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District Court Rules on Stranger-Initiated Annuity Transactions

On June 2, 2010, the U.S. District Court in Rhode Island ruled on motions to dismiss in a series of cases brought by insurers arising out of stranger-initiated annuity transactions. See [Western Reserve Life Assurance Co. of Ohio v. Conreal LLC, et al.](#), C.A. No. 09-470 (D.R.I. 2010). The court dismissed the insurers' rescission claims against the investor-owners of the annuities, but allowed fraud and certain other claims to proceed against other defendants involved in the sales of the annuities.

The stranger-initiated annuity transaction (STAT) scheme was described by the court as follows, based on the allegations of the complaint:

- The defendants who sponsored the STAT scheme solicited terminally ill individuals and paid them to sign applications for variable annuities.
- An investor put up the premiums for the annuity and was designated both the owner and the beneficiary under the annuity contract.
- The investor would engage in aggressive short-term trades or other speculative investments through the variable annuity contract.
- The investor's upside was the possible profits from the speculative investment strategy.
- The investor was protected on the downside, however, because the death benefit payable under the annuity (which was expected to be paid in the near future, since the annuitant was terminally ill) guaranteed the return of all premiums.

The claims asserted by the insurers included rescission claims against the investor-owners of the annuity contracts, breach of contract claims against the brokers who sold the contracts, and fraud claims against brokers, agents, and the sponsors of the STAT scheme.

The insurers sought rescission on two grounds: lack of insurable interest and fraud. Lack of insurable interest has often been asserted by insurers in somewhat similar cases seeking rescission of stranger-originated life insurance (STOLI) policies. However, in this case, the court held that there was no insurable interest requirement because the applicable Rhode Island statute imposes that requirement only on "insurance contract[s] upon the life or body of another." Noting that Rhode Island has separate statutory provisions governing life insurance policies and annuities, the court concluded that an annuity contract was not an "insurance contract upon the life or body of another" even when the annuity contract included a death benefit. The court rejected the insurers' contention that the annuities should be viewed as hybrid policies with a life insurance component that was subject to the insurable interest requirement:

[I]n order for an annuity to qualify as a hybrid policy, at a minimum it would need to have life insurance at its core That is not the case here. The basic bargain embodied by the policies in dispute is that, in exchange for premiums, the owners receive a future income stream. ... The death benefits merely sweeten that deal; they do not define it.

The court noted Rhode Island's recent enactment of the Life Settlements Act (LSA), which prohibits STOLI transactions, without including any reference to annuities in the legislation, as a further indication of a statutory distinction between annuities and life insurance.

The insurers also sought rescission on the grounds of fraud. The court rejected this argument as well. The court agreed with the owner-investors that rescission on the grounds of fraud was precluded by

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incontestability clauses that provided that the policies were “incontestable from the Policy Date.” The court stated that “[i]n Rhode Island, incontestability clauses prevent insurers from rescinding policies even on the grounds of fraud.” The court also rejected the insurers’ argument that the incontestability clauses should be stricken as against public policy, reasoning that such clauses were designed to “ ‘reassure prospective policy holders’ that the annuity would not be ‘disputed by the insurer many years after the contract had been issued.’ ” Accordingly, the court dismissed the rescission claims against the owner-investors.

However, the court allowed fraud claims to proceed against the sponsors, agents and brokers, who were not parties to the annuity contract and could not invoke the incontestability clauses. The court found that the insurers had adequately alleged fraud based on the failure to disclose: (i) the recruitment of terminally ill applicants; (ii) in some cases, the applicants’ ignorance of policy terms; (ii) the payments to the applicants; (iv) in some cases, forgery or possible forgery of applicants’ signatures; and (v) as to the agents, the fact that they were not the agents who actually sold the policies, contrary to representations by the agents on the applications. The court also allowed a breach of contract claim to proceed against the brokers while dismissing a negligence claim.

This court decision coincides with increased focus by regulators on stranger-initiated annuity transactions. At the meeting last month of the National Association of Insurance Commissioners, the Life Insurance and Annuities (A) Committee held a hearing entitled: “Is the STOLI Market Moving to Annuities, and How Should We Protect Consumers?” In addition, the Securities and Exchange Commission has been investigating participants in STAT schemes.



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