clear whether there exists a *legal* loophole making such exploitation lawful. To address the former, insurance companies should consider whether it still makes business sense to continue to engage in limited underwriting of annuity applications, and whether contestability clauses in their annuity contracts should be revised. With respect to the latter, however, it is not yet clear how legislatures and courts will address the issue. Insurable interest requirements at common law and based upon public policy concerns may, depending on the laws of the pertinent jurisdiction, arguably already prohibited any stranger-originated contracts that enable the stranger to benefit from the death of another human being. Insurers may also pursue a number of other

---

155 Such cases typically involve suits by the annuitant's estate, seeking to rescind a policy based on the fact that neither the annuitant nor the insurance company knew of the annuitant's failing health. *See generally* sources cited *supra* note 154.

156 RESTATEMENT (SECOND) OF CONTRACTS § 153 cmt. b (1981).

157 RESTATEMENT (SECOND) OF CONTRACTS § 154 introductory cmt. (1981).

arguments if considering legal actions against the STAT originators and agents, but rescission of the annuity contracts will in many cases hinge on how courts choose to interpret the scope of existing insurable interest laws.