

**Protecting the Golden Goose**  
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**By Chris Orestis**  
Life Care Funding Group  
[www.lifecarefunding.com](http://www.lifecarefunding.com)

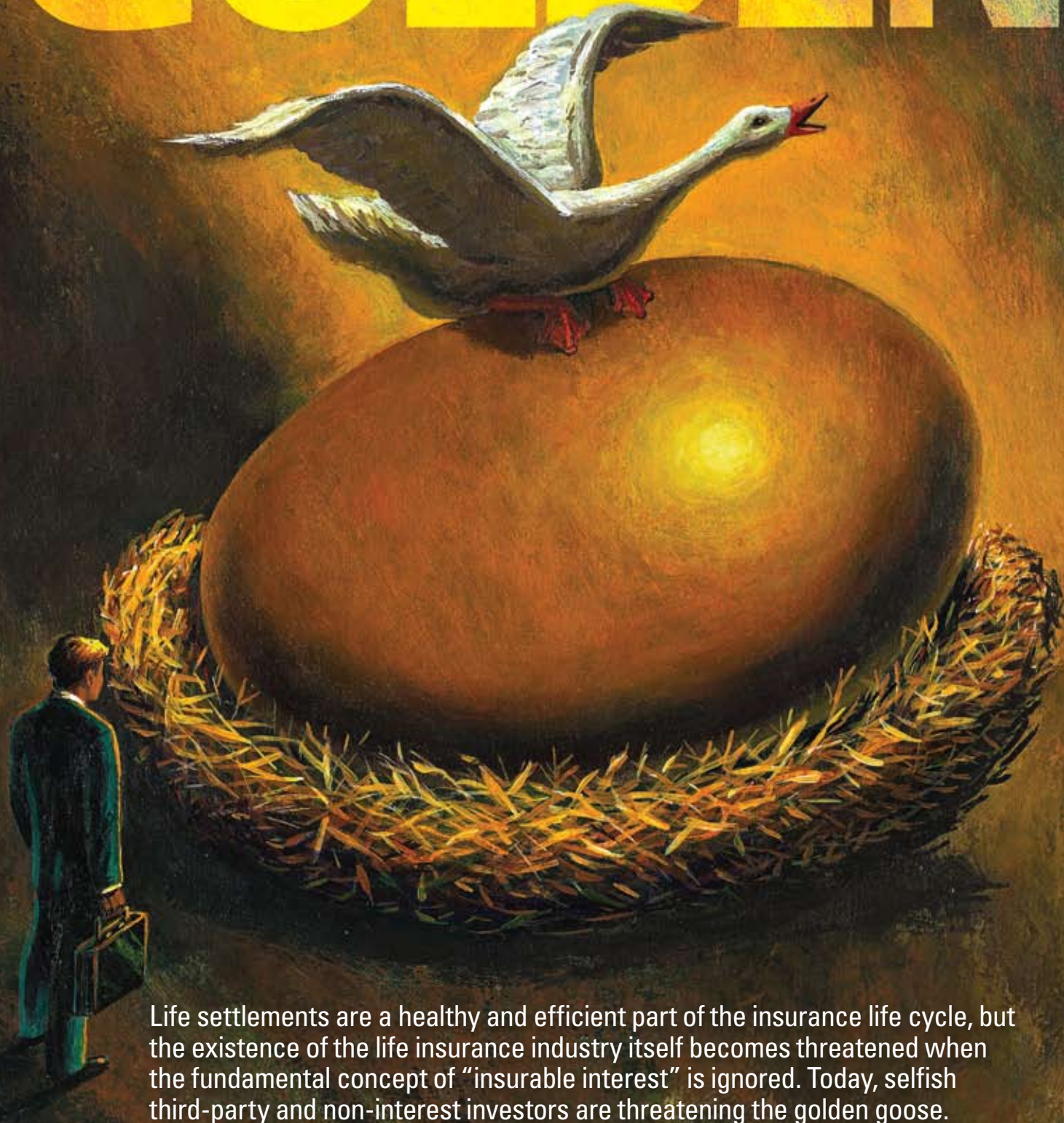


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# Protecting the GOLDEN

# GOOSE

by  
Chris Orestis



Life settlements are a healthy and efficient part of the insurance life cycle, but the existence of the life insurance industry itself becomes threatened when the fundamental concept of “insurable interest” is ignored. Today, selfish third-party and non-interest investors are threatening the golden goose.

## EVOLUTION OF A MARKET

The life settlement market is an offshoot of viaticals that emerged in the late 80s and early 90s. This unique vehicle afforded AIDS patients an opportunity for an early cash-out of a life insurance policy to cover the high costs of care not covered by health insurance. The life settlement market has been evolving rapidly ever since, with \$30 billion in transactions projected in 2007. Based on in-force life insurance policies in the United States held by individuals who fall within the target demographics for a life settlement transaction, the annual revenue potential is estimated at \$150 billion.

The University of Pennsylvania’s business school, the Wharton School, conducted a study on the potential impact of the life settlement market. This study found, among other things, that life settlement providers paid approximately \$340 million to consumers for their underperforming life insurance policies, an opportunity that was not available to them just a few years before. Another study conducted by Conning & Co., “Life Settlements: Additional Pressure on Life Profits,” found that senior citizens owned approximately \$500 billion worth of life insurance in 2003, of which \$100 billion was owned by seniors eligible for life settlements.

With these kinds of numbers and market potential, it’s no surprise that Wall Street is paying attention. In a *Business Week* article published in July 2007, it was observed, “Wall Street sees huge profits in buying policies, throwing them into a pool, dividing the pool into bonds and selling the bonds to pension funds, col-

lege endowments and other professional investors. If the market develops as Wall Street expects, ordinary mutual funds will soon be able to get in on the action, too.” Now regulators and lawmakers are paying attention, as well.

Life settlement transactions emerged from a worthy concept. Although a dirty word now, viaticals provided much needed liquidity during a time of crisis for people who did not have enough money to obtain care or improve quality of life in the face of a terminal condition. As is sometimes the case, what started out as a humane and economically sensible market development also opened the door for those that would seek to game the system for selfish interests. The problem the industry faces now is how to keep growing and providing an efficient outlet to liquidate life insurance policies without allowing those that would take advantage of this opportunity to kill the “golden goose.”

## FUNDAMENTAL PROPERTY RIGHTS

Life settlement transactions offer a healthy, competitive outlet to liquidate a life insurance policy that has outlived its purpose, and they raise cash in a time of immediate crisis. Transactions involving policies that were purchased based on insurable interest are the foundation of a legitimate transaction. In fact, this type of a transaction is supported by none other than Supreme Court Justice Oliver Wendell Holmes in his 1911 landmark decision, *Grigsby v. Russell*. Justice Holmes noted in his final opinion that life insurance possessed all the ordinary characteristics of property, and therefore

represented an asset that a policy owner could transfer without limitation.

This decision established a life insurance policy as transferable property that contains specific legal rights, including the right to:

- Name the policy beneficiary
- Change the beneficiary designation (unless subject to restrictions)
- Assign the policy as collateral for a loan
- Borrow against the policy
- Sell the policy to another party

Justice Holmes makes a clear distinction between a policy based on insurable interest and one where none exists. “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,” he explained. “The very meaning of an insurable interest is an interest in having the life continue.”

His decision clearly considers an insurance policy to be the same as real property and does not oppose transferring the property/policy to an entity without an interest in the life of the insured. To this point he is very clear: “... life insurance has become in our days one of the best recognized forms of investment and self-compelled saving. So far as reasonable safety permits, it is desirable to give to life policies the ordinary characteristics of property. To deny the right to sell except to persons having such an interest is to diminish appreciably the value of the contract in the owner’s hands.”

He does draw the distinction, though,

between this and a policy initiated and funded by a third party without any insurable interest or “interest in having the life continue.” Here he states, “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.” Justice Holmes also emphasizes again the distinction towards the conclusion of his ruling: “... the policy having been taken out for the purpose of allowing a stranger association to pay the premiums and receive the greater part of the benefit, and having been assigned to it at once. On the other hand, it has been decided that a valid policy is not avoided by the cessation of the insurable interest, even as against the insurer, unless so provided by the policy itself.”

### THREATENING THE GOLDEN GOOSE

The right of a policy owner to transfer ownership interest is a guaranteed right under Constitutional law established by one of the greatest legal minds in our country’s history. But the difference he recognized between policies based on insurable interest and those where none exists is a problem that the life settlement industry must address. In the case of investor owned life insurance (IOLI) or stranger owned life insurance (STOLI), are we looking at what Justice Holmes defines as, “a pure wager?” If that is the case, then this practice may now be threatening not only the long-term future of the life settlement marketplace but also the foundation of life insurance itself.

Life insurers are concerned about the explosive growth of the life settlement market for a couple of reasons. On the one hand, life insurers have a selfish concern about their bottom line when policies that no longer lapse or are converted for their cash value have a negative impact on their profitability. This is a healthy outcome of an efficient market that is providing outlets to maximize the value of ones interest in their constitutionally protected property. But, insurers also have a bigger picture concern about lawmakers and regulatory bodies taking a closer look at the growing life settlement market, and if their practices are changing the very nature of life insurance.

The tax-free exemption for inside build up of a life insurance policy is constantly under scrutiny by law makers. If it is ever concluded that life insurance has changed from its original function of providing a death benefit for beneficiaries to an investment vehicle for third parties to place “wagers” with no insurable interest in the insured, then the tax free exemption could be revoked. If this were to happen, life insurance would no longer be able to provide its key financial benefit and differentiator, and the industry as we know it would cease to exist. This is not good for anyone.

### THERE WILL BE BLOOD

The market is still evolving, and it won’t take long for the insurance industry to wield its considerable clout with regulators and lawmakers to ensure practices that game the system will not kill the golden goose. Third-party sponsored life insurance transactions initiated for the sole purpose of flipping them in the life settlement marketplace is not a practice that will last indefinitely. Conversely, in light of the Supreme Court’s ruling on the transferability of insurance as property, those holding a policy based on insurable interest that they no longer need will always be able to maximize the value of that property through a life settlement transaction. U.S. history has many examples of new economic outlets evolving to meet demands and, along the way, shaking out the questionable practices as it matures. There are also plenty of examples of federal and state lawmakers getting involved in that process as it is happening. Sometimes it’s early in the game, such as in the case of genetic sciences and cloning. Other times, it’s late in the game, such as in the case of sub-prime mortgages.

In both examples, a market emerges and then, based on the interests involved and the impact on the consumer and the economy, the government will step in to establish the rules. In the case of life settlements, that process is already underway as is evidenced by the recent actions taken by the NAIC, NCOIL, the North Dakota State Senate, and the Federal Court of Appeals for the Fourth Circuit. The life insurance industry and the government won’t sit idly on the sidelines. They will make sure that they have a say about how the life settlement industry conducts itself over the coming years.

The life settlement industry provides an important function to the insurance marketplace — and it is a practice defended by the Supreme Court. But the debate surrounding insurable interest will change the industry. Take a picture of this industry in 2008 and then take a look again in 2013 — because within five years it is going to look very different. ■

*Chris Orestis held senior positions on a number of political campaigns before working in 1993 and 1994 for both the White House and the Senate Majority Leader on Capitol Hill. He spent the next several years representing the health and life insurance industry as vice president and senior vice president respectively for the Health Insurance Association of America (HIAA) and the American Council of Life Insurers (ACLI). As senior management for both organizations, he was responsible for external affairs and activities related to revenue generation. In 1999, he was awarded the Robert R. Neal Medal by HIAA for distinction and service to the industry. Chris is an acknowledged expert on insurance and long-term care issues and is a featured columnist and contributing editor to a number of industry publications, including: InsuranceNewsNet, On the Risk, Society of Actuaries, HealthDecisions, ProducersWEB, and InsuranceIntell.*

