New Jersey Supreme Court Declares STOLI Policies Void *Ab Initio*

Suman Chakraborty, Squire Patton Boggs (US) LLP

In June 2019, the New Jersey Supreme Court became the latest court to declare that stranger-originated life insurance ("STOLI") policies are against the public policy of the state and void *ab initio*. *See Sun Life Assurance Company of Canada v. Wells Fargo Bank, N.A*, 20 A.3d 839 (N.J. 2019). This case note sets forth the facts of the dispute and the Court's holding.

A. Factual Background

In April 2007, Sun Life received an application for a $5 million insurance policy on the life of Nancy Bergman. The sole owner and beneficiary of the policy was to be a trust bearing Ms. Bergman's name. The application was signed by Ms. Bergman and her grandson, who was identified as a trustee. The trust had four additional members, all of who were investors who had no connection to Ms. Bergman. It was these investors whose money was used to pay premiums for the policy, although the original trust agreement provided that any proceeds of the policy would be paid to Ms. Bergman's grandson.

The application contained false information. Ms. Bergman, who was a retired teacher, had an annual income of $3000 a month and a net worth of between $100,000 and $250,000. The application, however, listed her income at $600,000 and her net worth as $9.235 million. And while the application stated that Ms. Bergman had no other life insurance in her name, in fact fa total of five (5) policies has been taken out on her life in 2007, valued at a total of $37 million.

Sun Life issued the policy in July 2007. The policy contained an "incontestability clause" which prohibited Sun Life from challenging the policy (other than for non-payment of premiums) after it had been "in force during the lifetime of the Insured" for two years.

Five weeks after the policy was issued, Ms. Bergman's grandson resigned as a trustee and the remaining four investors became the only trustees. As indicated above, none had any connection to Ms. Bergman. The trust documents were amended so that all policy proceeds would go the investors instead of the grandson.

The Sun Life policy was eventually sold and the investors received nearly all of the proceeds of the sale. The policy changed hands again before Wells Fargo acquired it around 2011 as part of a bankruptcy settlement. Wells Fargo continued to pay premium. In court papers it claimed to have paid $1,928,726 to maintain the policy.

Ms. Bergman passed away in 2014. Wells Fargo submitted a claim to collect the policy's death benefit and Sun Life began in an investigation into the claim. After discovering the facts of the policy's issuance, Sun Life declined to pay and filed an action

in federal court seeing a declaration that the policy was void *ab initio* because it was procured as part of a STOLI scheme. Wells Fargo counter-sued for breach of contract and, in the alternative, for a refund of premium paid if the policy was found to be void.

B. Procedural Background

The District Court partially granted a motion for summary judgment filed by Sun Life. It found that under New Jersey law, the policy was a STOLI transaction that lacked insurable interest in violation of the state's public policy. The court, however, did grant Wells Fargo's request that it recover its premium payments based on the fact that Wells Fargo had not been the party that engaged in the fraud.

The parties cross-appealed to the United States Court of Appeals for the Third Circuit. The Third Circuit determined that the questions of law presented were unresolved in New Jersey and thus certified to questions to the New Jersey Supreme Court:

(1) Does a life insurance policy that is procured with the intent to benefit persons without an insurable interest in the life of the insured violate the public policy of New Jersey, and if so, is that policy void ab initio?

(2) If such a policy is void ab initio, is a later purchaser of the policy, who was not involved in the illegal conduct, entitled to a refund of any premium payments that they made on the policy?

C. The Supreme Court's Decision

The Court began its decision by laying out the history of the "insurable interest requirement." Quoting an 1877 United States Supreme Court decision, the Court noted that "[a] man cannot take out insurance on the life of a total stranger, nor on that of one who is not so connected with him as to make the continuance of the life a matter of some real interest to him." The existence of an insurable interest distinguished valid life insurance policies from "mere wager policies.

The Court noted that New Jersey had codified the insurable interest requirement, barring procurement of a life insurance policy payable to someone who lacks an insurable interest in the life of the insured:

> No person shall procure or cause to be procured any insurance contract upon the life, health or bodily safety of another individual unless the benefits under that contract are payable to the individual insured or his personal representative, or to a person having, at the time when that contract was made, an insurable interest in the individual insured.

N.J.S.A. 17B-24-1.1(b).

The Court then discussed the relationship between the insurable interest requirement and the policy's incontestability clause. Forty-three states require incontestability clauses in life insurance policies, and they are found in almost all policies. The rationale for them is to create incentives for insurers to challenge suspicious policies quickly, rather than sitting collecting premiums and only objecting when a claim is made on the death benefit. The interplay of the insurable interest requirement and the policy's incontestability clause has been the subject of court decisions in other jurisdictions but not in New Jersey. If the incontestability clause served as a complete bar to challenging a policy, then insurers would lose the ability to challenge a STOLI policy after a set number of years.

The Court also noted that although the insurable interest had to be present at the time the policy was procured, that did not mean policies could not subsequently be sold or transferred. Life insurance policies can be sold in New Jersey pursuant to the Viatical Settlements Act, which permits terminally or chronically ill insureds to sell their policies to third-parties in return for a lump sum amount. One key component of the act was that such sales or transfers could not occur for two years from the sate the policy was issued.

In contrast, STOLI polices implicated different public policy concerns, including New Jersey's policy against wagering, which is rooted in the State Constitution. By taking out a policy on the life of a complete stranger, a party would essentially be betting on that person's life.

Taking all these public policy matters in consideration, the Court answered the Third Circuit's certified questions.

- *Question 1*

The first certified question asked whether "a life insurance policy that is procured with the intent to benefit persons without an insurable interest in the life of the insured violates the public policy of New Jersey." The Court answered yes:

> If a third party without an insurable interest procures or causes an insurance policy to be procured in a way that feigns compliance with the insurable interest requirement, the policy is a cover for a wager on the life of another and violates New Jersey's public policy.

The Court did not place weight on the fact that the policy in question had first been issued Ms. Bergman's trust with her grandson as beneficiary. "If the investors cause [a beneficiary] to transfer her interest to them a month, a day, or an hour after the policy is issued, it would elevate form over substance to suggest that the policy satisfies the insurable interest requirement."

The Court also found that the incontestability clause did not serve as a bar to challenging the policy's validity. If a policy never came into effect then "a policy never came into effect [and] neither did its incontestability clause; the clause thus cannot stand

in the way of a claim that the policy violated public policy because it lacked an insurable interest."

The Court emphasized that it was not suggesting that life settlements (i.e. sales/transfers) are always contrary to public policy – valid life insurance policies are assets that can be sold under the guidelines set forth in New Jersey law.

Finally, the court rules that STOLI policies were void *ab initio* (Latin for "from the beginning") rather than just "voidable." A policy that is voidable can still be enforceable if a counter-party is barred from seeking to void it, for example under the doctrines waiver or estoppel.

- *Question 2*

The second certified question asked "if such a policy is void ab initio, is a later purchaser of the policy, who was not involved in the illegal conduct, entitled to a refund of any premium payments that they made on the policy?" Sun Life argued that it should be permitted to retain the premium because New Jersey law required the parties to be left in the position they are found (as opposed to what occurs in rescission. Wells Fargo argued that the rules applicable to rescission should apply here – the parties unwind the transaction. This was a $2 million issue for Wells Fargo.; it had not participated in the fraud that underlay the initial issuance of the Bergman policy and it had paid premium to keep the policy active after it had acquired it.

The Court declined to adopt a bright-line rule. It found that the decision as to return of premium depended on equitable considerations that were fact sensitive. A party who contributed to fraudulent acts should not recoup premium paid because doing so could increase the likelihood of wrongful conduct. However, where a party who paid premium was not to blame for illegality, a return of premium could occur:

> To decide the appropriate remedy, trial courts should develop a record and balance the relevant equitable factors. Those factors include a party's level of culpability, its participation in or knowledge of the illicit scheme, and its failure to notice red flags. Depending on the circumstances, a party may be entitled to a refund of premium payments it made on a void STOLI policy, particularly a later purchaser who was not involved in any illicit conduct.

D. Subsequent History

After receiving answers its certified questions, the Third Circuit affirmed the District Court's original decision, which (1) granted partial summary judgment to Sun Life by declaring the policy void, and (2) ruled that Wells Fargo was entitled to a refund of the premium paid. *See Sun Life Assur. Co. v. Wells Fargo Bank NA*, Nos. 16-4337 and 16-4387, 2019 U.S. App. LEXIS 24916 (3d Cir. Aug. 21, 2019).