

## ■ NCCUSL Work on Insurable Interest and Trusts

### A WIN FOR ALL - BRIGHT LINE TEST WILL HELP WEED OUT STOLI

By Jim Maxson

**B**uilding on two-and-a-half years of work, efforts are under way to address uncertainty regarding the validity of life insurance policies owned by irrevocable life insurance trusts (ILITs).

The uncertainty was created by the decision in Chawla ex rel Giesinger v. Transamerica Occidental Life Insurance Co., 2005 WL 405405, (E.D. Va. 2005), aff'd in part, vac'd in part 440 F.3d 639 (4<sup>th</sup> Cir. 2009).

The Drafting Committee on a Uniform Insurable Interests Relating to Trusts Act convened by the National Conference of Commissioners on Uniform State Laws (NCCUSL), based in Chicago, has worked in relative obscurity to clarify subsequent confusion created by the decision.

This article will briefly address the purpose of ILITs, and examine how the Chawla case created doubt about their use for estate-planning purposes. Finally, it will look at how the Committee's work has resulted in a proposed amendment to the Uniform Trust Code (the UTC) codifying insurable interest requirements for ILITs. This codification will help the life settlement and life insurance industries combat the abuse of ILITs to further stranger-originated life insurance ("STOLI") schemes, as well as benefit estate planners and the consumers of their services.

#### The Value of ILITs

The district court's interpretation of Maryland's insurable interest statute in Chawla was widely perceived as erroneous, but concern over it prompted at least 10 states (Delaware, Florida, Georgia, Illinois, Maine, Maryland, Minnesota, South Dakota, Virginia and Washington) to enact legislation clarifying that ILITs do, under certain circumstances, have an insurable interest in the

life of the grantor and certain other individuals.

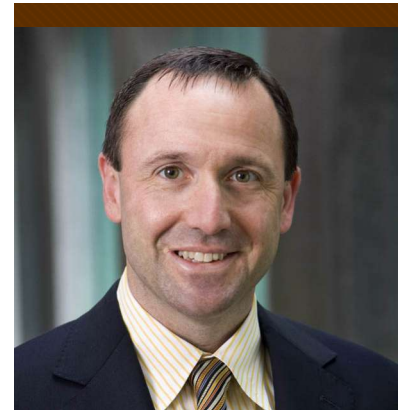
#### NCCUSL's Solution

Because of the concern that states would adopt potentially incompatible approaches to resolving this issue, NCCUSL decided to form a drafting committee, which resulted in a proposed amendment to the UTC adding a new section defining when a trustee (and, hence, the ILIT) has an insurable interest in the life of an insured.

This amendment to the UTC, entitled "*Insurable Interest of Trustee*," provides that a trustee has an insurable interest in the life of an individual, if, on the date the policy is issued: "(1) the insured is: (A) a settlor of the trust; or (B) an individual in whom a settlor of the trust has, or would have had if living at the time the policy was issued, an insurable interest; and (2) the life insurance proceeds are primarily for the benefit of trust beneficiaries who have: (A) an insurable interest in the life of the insured . . . ."

In sum, this formulation of insurable interest for ILITs addresses both the Chawla "problem," as well as concerns that ILITs have been used to promote STOLI schemes. A legitimate concern about the Amendment is that it creates a new requirement, applicable only to beneficiaries of ILITs. Under the insurable interest laws of most, if not all, states, it is only necessary for the owner to have an insurable interest in the life of the insured at the time of the policy's issuance, but there is no similar requirement for policy beneficiaries. States that adopt the Amendment will be imposing an insurable interest requirement on trust beneficiaries, as a precondition to issuing a life insurance policy.

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## The Need for Change in the Media's Portrayal of Life Settlements

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will be too late to respond effectively. Proactive efforts should emphasize the value that life settlements bring to consumers as an alternative to policy surrender. Life settlements effectively put significantly more dollars into the consumers' pockets, in the course of a regulated, well defined and secure transaction. Specifically, the industry needs to confront head-on and accurately address issues related to:

- Perceived speculation on the death of the insured;
- Perceived morbidity of the transaction;
- STOLI and its potential for abuse;
- Regulation intended to eliminate industry fraud; and,
- Disclosure and transparency in all stages of the transaction.

LISA and its members must also make concentrated efforts to educate consumers about the existence of the life settlement alternative. They should engage their agents and financial planners to speak to their clients about life settlements in a balanced and truthful manner.

In communicating with the consumers about the value of the transaction to them, emphasis should be placed on:

- New alternatives available to the consumer for liquidating a policy, which in many cases has become an unwanted, unneeded or financially burdensome asset;
- Eliminating cash outlay for future premiums;
- Providing additional funds for retirement; and,
- Providing liquidity in times of financial need.

I can see a future where life settlements are viewed in a similar light to annuity products or reverse mortgage loans. The more awareness there is of the increase in regulation and the reputable players in the business, the more favorable the coverage will be.

If we, as an industry, want to promote our value to the public and change the media's negative characterization, we must closely work with LISA in spearheading this effort. We need a proactive approach in communicating the strong value of life settlements in a consistent and effective manner. I am confident that efforts initiated on this front will lead to a more balanced portrayal of the industry in the future. ■

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In the context of ILITs, their utilization as estate planning vehicles, and the potential for their use to mask potentially illegal transactions, however, this additional restriction is not unreasonable.

### Impact on the Life Settlement Industry

It is unlikely that the Amendment will have much, if any, impact on the life settlement industry. There has been a historical tendency, by those who either have not taken the time to properly educate themselves, or willfully misrepresent the relationship for their own goals, to imply that life settlements and STOLI are fruits of the same tree. In fact, they are distinctly different, their sole link being the fact that they involve life insurance.

Life settlements are a legally sanctioned and highly regulated option for consumers to realize the value of an otherwise illiquid asset; whereas, STOLI is illegal and does not benefit consumers, the life settlement or the life insurance industries. Unfortunately, STOLI comes in many forms and it can be difficult to determine whether any given policy owned by an ILIT is STOLI.

### Conclusion

The Committee's well drafted Amendment, to the extent it is adopted by state legislatures, will provide what amounts to a "bright-line" test for the life settlement and life insurance industries to determine whether or not policies are legitimately issued candidates for settlement, or illegal STOLI that should be shunned. ▮

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