Stranger-Originated Life Insurance (STOLI): Controversy and Proposal for Market-Based Solutions

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Abstract: A Stranger-Originated Life Insurance (STOLI) transaction arises when a life insurance policy is effectively procured by a stranger, usually a third-party investor unrelated to the insured. Despite the growing frequency and popularity of STOLI transactions, there has been much discussion, but a lack of academic research, on the issues and challenges they have generated. The purpose of this research is to shed some light on this innovative insurance transaction by providing a clearer understanding of the controversy created by the STOLI phenomenon, and to argue that regulatory action aimed at restricting or prohibiting these transactions seems unnecessary. After examining the controversy generated by STOLI transactions from the perspective of consumers, insurance carriers, and state insurance regulators, we review the primary initiatives to regulate STOLI transactions, analyze the concerns that have been raised about these transactions, and conclude with proposals for market-based solutions and other reforms to address these concerns and other issues that have given rise to the STOLI controversy. [Key words: STOLI, life insurance, market-based solutions]

INTRODUCTION

Cash value life insurance serves many critical economic functions. Most importantly, it provides financial protection against premature death to family members and/or business partners. When the need for financial protection no longer exists, however, what viable options does a policy...
owner have if he or she no longer needs the insurance coverage and decides to cash in the policy? Traditionally, the policy owner’s primary option has been to surrender the policy and receive the cash value, if any, from the insurer. Recently, though, with the rise of a secondary market for life insurance policies, an additional option has become available: the policy owner can sell the policy to a third-party investor. The investor becomes the new policy owner, who pays the remaining premiums on the policy and collects the death benefit at the insured’s death. This second option has become known as a life settlement.4

Doherty and Singer (2002) describe life insurance arrangements as “a previously inaccessible asset class.” Due to the increasing investor demand, the secondary market for life insurance has grown rapidly. The Government Accountability Office (GAO) estimated that the total face value of policies settled in 2008 ranged from $9 billion to $12 billion approximately (GAO, 2010). The Securities and Exchange Commission (SEC) estimated the face amount of life insurance settled in 2009 to be $7.01 billion.5 Kamath and Sledge (2005) estimated that by 2030 the potential market size of the life settlement industry could reach $160 billion, in terms of total face value transactions.

The growing investor demand for policies in the secondary market has contributed significantly to the creation and increasing use of a transaction similar to the typical life settlement: the Stranger-Originated Life Insurance (hereafter, STOLI). In a STOLI transaction, a life insurance policy is effectively procured by a stranger, usually a third-party investor unrelated to the insured who does not have an insurable interest in the insured’s life. For example, an investor group may solicit an elderly individual to be the insured and initial owner of a sizable life insurance policy, and then lend the individual a substantial amount of money to pay the premiums for the first two years. At the end of the two-year period, the individual owner is required either to repay the loan plus interest or to transfer ownership of the policy to the investor group. Should the insured die in the first two years, a portion of the death benefit would be used to repay the loan, including interest, with the balance to be paid to the beneficiary named by the individual owner. As the amount of the loan when due is rather large, transfer of the policy is the usual option, in which case the loan is forgiven and the individual owner may also receive additional compensation. Following the transfer, the investor group names itself as policy beneficiary and pays all future premiums until the insured’s death, after which the

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4 Please note that convertible term life insurance may also be subject to life settlements, although our paper focuses only on cash value life insurance.

group receives the full death benefit under the policy. Of course, the sooner the insured dies, the greater the yield of the investment to the investor group.

Perhaps not surprisingly, the growing phenomenon of STOLI transactions has generated a great deal of controversy, particularly among consumer advocates, life insurance carriers, and state insurance regulators. Consumer advocates question whether the individual solicited to purchase the policy has been provided with adequate disclosures of the risks and other drawbacks inherent in these transactions, while some insurance carriers believe that STOLIs (as well as other life settlement transactions) threaten the model that they use to price their products. Some regulators have publicly questioned whether the policies involved are lawful insurance contracts under the insurable interest requirement imposed by their states. As a result of these and other concerns, industry groups have proposed model rules designed to restrict or prohibit STOLI transactions and many states have now adopted similar legislation. Also, many insurers have filed lawsuits in order to rescind policies that they claim were subsequently sold by the insured as part of a STOLI transaction.

Despite the increasing popularity and controversy generated by STOLI transactions, there has been much discussion, but a surprising lack of academic research, on the issues and challenges they have generated. The purpose of this paper is to shed some light on this innovative insurance transaction by providing a clearer understanding of the controversy created by the STOLI phenomenon and to argue that regulatory prohibition of these transactions seems unnecessary. The paper begins by describing the nature of STOLI transactions and differentiating them from similar transactions. Next, the controversy generated by STOLI transactions from the perspective of consumers, insurance carriers, and state insurance regulators is discussed, and an overview of the primary proposals to regulate STOLI transactions is provided. After reviewing and analyzing the concerns that have been raised about these transactions, the paper concludes with proposals for market-based solutions and other reforms to address these concerns and other issues that have given rise to the STOLI controversy.

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6 For a list of the consumer liaison representatives that participated in the NAIC, please see NAIC (2010).

7 For a recent overview of current issues pertaining to the STOLI controversy, however, see Cole and McCullough (2008).
AN OVERVIEW OF STOLI TRANSACTIONS

As noted previously, STOLI refers to a transaction in which a life insurance policy has been effectively procured by a stranger. STOLI transactions are typically marketed to consumers between the ages of 65 and 85. Various forms of STOLI transactions exist, but by and large they fall into one of two categories (Texas Department of Insurance, 2007). In the first, the client is asked to apply for a life insurance policy on his or her own life, and then immediately sell the policy to a third-party investor group in exchange for either a lump sum payment or the investor group’s agreement to pay a portion of the death benefit to the client’s family. In the second, the client is asked to apply for a policy on his or her own life in anticipation of a future life settlement transaction, which most likely will occur after the two-year contestability period. Regardless of how they are structured, all STOLI transactions have one thing in common: life insurance is acquired primarily as an investment vehicle for a third-party investor (i.e., a stranger), rather than to provide financial protection against premature death for those who have an insurable interest in the life of the insured.

STOLIs are not to be confused with viatical settlements, traditional life settlements, or premium financing agreements, as there are significant differences among these transactions. Although the latter three may involve some aspects of a STOLI, such as the sale of a life insurance policy or the loan of funds to pay life insurance premiums, in each case the policy was initially procured by the insured to protect and benefit family members, business partners, or others with a financial interest in the insured’s life. In contrast, STOLIs are effectively initiated by third parties who may be strangers to the insured, but are seeking to obtain insurance on the insured’s life for their own investment purposes.

Although both a viatical settlement and a STOLI transaction involve the sale of a life insurance policy at a discounted price before it matures, the circumstances in which the former occurs distinguish it from the latter. Strictly speaking, a viatical settlement usually involves the sale of a policy by a terminally ill insured seeking to raise cash for medical needs or other purposes. During the AIDS crisis of the 1980s, investors began to form viatical settlement companies to purchase the life insurance policies of AIDS patients and other terminally ill people at a deep discount from the

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8In some states the regulatory definition of “viatical settlements” has been broadened to include all types of settlements, regardless of whether the policyholder is suffering from a terminal illness. Accordingly, the terms “viatical settlement” and “life settlement” are sometimes used interchangeably. In this paper, we use the narrower definition of “viatical settlements” where the insured is diagnosed with a terminal illness.
face amount of the policy, then named themselves as policy beneficiaries in order to realize a profit from the purchases when the policies matured (Poe, Huntley, and Thornton, 1993). The practice continues today, since viatical settlements offer a way for the terminally ill insured to extract value from the policy while he or she is still alive. As the insured now faces a very limited life expectancy, the immediate need for liquidity outweighs the need for financial protection, and the insured is compelled to sell the policy. In this respect, a viatical settlement can be considered the insured’s response to a drastic change in his health status, which creates a financial need that did not exist when the policy was initiated. In contrast, the insured in a STOLI transaction is selling a policy he or she has purchased recently with the primary intent of selling it for profit to a third-party investor group.

A traditional life settlement is a variation of a viatical settlement, except that the insured is not diagnosed with a terminal illness. In a traditional life settlement, the insured has typically owned the policy for a number of years, but no longer needs the financial protection that the policy affords, and thus does not desire to keep the policy in force. Rather than lapse or surrender the policy when the need for insurance changes, the insured decides instead to sell the policy to a third-party investor group in a life settlement transaction. The opportunity to sell the policy to a life settlement company allows the policyholder to realize greater value from the policy than what he or she would receive by surrendering the policy to the insurer (Zolkos, 2007). A traditional life settlement is different from a STOLI transaction in that a life settlement is motivated by changes in circumstances arising after the issuance of the policy; the insured originally purchased the policy to provide financial protection for his or her family or business, rather than to sell it to investors in a secondary market.

Premium financing is a third type of transaction to be distinguished from STOLIs. This practice refers to the loaning of funds to an individual to enable him or her to purchase a life insurance policy. Usually such loans are provided by a third-party entity known as a “premium financing company,” although insurance companies and brokerage firms occasionally provide these services, as well. Under a premium financing contract, the lender pays the premium for a specified duration, and charges the cost of the loan to the policy owner. Unless specified otherwise, the principal and interest of the loan are then repaid from the policy proceeds at the insured’s death, with the balance paid to the beneficiary named in the policy.

A premium financing transaction differs from a STOLI transaction in several respects. First, the former involves no change of policy ownership and the owner/borrower retains all policy rights and benefits. Second,
unlike the investor group in a STOLI transaction, the lender does not benefit from the early death of the insured because any proceeds in excess of the loan repayment go to the named beneficiary, rather than to the lender. Third, the primary purpose of the premium financing transaction is to enable the insured to purchase the insurance necessary to provide financial protection for the insured’s family or business (LIFA, 2006).

**CONTROVERSY GENERATED BY STOLI TRANSACTIONS**

The increasing number of STOLI transactions has sparked great controversy among a variety of interest groups, including consumer advocates, insurance carriers, and state insurance regulators. Consumer advocates such as the Florida Insurance Consumer Advocate have expressed concerns that the individuals solicited by investor groups to purchase insurance in a STOLI transaction may not receive adequate disclosure about the potential risks they incur as a result of the transaction. As a result, these individuals may not fully understand the ramifications of the deal and make decisions they may later regret (Insurance Consumer Advocate, 2009). For example, the consumer may not be aware that the purchase of a large policy in a STOLI transaction may disqualify the consumer from purchasing additional life insurance coverage in the future, as insurers often limit the amount of life insurance coverage available to an applicant who has already been covered by another policy with significant face value. The consumer also might not fully appreciate that as a result of the STOLI transaction, the owner of the policy on the consumer’s life will be a third-party investor group, and the consumer no longer will have any control over who owns the policy on his life and/or who will receive the death benefit. The consumer may not appreciate the potential tax liability that may occur as a result of entering into a STOLI transaction.9 Finally, the consumer may not be made aware of the fees paid to brokers and to the investor groups in connection with the STOLI transaction.

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9In the case of STOLIs, as with traditional life settlements and most other sales of a life insurance policy, it is likely that the purchase price received by the seller of the policy will be treated as taxable income to the extent that the sales price exceeds the seller’s cost basis in the policy (Leimberg, Whitelaw, Weber, and Colosimo, 2006). The cost basis usually is the total premiums paid to date, minus the cost of insurance protection provided until the date of the sale, as well as any dividends that have been received by the seller. However, proceeds from the sale of a policy in a viatical settlement transaction usually are not treated as taxable income to the seller under federal law if the seller is the insured and is terminally or chronically ill.
These concerns were illustrated by a lawsuit filed by Larry King, the former CNN talk show host, against an insurance brokerage firm that, according to Mr. King, had arranged for Mr. King to purchase and then sell life policies in connection with two STOLI transactions. Mr. King’s suit claimed that the firm failed to inform him that the new policies, now owned by strangers, would significantly reduce his ability to buy additional life insurance (Huslin, 2007). The suit also alleged that the firm did not fully disclose the total amount of the commissions and other fees paid to the firm, which roughly equaled the after-tax proceeds Mr. King received for the sale of the two policies involved (Pleven and Silverman, Nov. 26, 2007).

On the other hand, some insurance carriers are concerned that the growing number of STOLI transactions, along with traditional life settlements, may reduce their net income. It has been noted that over eighty percent of typical life insurance policies lapse prior to the death of the insured (Huslin, 2007). Policies sold as part of a life settlement or a STOLI transaction, on the other hand, seldom, if ever, lapse, since the third-party investor group must maintain the policies until the death of the insureds in order to realize any gain from the transaction. As a result, since the insurer’s actual lapse ratio for these policies is much lower than what is expected in the actuarial assumptions when premium rates are set, these transactions can cause actual payouts to be significantly higher than expected payouts, which reduces the operating income for the insurer and directly affects its net profit. However, it should be noted that since the investor group continues to pay premiums to the insurer, the lower lapse rates also mean additional premiums and, thus, more steady income for the primary insurers than if the policies had lapsed. So, while the death benefit payments will be higher, the reduction in insurers’ income is

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10 Duhigg (2006) notes that in 2005, for example: “Insurance companies reduced their financial exposure by $1.1 trillion when 19.8 million policyholders stopped paying premiums, according to the Insurance Information Institute. In comparison, the industry paid death benefits on only 2.2 million policies. If those lapsed policies had been sold to investors rather than canceled, insurance companies could have eventually paid out as much as a trillion dollars.”

11 In life insurance, premium rates may be based upon a number of actuarial assumptions; these include the probability of death (i.e., mortality rates), interest rates, investment spreads, and lapse and surrender rates. Insurers may base their pricing on lapse and surrender rate assumptions in order to offer competitive rates (Gatzert, 2010: 294). When policies are sold on the secondary market, they are much less likely to lapse or be surrendered. As a result, their respective lapse and surrender rates are lower than what the insurance company most likely assumed when setting the premium rate, and the amount of profit the company earns from the policy is less than what it might have earned had the policies not been sold in a STOLI transaction. Although many insurers no longer use lapse-support pricing, certain carriers may continue to use this practice (see Doherty and Singer, 2002: 23).
partially offset by these additional premiums and investment income earned therefrom. Regardless, the growth of secondary markets for life settlements and STOLI transactions means that more life insurance policies that used to lapse will stay in force, making it more difficult than ever for insurers to predict lapse rates and, thus, increasing their pricing risk.

Another concern expressed by life insurance carriers is that tax authorities may conclude that STOLI transactions are designed primarily as investment vehicles for speculators, rather than as financial protection for families and businesses. As a result, these authorities may eventually decide that all life insurance policies should be subject to tax rules governing investment products. Currently, life insurance owners generally enjoy certain income tax benefits, such as the tax-deferred buildup of cash value in the policy and the tax-free transfer of death benefit payments to policy beneficiaries. It is feared that by fundamentally changing the traditional use of life insurance, the rise of STOLI transactions could threaten the favorable tax treatment currently afforded standard life insurance policies.

State insurance regulators also have concerns about STOLI transactions, in two key areas. First, as noted above, many regulators have argued that STOLIs violate the principle that a person originating an insurance policy must have an insurable interest in the life of the insured. This requirement is most commonly stated to mean that the original purchaser of a life insurance policy must have a financial interest in the insured’s continuing to live (ACLI, 2007). The doctrine evolved out of a concern for public welfare, due to the fear that the lack of a valid insurable interest would allow “a moral hazard of the worst sort,” to prevent people from abusing the concept of life insurance by wagering on (and perhaps causing) the death of others to whom they have no financial connection (Black and Skipper, 2000: 197). According to these regulators, the person effectively originating the policy in a STOLI transaction is not the insured, but instead is the third-party investor group who solicited the insured to take out the policy. As this group bears no familial or financial relationship to the insured, no insurable interest is likely to exist.

The second area of concern is whether certain conduct of investor groups and/or their brokers in setting up a STOLI transaction violates state anti-rebating laws, which typically prohibit the offering of anything of value to induce the purchase of life insurance, unless the inducement is stated in the policy. Under this view, when an elderly individual in a STOLI transaction is induced to purchase the policy in exchange for the investor group’s offer to pay a fee to the insured or its promise to purchase the policy from the individual at a later date, such an arrangement may constitute an illegal rebate under these statutes.
SUMMARY OF PROPOSALS TO REGULATE STOLI TRANSACTIONS

As a result of the above concerns, many consumer advocates, insurance carriers, and state insurance regulators maintain that STOLIs are abusive transactions and that regulatory action is necessary to deter and even prohibit them. Disagreement exists, however, as to what regulatory changes are best suited to solving the problem. For example, two of the primary proposals, one supported by the National Association of Insurance Commissioners (NAIC) and the other by the National Conference of Insurance Legislators (NCOIL), have taken different approaches in terms of recommending how STOLIs should be regulated.12

NAIC first developed its Viatical Settlement Model Act in 1990 in order to provide regulatory guidelines for viatical settlement transactions. In 2007, the NAIC Life Insurance and Annuity Committee further amended this model law, with the objective of regulating STOLIs. Two of the primary changes made by the amended NAIC Model Act were to narrow the definition of a viatical settlement contract and to establish a waiting period before a life policy could be sold by the original owner (NAIC, 2007).

Prior to the 2007 amendments, the definition of a viatical settlement contract was broad enough to include all loan and other financing arrangements in which a life insurance policy serves as the primary collateral (other than a carrier policy loan) (Casey, 2007). In the amended NAIC Model Act, this broad definition is replaced by a definition that includes specific types of premium finance loans while excluding certain others. The new definition also leaves a significant amount of discretion in the hands of each state’s Insurance Commissioner as to whether a particular premium financing arrangement will be considered a viatical settlement in that state.

The other important change made by the amended NAIC Model Act is to make STOLIs more difficult by increasing the period of time that the original owner of a life policy must wait before selling the policy. The prior Act had stated that the original owner had to wait at least two years before selling the policy in a life settlement transaction. Under the amended NAIC

12NAIC is an organization of insurance regulators from the 50 states, the District of Columbia, and the five U.S. territories. Insurance is largely regulated at the state level, so NAIC “provides a forum for the development of uniform policy when uniformity is appropriate” (www.naic.org). NCOIL, on the other hand, is an organization of state legislators whose main area of public policy interest is insurance legislation and regulation. Most legislators active in NCOIL either chair or are members of the committees responsible for insurance legislation in their respective state houses across the country (www.ncoil.org).
Model Act, this waiting period is extended to five years, although certain exceptions are allowed if specific requirements are met.

Another regulatory proposal, the NCOIL Model Act, was first adopted in November 2000 and most recently amended in December 2007. The amended NCOIL Model Act is described as a “targeted attempt to prohibit controversial stranger-originated life insurance (STOLI) transactions while encouraging legitimate life insurance,” according to a press release issued by NCOIL in 2007 (NCOIL, 2007). As amended, the NCOIL Model Act provides a definition of STOLI, which is “a practice or plan to initiate a life insurance policy for the benefit of a third party investor who, at the time of policy origination, has no insurable interest in the insured”; this definition is not intended to include traditional life settlements (see NCOIL Model Act, at § 2(Y)). Also, rather than seeking to curb the use of STOLIs by extending the waiting period for selling a policy in a life settlement transaction, the NCOIL Model Act effectively prohibits most STOLIs by making it unlawful for any person to “issue, solicit, market or otherwise promote the purchase of an insurance policy for the purpose of or with an emphasis on settling the policy” (see NCOIL Model Act, at §§ 13(A)(4)).

Both Model Acts appear to have significantly affected the regulation of STOLIs in a majority of states. As of May 14, 2010, twenty-nine states, including California and New York, have enacted some form of anti-STOLI legislation, according to the National Association of Insurance and Financial Advisors.13

DISCUSSION AND ANALYSIS

A large majority of states regulate viatical and life settlement transactions; as of 2009, thirty-nine states regulated life settlements (Thomas, 2009). As STOLIs are a type of life settlement, they are already regulated by these states to some degree. Although many states have proposed and/or adopted regulations that curb the use of (or even prohibit) STOLI transactions, we question whether this type of regulation is necessary if (i) the concerns underlying the regulation are not valid, (ii) an adequate regulatory solution already exists, or (iii) an adequate market-based solution exists. In this section, a closer look is taken at the various arguments that have been used to advance these regulatory initiatives to determine whether they are really necessary.

One of the primary stated reasons why a regulatory solution is sought to curb the use of STOLIs is that these transactions violate the insurable

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interest principle. Under this argument, the policy owner does not have an insurable interest in the policy when it is actually being purchased solely as an investment for the benefit of a third party. As the effective owner lacks an insurable interest at the policy’s inception, so the argument goes, the policy should be void.\footnote{See, for example, New York Insurance Law § 3205[b][2].}

The often-stated rationale for the insurable interest requirement is that public policy should prohibit contracts that are effectively mere wagers on the life of a human being (Leimberg, 2005). What this argument apparently overlooks is that in preventing speculative wagering on human life, the purpose of the insurable interest requirement is to protect and benefit the insured, not the life insurer (Armstrong, 2002). If the insured agrees to waive this protection, why should the insurer be excused from paying the policy? If the insurer has agreed to issue the policy and has accepted the payment of premiums, it should be obligated to honor its contract and pay the policy proceeds to the named beneficiary (see sources cited by Armstrong, 2002: 7–8).\footnote{For these and other reasons, the insurable interest principle has increasingly come under attack, with some commentators advocating that it be abolished entirely. See Loshin (2007) and sources cited therein.}

In other circumstances such as corporate-owned life insurance (COLI) and bank-owned life insurance (BOLI), the insurable interest requirement does not have to be satisfied if the insured has expressly or implicitly consented to the waiver of this protection. For example, in the case of corporate-owned life insurance, an employer is allowed to take out a policy on the life of an employee (even a non-essential employee) if the employee consents to the policy. Also, a life policy once issued may thereafter be sold or given to anyone by the original owner, whether the assignee has an insurable interest or not—this is true whether the assignment is made as a true gift, as collateral for a loan, or as a sale in a traditional viatical or life settlement transaction. Further, in most states, the policy owner may name anyone as beneficiary, whether the person so named has an insurable interest or not. In each of these cases, the insured (who is typically the original policy owner) has expressly or impliedly agreed to waive the protection of the insurable interest requirement. Similarly, if the policy is originally purchased by the owner for the purpose of selling it to an investment group, the insured’s waiver of the protection is clearly implied, even though it means the policy proceeds will be paid to a disinterested third party.\footnote{Some states also require that the beneficiary have an insurable interest in the life of the insured at the time the policy is procured.}
This insurable interest argument also overlooks the fact that seeking economic protection for loved ones or others with an economic interest in the life of the insured is not always the only motive, or even a primary motive, for purchasing a life insurance policy. In fact, other than basic term policies, life insurance is often pitched by financial planners to potential clients as an investment product. The fact that such a product may be purchased and later used by the original owner for investment purposes other than that preferred by the insurer seems hardly a reason for prohibiting transactions that enable them to do so.

In some states, however, the insurable interest requirement may be extended by interpretation to mean that the policy owner’s intent at the time of purchase must have been to provide economic protection for the benefit of those who have an economic interest in the insured’s life (ACLI, 2007). Under such an interpretation, if the owner originates the policy solely for the purpose of immediately selling it to a third party, the insurable interest requirement is violated and the policy would be void. In these states, a true STOLI would clearly seem to violate the insurable interest requirement. However, in such a case there still would be no need for the type of additional regulation described above since STOLIs would already be prohibited in these states. Further, as the insurer generally can use the insurable interest defense to void the policy at any time, even after expiration of the contestability period (Rejda, 2008: 246), it appears that the objective of prohibiting STOLIs may already have been achieved in these states.

In sum, whether because the insurable interest requirement should not apply (as its protection has been waived by the owner) or be broadly construed (so that STOLI policies are already void), additional regulation similar to that outlined in the prior section does not seem necessary in light of the insurable interest requirement.

A similar argument can be made as to why no additional regulation is necessary in the case of anti-rebating regulations. In many states, the offering of anything of value to induce the purchase of life insurance is an illegal rebate unless the inducement is stated in the policy (Black and Skipper, 2000: 954). When a prospective policy owner is induced to buy a life policy by a promise of repurchase at a price substantially higher than

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10In fact, the highest court in New York and a California appellate court have recently ruled that life policies issued as part of a STOLI transaction did not violate the insurable interest requirement, so long as the insured was the person who applied for the policy. In both cases, the policies in question were issued prior to new laws taking effect in both states that would effectively limit or prohibit STOLI transactions (Henderson and Tam, 2011; Byrnes and Bloink, 2011).
the premiums paid, which is what occurs in a STOLI transaction, it appears that such a promise might violate the anti-rebate requirement. In states that prohibit the offering of a rebate, however, the restriction ordinarily applies only to the insurer, its agents and employees, and would not seem to apply to a third-party entity such as an investor group soliciting a STOLI transaction. As a result, it seems unlikely that a conflict with the anti-rebating requirement would exist in these states. In some states, however, even the knowing receipt of a valuable consideration as an inducement to purchase a policy might be an illegal rebate. In such a state, the prospective policy owner’s receipt of a commitment by a third-party investment group to purchase the policy shortly after it is issued might violate the state’s anti-rebating laws. Nevertheless, in such a case there still would be no need for the type of additional regulation described above since a strong disincentive for entering into STOLIs already exists in these states.

Another argument supporting regulatory proposals to ban STOLIs is that if these transactions continue to proliferate, Congress is likely to consider life insurance as just another investment product and tax them as they would any other investment product. This argument neglects the commonly held assumption that in the case of a life settlement, whether STOLI or otherwise, the transaction likely will be treated as an investment transaction, much like the sale of a capital asset (Leimberg, et al., 2006). In this view, the policy owner/seller may realize taxable income to the extent the purchase price he has received exceeds the premiums he has paid up to the time of sale. Also, to the extent that the transfer-for-value rule applies to STOLIs, the purchaser/investor may realize taxable income to the extent the death benefit exceeds the total of the purchase price and the premiums he has paid following the time of sale.17 If life settlements are already taxed in a manner similar to other investment transactions, it is difficult to see why or how Congress would change the tax treatment for life insurance policies as the result of STOLI transactions.

Yet another justification offered for the regulatory prohibition of STOLIs is that if they continue to grow in number, Congress might closely scrutinize the sale of life insurance policies in the secondary market and decide to treat such transactions as the sale of a security that would be subject to federal and state securities regulations. This concern is problematic in three respects. First, a contract for the sale of an interest in a life insurance policy in the secondary market, whether through a traditional

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17Under the “transfer for value” rule, a portion of the death benefit paid to the purchaser of a life insurance policy may be treated as taxable income (Leimberg et al., 2006). The amount taxable is the difference between the life insurance proceeds and the investor’s basis (i.e., usually the purchase price plus premiums paid).
life settlement or a STOLI transaction, may already be considered an “investment contract” within the meaning of the securities laws of some states today, and the licensing and conduct of persons who sell life settlements to investors already may be regulated by their respective securities agencies (Leimberg, et al., 2006).18 Second, to the extent that other states and the federal government elect to treat these transactions as the sale of a security, the overall public benefit may be positive rather than negative. Compliance with security regulations would likely result in increased public transparency about the investor groups that purchase such policies, more comprehensive disclosure to consumer policy holders/insureds, and greater expenses associated with such purchases that would likely make them cost prohibitive to unsophisticated investor groups. Finally, although some are concerned that regulating STOLIs as securities will result in higher-priced policies, it is difficult to see how such regulation, involving as it does the sale of life insurance policies in a secondary market, would raise costs to insurers. For all of these reasons, it appears that implementing additional regulation to prohibit STOLIs based on the fear that failure to regulate would lead to STOLIs being classified as securities seems unnecessary.

At first blush, it seems strange that the life insurance industry has been in the forefront of the regulatory movement to curb or even prohibit STOLI transactions. Why are insurers complaining? Don’t STOLIs give people even more reason to buy policies, generating greater business for life insurance companies? Perhaps the real reason why the life insurance industry seeks state regulation banning STOLI transactions, and their true concern about the growth of these sales in the first place, is that such transactions, along with traditional life settlements, have increased the number of policies in which the insurer will be required to pay the full death benefit and reduce the number of policy lapses (Center for Economic Justice, 2006). Many insurers use lapse-support pricing, particularly for policies that lack non-forfeiture provisions (Leimberg, et al., 2006). Clearly, a large reduction in the number of lapses could adversely affect the insurer’s profitability. Insurers generally maintain reserves with the assumption that none of their policies will lapse (Black and Skipper, 2000: 745), so the decrease in lapsed policies brought about by the existence of STOLIs should not affect the insured’s reserves, but only the amount of death benefits they will have to pay on their policies.

18Leimberg, et al., also note that in other states, life settlements are already regulated so extensively by state insurance regulations that additional securities regulation would be unnecessary (Leimberg, et al., 2006).
Rather than additional state action to ban STOLI transactions, market-based solutions to this concern seem to be well within the power of the insurers themselves. One such solution would be for insurers to re-price their policies, particularly when issuing a policy that is likely to be the subject of a STOLI transaction (i.e., a large dollar policy issued to an older, wealthy person in a non-recourse premium financing transaction). In such a case, the insurer might consider raising the amount of the premium to take into account the greater likelihood that the policy will not lapse (Center for Economic Justice, 2006). Another non-regulatory market solution would be for life insurers or their subsidiaries to participate in third-party investment groups that purchase life policies in STOLI or traditional life settlement transactions. Some life insurance companies have already engaged in this practice as a way of hedging against losses incurred as a result of fewer lapping policies (Richardson, 2005). Yet another non-regulatory solution, and one that would be best from the consumer’s point of view, would be for insurers to increase the cash values of their policies to the point that selling the policies to third-party investor groups is a less attractive financial option. By providing the policy owner with less opportunity for arbitrage, not only would the number of STOLIs likely be reduced, but so would the number of life settlements in general (Center for Economic Justice, 2006).

Although no regulatory response seems necessary to protect insurers or third-party investor groups in a STOLI transaction, protection for the consumer policy owner/insured is another matter. Many states that regulate life settlement transactions already require investors and their brokers who purchase policies in a traditional life settlement to make certain disclosures to the policy owner/insured (Simon and Schmitt, 2006). However, STOLIs may pose additional risks for the policy owner/insured that may not be incurred under a traditional life settlement. For example, a prospective owner/insured should be advised that the purchase of a life insurance policy may restrict the insured’s ability to purchase additional life insurance in the future or lead to higher premiums for future policies. The policy owner/insured should also be warned that sale of a policy to a disinterested third party means that such a party will have an economic interest in the death of the insured.19 Also, the timing of the disclosure would be affected. In a traditional life settlement, disclosures typically must be provided to the policy owner/insured on or before the time the settlement occurs, while any disclosures made to the policy owner/insured in a STOLI transaction would need to be made, in order to be effective, on

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19For examples of other types of consumer disclosures required by Ohio in STOLI transactions, see Bricker & Eckler LLP, 2008.
or before the time the policy is originally purchased. To the extent that the substance and the timing of disclosures may be different in a STOLI transaction, any additional regulation of STOLIs that includes mandatory disclosures and other safeguards to protect the interests of the consumer policy owner/insured would be appropriate.

**CONCLUSION**

STOLI transactions have become more common in recent years and have raised a number of concerns among consumer advocates, insurance carriers, and state insurance regulators. As a result, regulatory proposals have been put forward to curtail and even prohibit the use of STOLI transactions. After examining the arguments that have been made to support these initiatives, it is apparent that in some cases these concerns may not be valid, in others an adequate regulatory solution already exists, and in still others adequate market-based solutions exist. Accordingly, regulatory prohibition of STOLI transactions seems unnecessary, particularly when its objective is to protect the interests of insurance carriers and third-party investor groups. Nevertheless, additional regulation of STOLIs may be appropriate to provide the consumer policy owner/insured with adequate disclosures and other safeguards, in order to protect their interests in these very controversial transactions.

**REFERENCES**


