Kelley Drye

New York Court of Appeals Decision Could Give Added Life to "Life Settlements" Industry

Philip D. Robben, Clifford Katz

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On November 17, 2010, New York's highest court, the Court of Appeals, issued a 5-2 decision in *Kramer v. Phoenix Life Insurance Company*. Writing for the court, Judge Ciparick held that "New York law permits a person to procure an insurance policy on his or her own life and immediately transfer it to one without an insurable interest in that life, *even where the policy was obtained for just such a purpose*" (emphasis added). The decision appears poised to have wide-ranging impact in the life insurance industry and, in particular, in the "life settlement" segment of the life insurance market.

Background

The policies at issue in *Kramer*, totaling over $56 million, were obtained by the life insured, Arthur Kramer, as part of what is commonly called a "stranger-owned life insurance" arrangement or STOLI. Under a STOLI arrangement, life insurance is purchased by or on behalf of an insured and then all beneficial interest in such policy is transferred to investors, who pay the premiums and stand to collect the death benefit on the insured's death. In keeping with this general pattern, Mr. Kramer purchased the policies and thereafter, through the use of two trusts, transferred his entire interest in those polices to investors that, in this context, were complete strangers to him and had no insurable interest in his life.

When Mr. Kramer died, his wife, the plaintiff, refused to turn over his certificate of death to the investors holding the beneficial interest in the life insurance policies and brought a lawsuit against all of the participants in the STOLI arrangement and the life insurance companies that issued the policies. Ms. Kramer's action was premised on the argument that none of the investors had an insurable interest in her husband's life. Under New York law, an "insurable interest" is "in the case of persons closely related by blood or by law, a substantial interest engendered by love and affection" or in the case of non-related persons "a lawful and substantial economic interest in the continued life, health or bodily safety of the person insured." N.Y. Ins. Law. § 3205(a)(1). Ms. Kramer alleged that because the requisite insurable interest was lacking, she was entitled to the proceeds of the policies.

On motions to dismiss, a judge of the Southern District of New York federal court held that a person responsible for arranging the STOLI violated the New York State Insurance Law because he caused life insurance policies to be obtained for the benefit of persons without an insurable interest in Mr. Kramer's life. Following an appeal to the U.S. Court of Appeals for the Second Circuit, and in light of the fact that the case turns on a question of New York law, that court certified a question to the

Court of Appeals. The Circuit asked the New York court to decide whether New York's insurable interest statute - Insurance Law § 3205(b) - prohibited a person from procuring a policy of life insurance on his or her own life and immediately thereafter transferring the policy to another person with no insurable interest in the insured's life if the insured never intended to provide insurance protection for a person with an insurable interest in the insured's life.

The Court's Opinion: The Insured's Intent is Irrelevant

The issue before the Court of Appeals turned on the interpretation to be given to Section 3205(b) of the New York Insurance Law. Section 3205(b)(1) provides:
Any person of lawful age may on his own initiative procure or effect a contract of insurance upon his own person for the benefit of any person, firm, association or corporation. Nothing herein shall be deemed to prohibit the immediate transfer or assignment of a contract so procured or effectuated.
Section 3205(b)(2) set forth the requirements that must be met where someone other than the insured procures insurance on the insured's life and provides that, in that circumstance, the policy beneficiary must be the insured or someone with an insurable interest in the insured's life:
No person shall procure or cause to be procured, directly or by assignment or otherwise any contract of insurance upon the person of another unless the benefits under such contract are payable to the person insured or his personal representatives, or to a person having, at the time when such contract is made, an insurable interest in the person insured.
In this case, Mr. Kramer procured the life insurance. Both Ms. Kramer and the life insurance companies urged the Court, however, to apply the standard in Section 3205(b)(2) or the common law rule and hold that the procurement of a life insurance policy with the intent to immediately assign it to another person without an insurable interest is impermissible. The Court rejected each of the arguments advanced to support this conclusion.

First, starting with the plain meaning of Section 3205(b)(1), the Court held that the unambiguous terms of the provision provided no support for the argument that "a policy obtained by the insured with the intent of immediate assignment to a stranger is invalid." Rather, the Court noted, the statute does not call for any examination of the insured's intent in procuring the policy. Second, rejecting an argument that the polices at issue did not fit the terms of Section 3205(b)(1) because they were not purchased at Mr. Kramer's "own initiative," the court held that such requirement merely requires that the insured obtain the policy at the insured's discretion. That the insured is given the idea to purchase the policy by others or substantially assisted in doing so - clearly the case in *Kramer* - does not call for a finding that the insured failed to act on his or her own initiative. Finally, the Court rejected out of hand the notion that the standard in Section 3205(b)(2) had any application where, as in *Kramer*, the insured purchases a policy at his or her own initiative. Rather, the court held, "Where an insured, ‘on his own initiative,' obtains insurance on his or her own life, the validity of the policy at its inception is instead governed by § 3205(b)(1)."

The Dissent: Majority Overlooks Years of Contrary Precedent and Policy

Writing for the dissent, Judge Smith, traced the historical development of the insurable interest rule and criticized the majority for allowing the free transfer rule of Section 3205(b)(1) to overtake and displace New York's long-standing policy against allowing insurance policies - via a STOLI arrangement or otherwise - to be used as a means to wager on the lives of insureds. Judge Smith explained the public policy reasons underlying his opinion:
There are good reasons why the common law, as reflected in both *Warnock* and *Grigsby*, invalidated

stranger-originated life insurance. Even if we ignore the possibility that the owner of the policy will be tempted to murder the insured, this kind of "insurance" has nothing to be said for it. It exists only to enable a bettor with superior knowledge of the insured's health to pick an insurance company's pocket. In a sense, of course, all insurance is a bet, but for most of us who buy life insurance it is a bet we are happy to lose. We recognize that the insurance company is more likely than not to make a profit on the policy, receiving more in premiums than it will ever pay out in proceeds, and that is the result we hope for; we pay the premiums in order to protect against the risk that we will die sooner than expected. But stranger-originated life insurance does not protect against a risk; it does not make sense for the purchaser if it is expected to be profitable for the insurance company. The only reason to buy such a policy is a belief that the insured's life expectancy is less than what the insurance company thinks it is.

Potential Impact

As noted by both the majority and dissenting opinions, the impact of the *Kramer* holding on STOLI arrangements going forward is likely to be minimal as New York recently enacted Section 7815 of the Insurance Law that bars such arrangements. Nevertheless, the impact of the Court's decision in *Kramer* could be far reaching.

First, the prohibition found in Section 7815 only went into effect in May 2010. Thus, the legality of STOLI arrangements put in place before that time, at least as far as they might be attacked for lack of an insurable interest, seems assured following *Kramer*.

Second, the *Kramer* majority's rejection of an intent based standard is significant in and of itself for the changes it may bring to the insurance marketplace. Prior to *Kramer*, a court examining a transfer could look to the insured's intent at the time the policy was purchased in order to establish whether the insurable interest standard was met and the transfer of the policy at a later point was lawful. *See, e.g.*, *Life Product Clearing LLC v. Angel*, 530 F. Supp.2d 646, 653-54 (S.D.N.Y. 2008). After *Kramer*, however, resorting to an examination of intent is no longer relevant, and the insured's intent, therefore, cannot serve as a check on the transfer of a life insurance policy. Thus, following *Kramer*, purchases of insurance policies specifically for the purpose of transferring them as part of a secondary market transaction are perfectly legal. And, since such transactions will be legal, they can be expected to increase.

Third and finally, the decision in *Kramer* is contrary to the reasoning underlying a 2005 opinion of the New York State Insurance Department. It is possible that the Insurance Department or, indeed, representatives of life insurance companies aggrieved by the decision, may well petition the New York State Legislature to legislatively reverse *Kramer*. Only time will tell.

For more information on this client advisory please contact:

Philip D. Robben
(212) 808-7726
probben@kelleydrye.com

Clifford Katz
(212) 808-7609
ckatz@kelleydrye.com