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## An Update on Recent Developments Involving Stranger Owned Life Insurance (STOLI)

In November, shortly after the media reported on the lawsuit involving Stranger Owned Life Insurance (STOLI) filed by CNN talk-show host Larry King, Fred Jonske, M Financial Group's CEO, distributed a communication to all Member Firms entitled "Recent Developments Involving STOLI." In the Memo, Fred commented on the King case, described recent industry activities and legislative developments related to STOLI, and reiterated M Financial's position – on behalf of the life insurance industry and clients – opposing STOLI.

In light of the increasing attention on STOLI – and to provide a concise resource for Member Firms – M Financial's Sales Support Team has prepared a summary of the overall industry landscape with regard to this topic. This MIR includes a review of existing and proposed legislation and its bearing on detection and prevention, a discussion of other relevant industry developments and the impact on clients, and a review of carrier actions with regard to STOLI.

### NAIC Viatical Settlements Model

In June of this year, the National Association of Insurance Commissioners (NAIC) approved amendments to the Viatical Settlements Model Act that address STOLI. Its proposed five-year moratorium on settlements is designed specifically to curtail settlements of investor-initiated insurance purchases. By prohibiting policy settlements for five years from issue, it will be extremely difficult (for tax and other reasons) to complete cases in which the policy is originally purchased with the intent of selling it in the secondary market.

This five-year moratorium would provide an efficient way of deterring STOLI-related fraud by reducing the economic incentives for STOLI, primarily because it focuses on intent. At the same time, there is no detriment to the legitimate settlement marketplace (a secondary market for policies clients no longer want or need – due to changing circumstances – that were not initiated for the sole purpose of selling them at a later date). The NAIC amendments include adequate exceptions to the moratorium for insureds who use their own premium funding dollars, or who experience specified post-purchase changes in circumstances.

This moratorium provision was passed by the NAIC as the result of much input and encouragement from the life insurance community, including AALU, and has its full support.

Going forward of course, specific legislation must be adopted by the various states in order to implement these NAIC-sponsored principles. However, placing these provisions into an NAIC model act comprises great progress. Already there is significant activity among state legislatures, with more planned for 2008 legislative sessions, providing encouragement that actual STOLI-related state law will, in one form or another, become a reality.

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## **NCOIL Life Settlement Model Act**

On a parallel track, but using a different approach, the National Conference of Insurance Legislators (NCOIL) approved a Life Settlement Model Act on November 17, 2007. The NCOIL Act contains anti-STOLI features, including a broadened definition to capture various forms, categorization as a fraudulent act, new reporting requirements, and increased penalties.

AALU and other industry advocates were active in this development, not only in urging NCOIL to address STOLI issues within a life settlements act, but also in making sure that, similar to the NAIC Model Act discussed above, the interests of legitimate life settlement needs of insureds were preserved through the inclusion of broad exceptions for acceptable settlement arrangements.

Whether the NAIC or NCOIL model is ultimately considered in a particular state legislature, NAIFA and ACLI will actively pursue policy goals and represent our industry in 2008 state legislative battles on the STOLI issue. NAIFA and ACLI have the necessary infrastructure to be effective at the grassroots level. In addition, AALU members who have key relationships with state legislators will be valuable participants in this process.

## **Other Industry Developments Rating Agencies**

Although there have been no official statements from rating agencies or ratings action driven by STOLI activity, Fitch Ratings issued a Special Report in September detailing the risks of STOLI for insurers, investors, and consumers. Fitch's chief concern was the lack of transparency in this market, leading to "confusion and sales abuses" for consumers.

Since, in its opinion, a chief problem is the lack of adequate regulation, Fitch applauds the NAIC Model Act's five-year moratorium as a significant step toward limiting – and potentially eliminating – the STOLI market.

It remains to be seen whether other rating agencies

will address the STOLI arena and/or pursue greater specificity in evaluating risks to the long-term financial health of insurers impacted by STOLI business.

## **Federal Legislative Scene**

The ultimate risk of abusive insurance practices (and the negative publicity that follows) is the chilling specter of losing the tax benefits afforded life insurance products based on their social merits. It matters little that there is already in our tax code a "transfer-for-value" provision removing the death benefit tax-exemption for unrelated third-party transferees. It takes no imagination to picture public outrage resulting in an overreaction that revokes all life insurance tax benefits, regardless of the purchaser or purpose. As a practitioner once commented, "Congress is famous for coming up with new answers for problems where solutions already exist."

Although there is no currently proposed legislation specifically affecting life insurance taxation, there are some relevant macro issues present. Recall that as part of the 2006 Pension Protection Act (PPA), Treasury is required to conduct an extensive two-year IOLI study, which may be revisited by Congress.

Some other factors are also worth pointing out. First, the President's blue-ribbon Tax Advisory Panel's November 2005 report recommended a tax-advantaged savings accounts scenario that would remove all tax-favored buildup from life insurance and annuities. Neither the Administration nor Congress has developed any specific bills relating to that broad policy proposal, but its existence serves as a barometer of some of the high level intellectual sentiment continuing to threaten our product's tax-favored status.

Furthermore, life insurance and annuities continue to be near the top of the list of "tax expenditures" prepared by the Joint Committee on Taxation. With mounting deficits, a PAYGO regime in which all new expenditures must be offset with new revenue (including the elimination of tax benefits), and efforts to pass a permanent AMT "fix," we must continue to seriously consider the legislative vulnerability of life insurance.

Adverse publicity undermines the public policy foundation supporting favorable federal law treatment and defames the noble social purpose of life insurance, erosion which can only serve to exacerbate its exposure. We were all reminded of this on November 26, when *The Wall Street Journal* published a front-page article entitled “An Insurance Man Builds A Lively Business in Death.” The article – which referenced the Larry King case and the activities of one of the most active and aggressive players in the STOLI market – is exactly the type of attention that can spark a legislative overreaction.

### **Recent STOLI Letter to Treasury**

As reported by AALU President Larry Raymond, Rep. Richard E. Neal (D-MA) and Rep. Phil English (R-PA) of the Select Revenue Measures Subcommittee of House Ways and Means addressed a letter to U.S. Treasury Secretary Henry Paulson on STOLI. In the letter dated November 16, 2007, Congressmen Neal and English urge the Treasury to issue some form of public statement alerting elderly taxpayers to the potential adverse tax consequences of participating in a STOLI transaction. Included in that letter was a characterization of STOLI policies as “...similar to the wager policies considered against public policy and rejected by the Supreme Court...” in 1882.

The letter does not recommend federal legislation, but it is possible that Congressional hearings will follow. One positive note is that the letter seeks to differentiate STOLI from legitimate settlements with Congressmen Neal and English stating their intention not to “inhibit the ability of individuals to legitimately settle life insurance policies.” AALU and ACLI will continue to monitor reactions to the letter in the coming months.

### **Carrier Approaches**

As Fred indicated in his communication to Member Firms, M Financial and its Partner Carriers are committed to preventing STOLI transactions, and actively communicate about suspected activity and actions to stop it.

The overall impact of these efforts can be seen in two general areas – price increases at the older issue ages and greater use of filters during the underwriting process.

The former will tend to diminish or eliminate the arbitrage exploited by promoters and investors, thereby curtailing submissions in the first place. The latter hopes to detect STOLI through enhanced fact-finding focused on a policy’s financing and ownership.

Most Marketers have experienced the expansion of the application process, specifically in the form of supplemental questions and/or required review of trust documents above specified older ages. Some of the application questions focus on intent (with respect to subsequent policy disposition) in order to provide the insurer with a foothold for any future policy rescission action it might deem appropriate. A number of carriers have taken action to rescind policies found to be part of a STOLI transaction. Others have terminated agents involved in such transactions.

Of course, the ongoing concern for M Carriers is that attempts to filter out STOLI submissions are making the application process too onerous for legitimate business. While these filters are necessary – and increasingly effective – it seems unfair for Marketers and their senior clients seeking to buy and hold life insurance for their estate, legacy, and business planning purposes to be adversely affected by the sales practices of others. This can be a challenging balancing act, and M Financial will continue to monitor those developments in regular operating meetings with Carriers.

In the wake of the Larry King lawsuit, some carriers have also taken steps to shift the dialogue on STOLI from “it’s bad for the industry” to “it’s bad for clients.” The risks for clients have not been well communicated, allowing STOLI proponents to accuse the life insurance industry of acting in its own self-interest and continue their pitch of “free insurance.” However, carriers are taking steps to address misconceptions in the marketplace and educate their policyholders.

Sun Life Financial, an M Partner Carrier, has created a list of things for clients to consider when settling a policy. The list includes the following:

- If you sell, the purchaser of your policy will have a financial interest in your death. The sooner that death, the greater the financial return to the purchaser.

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- After a sale, the life insurance policy will remain in force until your death. A stranger, with no interest in your future well being, will own the policy. The policy may be resold a number of times before your death, making it virtually impossible to know who owns the policy on your life.
- Because a policy will remain in force after a sale, you may be precluded from purchasing new life insurance or from replacing existing insurance for your personal or business planning.
- If you sell your policy, you will be contacted on a regular basis by a stranger inquiring into the status of your health. Since the policy may be resold repeatedly, this contact may be made by different individuals each time.
- Any money or other compensation you receive in a sale of your policy may result in income taxation to you. If you keep your policy until death without selling it, the life insurance is typically paid to your beneficiaries free of income tax.
- Policy sales are complex transactions with significant tax and legal implications. We recommend that before you consider selling your policy, you consult with an independent attorney and/or accountant to fully understand the transaction.

Source: Sun Life Financial

Carriers are also increasing education campaigns on alternatives to settlements in an effort to preserve business while maximizing value for clients. These initiatives, coupled with the advocacy Member Firms continually provide to clients, will be beneficial in the ongoing efforts to eliminate STOLI from the life insurance industry.

## Summary

Vigilance will be required on all fronts – M Financial, Member Firms, industry trade groups, and carriers – to combat STOLI and its potentially long-term pernicious effects on our business. That activity must be substantively effective and proactively communicated so that our mainstream industry position is clearly perceived by the government and the public. The life insurance industry must leave no doubt as to where it stands on this issue and demonstrate it can effectively address issues so that legislative action is not necessary.

The proliferation of STOLI can only serve to harm our best long-term interests by violating the social purpose of life insurance, creating even greater legislative risk, raising insurance prices for older clients needing estate planning liquidity, and making it more cumbersome to administer the new business process.

Note on Information Source: In addition to the frequent ad hoc updates from AALU, an excellent all-in-one-place source of comprehensive developments in this area is the quarterly newsletter “STOLI ALERT,” jointly published by AALU, ACLI, NAIFA, and NAILBA, which can be accessed directly off the website [www.naifa.org](http://www.naifa.org).

## For More Information

Information contained in this newsletter is provided by M Financial Group’s Sales Support Team. If you have any questions or input, or require additional information, please contact any of the following individuals at 800.656.6960.

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