LOS ANGELES
Daily Journal
www.dailyjournal.com
THURSDAY, APRIL 19, 2012

The battle over life settlement policies

By William Molinski and Khai LeQuang

Insurance companies today are going to court to try to invalidate millions, and potentially billions, of dollars in life insurance policies they issued years ago. What's more, they're asking courts to let them pocket millions of dollars in premiums they collected over the years, leaving their policyholders with nothing, and in the process giving themselves a massive windfall for writing policies they now claim are illegal.

These policies were originally purchased by consumers and then sold to investors on the secondary market. Selling one's life insurance policy can be a good deal for anyone who is financially strapped, or simply looking to monetize their life insurance. Over the past decade, consumers came to realize that an emerging secondary market for life insurance greatly enhanced the value of a life insurance policy, and many of them purchased life insurance with the idea they might one day sell their policies to an investor for a profit.

Insurance companies, however, don't like investors owning policies because investors exercise contractual rights that insurance companies tout, but don't expect consumers to take advantage of. In fact, insurance companies hope not to pay the death benefits on many of their policies because they think people will let their policies lapse or surrender them before they die. When that happens, the insurance company cancels the policy and keeps most of the premiums. What it keeps is free money. But when consumers began selling their policies to investors, a lot of that free money went away.

Insurance companies don't like investors owning policies because investors exercise contractual rights that insurance companies tout, but don't expect consumers to take advantage of.

The pretext of insurable interest.

The insurance companies now want that free money back. Although they profited enormously from selling policies to consumers who bought their policies aware they could sell them on the secondary market, those same insurance companies are now trying to rescind the policies *and* keep all the premiums. The legal pretext for this bold gambit is insurable interest. "Insurable interest" means an interest in the continued life of another person. The insurable interest requirement is intended to prevent a stranger from taking out a policy on someone else's life. Only someone who has an interest in a person staying alive can take out a policy on that person's life. Under California law, an insurable interest must exist when a policy "takes effect, but need not exist thereafter. … " Ins. Code Sections 286, 10110.1(f). Once a policy is issued, every person has the right to sell their policy, including to someone without an insurable interest. Section 10130. California courts have long recognized that the law was "designedly adopted to set at rest any question as to the assignability of a life insurance policy and also to affirm the right to make such assignment to a person having no insurable interest in the life of the insured." *Lewis v. Reed*, 48 Cal. App. 742, 746 (1920).

Insurance companies now say that a policy should be void for lack of insurable interest if a person purchased their policy with the intent to exercise this deeply rooted legal right. Courts in California have consistently rejected attempts to graft an intent requirement onto the insurable interest rules, but insurers continue to ask courts to reconsider these prior holdings.

Challenges to insurable interest.

The most recent challenge to a policy on insurable interest grounds was resolved in *Hartford Life & Annuity Ins. Co. v. Doris Barnes Family 2008 Irrevocable Trust.* Shortly after Doris Barnes purchased her policy, she and her husband sold the beneficial interest in a trust that was formed to purchase the policy. The insurer, Hartford, claimed the policy was void for lack of insurable interest because Mrs. Barnes never intended to keep the policy when she purchased it. Hartford also claimed it was allowed to keep all the premiums. In holding that the policy was not void for lack of insurable interest, Judge Philip S. Gutierrez of the Central District observed, "The Insurance Code does not state or imply that the intent to sell a policy in the future is relevant to whether one has an insurable interest. Rather, the Code plainly states that a policy may be transferred to one without an insurable interest after the policy goes into effect." Hartford has appealed the ruling.

In *Wells Fargo Bank, N.A. v. American Nat'l Ins. Co.*, the policyholder discovered there was fraud in the origination of the policy and asked the insurer to rescind the policy and return the premiums. The insurer refused and required the policyholder continue making premium payments to keep the policy in force. Later, the insurer claimed the policy was void for lack of insurable interest and that it was entitled to keep the premiums. Judge Dean Pregerson of the Central District held, among other things, that the policy was not void for lack of insurable interest simply because the insured, Benjamin Cabal, purchased the policy with the intent to sell it. The insurer appealed, and a decision from the 9th U.S. Circuit Court of Appeals is expected later this year.

Last year, in *Lincoln Nat'l Life and Annuity Co. v. Berck*, the California Court of Appeal held in an unpublished opinion that a policy is not void for lack of insurable interest simply because the insured, Jack Teren, procured the policy with the intent to sell it. Like *Barnes* and *Cabal*, the case involved the sale of the beneficial interest in a trust that was formed to purchase the policy. The California Supreme Court denied review.

These cases all relied on *Lincoln Nat'l Life Ins. Co. v. Gordon R.A. Fishman Irrevocable Life Trust.* In *Fishman*, Lincoln challenged three policies that were purchased with non-recourse premium financing. The loans were used to fund the first two years of premiums, and after the two years, the insured, Dr. Fishman, had the choice either to repay the loans or simply surrender his policies in full satisfaction of his debt. Lincoln claimed these loans were intended to facilitate the transfer of the policies to the lender after two years, which Lincoln argued rendered the policies void for lack of insurable interest. Judge Stephen Larson of the Central District rejected Lincoln's claim, holding that an insured's intent to later transfer a policy is irrelevant to whether an insurable interest existed at the time the policy took effect.

The stakes in 2012.

In 2010, the California Legislature amended the Insurance Code to restrict the transfer of a life insurance policy for a period of two years from when it is issued. Ins. Code Section 10113.3(m). The restriction applies only to policies issued after 2010 and does not prohibit a person from purchasing a policy with the intent to sell it after this two-year period. Hence, what is at stake in today's lawsuits involving policies that were issued before 2010 is not public policy. The battle is over whether insurers will be able to reap a huge windfall by potentially voiding billions of dollars in life insurance policies they issued, and yet keep all the premiums while providing nothing in return.

William Molinski *heads Orrick, Herrington & Sutcliffe's Commercial Litigation practice. Based in Los Angeles, Molinski represents corporations and individuals in all aspects of commercial litigation with a particular emphasis in the areas of life settlements, consumer class actions, trade secrets, trademarks and other intellectual property.*

Khai LeQuang, *a partner in Orrick's Commercial Litigation practice, is based in Los Angeles. LeQuang's practice encompasses all aspects of complex commercial litigation, including product liability, insurance, internet law, employment litigation, antitrust and international arbitrations.*