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A legal update from Dechert LLP

Recent Developments in the Life Settlement Industry

Recently, the Supreme Court of Delaware issued two rulings regarding life settlements that have attracted media and life settlement industry attention.¹ The Delaware high court ruled in both cases that under Delaware state law, insurance companies may challenge the validity of insurance policies on the basis of lack of an insurable interest after the expiration of the two-year statutory contestability period.² This *DechertOnPoint* briefly discusses these two recent cases and their potential impact on life settlement transactions in Delaware and throughout the United States.³

In September 2011, the Supreme Court of Delaware, the state's highest court, rendered significant decisions in connection with life settlement litigation pending in the Delaware federal court. The United States District Court for the District of Delaware certified three legal

questions to the Delaware high court that arose in the cases of *Lincoln Nat. Life Ins. Co. v. Joseph Schlanger 2006 Ins. Trust*⁴ (“*Schlanger*”) and *PHL Variable Ins. Co. v. Price Dawe 2006 Ins. Trust*⁵ (“*Dawe*”). Both *Dawe* and *Schlanger* involved insurance companies challenging the validity of life insurance policies that the companies claimed had been issued in connection with so-called stranger-originated life insurance (“STOLI”) transactions.⁶

Delaware state law provides insurance carriers with a two-year contestability period dating from the time an insurance policy is issued in order to bring certain claims related to the issuance of the policy.⁷ The federal courts deciding both *Dawe* and *Schlanger* asked the state court to decide the question of whether, under Delaware law, the two-year contestability period precludes a challenge to insurance claims on the grounds that the policyholder

¹ *PHL Variable Life Ins. Co. v. Price Dawe 2006 Insurance Trust, et al.*, C.A. No. 174, 2011; C.A. No. 10-964 (*Dawe*) (Del. 2011); *Lincoln Natl. Life Ins. Co. v. Joseph Schlanger Ins. Trust, et al.*, C.A. No. 178, 2011. C.A. No. 09-506 (*Schlanger*) (Del. 2011); Leslie Scism, *Ruling Is Defeat for Death Benefit Investors*, WALL ST. JOURNAL.COM, Sept. 26, 2011.

² *PHL Variable Life Ins. Co.*, C.A. No. 174, at 5; *Lincoln Natl. Life Ins. Co.*, C.A. No. 178, at *5.

³ For previous *DechertOnPoints* on the life settlement industry, see Oct. 2009 “[Life Settlement Securitizations Under Scrutiny](#),” Aug. 2010 “[Additional Governmental Oversight Recommended for Life Settlement Industry](#),” Feb. 2011 “[Recent Developments in the Life Settlement Industry](#).”

⁴ *Lincoln Natl. Life Ins. Co. v. Joseph Schlanger Ins. Trust*, C.A. No. 09-506-BMS, 2010 WL 289315 (D. Del. July 20, 2010).

⁵ *PHL Variable Ins. Co. v. Price Dawe 2006 Ins. Trust*, C.A. No. 10-964-BMS (D. Del. Nov. 12, 2010).

⁶ *Lincoln Natl. Life Ins. Co.*, C.A. No. 178, at *5; *PHL Variable Life Ins. Co.*, C.A. No. 174, at 3. For in-depth discussion about the legal issues related to STOLI, see “Recent Developments in the Life Settlement Industry,” February 2011 *supra* note 3, at 1.

⁷ 18 Del. C. § 2908; 18 Del. C. § 2704 (2011).

lacked an insurable interest.⁸ An additional question raised in the *Dawe* case was whether the Delaware statute requiring an insurable interest is violated when the insured individual procures a life insurance policy on his or her own life and immediately transfers the policy to a person without an insurable interest in the insured's life.⁹ Finally, in *Dawe*, the federal court asked the state high court whether Delaware law confers an insurable interest upon a trustee of a trust established by the individual insured, when at the time of the application for the life insurance policy in question, the insured intends to transfer the beneficial interest of the trust to a third-party having no insurable interest in the individual insured's life.¹⁰

Background

Both the *Schlanger* case and the *Dawe* case involve similar factual circumstances. In *Dawe*, PHL Variable Insurance Co. (Phoenix) ("PHL") issued a \$9 million dollar insurance policy on the life of Price Dawe on March 8, 2007, naming the Price Dawe 2006 Insurance Trust as owner and beneficiary of the policy.¹¹ A separately established family trust was named the beneficiary of the insurance trust.¹² Dawe transferred the beneficial interest in the policy to GIII, a private investing entity.¹³ At Dawe's death, three and one-half years after the origination of the policy, PHL contested the insurance trust's claim for the death benefit on the grounds that the policy was invalid for lack of an insurable interest.¹⁴

⁸ *Lincoln Natl. Life Ins. Co.*, C.A. No. 178, at *4; *PHL Variable Life Ins. Co.*, C.A. No. 174, at 4.

⁹ *PHL Variable Life Ins. Co.*, C.A. No. 174, at 4-5.

¹⁰ *PHL Variable Life Ins. Co.*, C.A. No. 174, at 5 ("Does 18 Del. § 2704(a) and (c)(5) confer upon the trustee of a Delaware trust established by an individual insured an insurable interest in the life of that individual when, at the time of the application for life insurance, the insured intends that the beneficial interest in the Delaware trust would be transferred to a third-party investor with no insurable interest in that individual's life following the issuance of the life insurance policy?").

¹¹ *PHL Variable Life Ins. Co.*, C.A. No. 174, at 2.

¹² *Id.*

¹³ *Id.* at 3-4.

¹⁴ *Id.*

Similarly, in *Schlanger*, Lincoln National Life Insurance Company ("Lincoln") issued a \$6 million life insurance policy on Joseph Schlanger's life to the Schlanger Trust on December 14, 2006.¹⁵ More than two years after the policy's origination, the Schlanger Trust filed a claim for the death benefit under the policy, and Lincoln National contested the claim and asserted that the policy was invalid for lack of an insurable interest.¹⁶

Certified Questions

With respect to the first question certified for both the *Dawe* and *Schlanger* cases, the state court noted that although under Delaware law all life insurance policies are required to contain a contestability provision stating that a policy is "incontestable after it has been in force during the lifetime of the insured for a period of not more than two years after its date of issue,"¹⁷ the Delaware Insurance Code also states that the contestability provision applies to preclude challenges to the "validity of the policy."¹⁸ The court held that, despite the fact that the contests in question were brought to court outside of the two-year statutory period, the insurance companies did not violate the statutorily required incontestability provisions because the insurance policies were void for lack of an insurable interest.¹⁹ Because the insurance policy was originated without an insurable interest, the policy was merely "a wager on human life"²⁰ and invalid as against public policy and the Delaware State Constitution.²¹ Accordingly, if the contract was void at inception, each of its provisions, including the incontestability provision, were invalid and did not serve as a bar on the insurance companies' ability to challenge the claims.²²

¹⁵ *Lincoln Natl. Life Ins. Co.*, C.A. No. 178, at *2-3.

¹⁶ *Id.* at *3-4.

¹⁷ 18 Del. C. § 2908 (2011).

¹⁸ 18 Del. C. § 2917 (2011).

¹⁹ *PHL Variable Life Ins. Co.*, C.A. No. 174, at 5; *Lincoln Natl. Life Ins. Co.*, C.A. No. 178, at *5.

²⁰ *PHL Variable Life Ins. Co.*, C.A. No. 174, at 15.

²¹ *Id.*, at 9-12; *Lincoln Natl. Life Ins. Co.*, C.A. No. 178, at *9-12.

²² *PHL Variable Life Ins. Co.*, C.A. No. 174, at 11-12.

In answering the second question, regarding the ability of the insured to transfer the policy to a person without an insurable interest if the insured had no intent to provide protection for one with an insurable interest,²³ the court found that under Delaware law a person may take out an insurance policy on their own life for the benefit of *any* person or entity, but no person may take out an insurance policy on the life of another unless the benefit is paid out to the individual insured or another having an insurable interest in the insured.²⁴ A third party, according to the court, cannot use the insured as a conduit to procure a policy it otherwise would be forbidden from procuring due to its lack of an insurable interest.²⁵ The court further determined that one way to determine whether the third party procured the policy through the insured is to determine which party pays the insurance premiums.²⁶ If the insured is responsible for paying the premiums, then regardless of the insured's intent, when procuring the policy, the policy is legally valid and freely transferable by the insured to whomever he or she chooses — regardless of whether the transferee has an insurable interest in the life of the insured.²⁷

The court employed similar analysis in answering the third question regarding a trust's interest in the insured's policy.²⁸ The court held that the trustee in *Dawe* would have an insurable interest so long as the individual insured actually established and provided the corpus for the trust.²⁹ If the trust were funded by a third party as part of a pre-negotiated agreement, then the

²³ *Id.* at 13.

²⁴ Del. C. § 2704(a).

²⁵ *PHL Variable Life Ins. Co.*, C.A. No. 174, at 24. Compare *Kramer v. Phoenix Life Ins. Co.*, 2010 N.Y. Slip Op. 8376 (Ct. App. 2010) (finding that under the analogous provision of New York state law, an individual insured could immediately assign to a third party that lacked an insurable interest). See generally February 2011 "[Recent Developments in the Life Settlement Industry](#)."

²⁶ *PHL Variable Life Ins. Co.*, C.A. No. 174, at 26-27.

²⁷ *Id.* at 25, 28-9.

²⁸ *PHL Variable Life Ins. Co.*, C.A. No. 174, at 29.

²⁹ *Id.*

substantive insurable interest requirements of the Delaware statutes would not be satisfied.³⁰

Conclusion

As a result of the *Dawe* and *Schlanger* cases, investors who originally considered purchasing portfolios of life settlements comprised only of policies more than two years old because such policies were thought to be a safer investment, may feel less comfortable if insurance companies may more readily challenge claims despite statutory incontestability provisions in most jurisdictions. In the future, investors may require legal comfort on policies beyond the two-year contestability period, such as a legal opinion that covers the insurable interest issues discussed above for these policies.

The Delaware court's opinion, however, did affirm the common law ability of an individual or such individual's statutory trust to sell a policy on the individual's life at market value. Such transactions are valid under Delaware law provided that the procurement of the policy by the insured is not part of a pre-arranged contract between the insured and a third party in which the third party either provides payment of premiums for the policy or funds the corpus of the insurance trust.³¹ *Dawe* and *Schlanger* also render clearer guidance to third-party investors as to what criteria to look for (and what procedures to avoid) in order to minimize the risk of insurers contesting death benefit claims on settled policies.

In short, despite Delaware's decision to permit challenges to insurance claims beyond the standard two-year incontestability period, the Delaware court's ruling explicitly affirms the legality of selling life policies to third-party investors, and provides guidance on how to ensure that the policies are legally valid when originated or purchased in a settlement transaction.



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³⁰ *Id.* at 29, 32-4.

³¹ Elizabeth Festa, *Delaware Court Weighs in on Life Settlement Cases*, NATIONAL UNDERWRITER, Sept. 26, 2011.

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