LATE TESTIMONY

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CONSUMER PROTECTION & COMMERCE

TWENTY-FIFTH LEGISLATURE
Regular Session of 2009

Wednesday, February 11, 2009
2:00 p.m.

TESTIMONY ON HOUSE BILL NO. 1439 – RELATING TO INSURANCE.

TO THE HONORABLE RYAN I. YAMANE, CHAIR, AND MEMBERS OF THE COMMITTEE:

My name is J.P. Schmidt, State Insurance Commissioner ("Commissioner"), testifying on behalf of the Department of Commerce and Consumer Affairs ("Department"). The Department opposes this bill.

The purpose of this bill is amend the Life Settlements Act, Hawaii Revised Statutes ("HRS") chapter 431E, which was passed last session as Act 177, Session Laws of Hawaii. HRS chapter 431E is based upon Life Settlements Model Act ("Model Act" of the National Conference of Insurance Legislators ("NCOIL").

The Department believes that the Life Settlements Act should not be modified since it was the adoption of the Model Act. The consumer protection aspects in the Model Act should be preserved.

We thank this Committee for the opportunity to present testimony on this matter and respectfully request that this bill be held.

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February 11, 2009

Representative Robert N. Herkes, Chair
Representative Glenn Wakai, vice Chair
Committee on Consumer Protection & Commerce
Hawaii State Capitol, Room 325
Honolulu, HI 96813

RE: HB1439 Relating to Insurance

Dear Chair Herkes, Vice Chair Wakai and Members of the Committee:

Thank you for this opportunity to submit written testimony in strong support of HB1439 which would make various clarifying and technical amendments, and corrects inadvertent errors, in the Life Settlements Model Act, chapter 431E, HRS, which establishes consumer protections in life settlement transaction.

The Hawaii Life Settlements Act, HRS Chapter 431E (the "Hawaii Act") was based on the Life Settlements Model Act of the National Conference of Insurance Legislators (NCOIL), adopted in November 2007 (NCOIL Model Act). The following is a summary of proposed amendments to the Hawaii Act:

1. Most of the proposed amendments are based on the 2008 laws adopted in Kansas, Indiana, Maine, Connecticut, Kentucky, Oklahoma and Arizona. Likewise, the proposed amendments are similar or legislation passed by the California General Assembly and by the New York Senate.

2. The key interested parties – life insurance and life settlement organizations – supported and endorsed laws that included amendments similar or identical to the proposed amendments. The American Council of Life Insurers (ACLI) issued public statements praising the new laws in most of the aforementioned states, and praised the California legislation.

3. The majority of the proposed amendments are technical amendments to the NCOIL Model Act, correcting several errors that impair the effectiveness or enforcement of the law, as well as several scriveners' errors.

4. The definition of Stranger-Originated Life Insurance (STOLI) is amended to improve the detection and enforcement against such practices and in light of several recent federal court decisions. In 2008 eight state legislatures acted to amend the NCOIL Model Act definition. In particular, STOLI is defined as the procurement of new life insurance BY a stranger (rather than by a person with an insurable interest) and not the lawful assignment of a life insurance policy.

5. The proposed amendments include measures to protect the property rights of Hawaii's life insurance policyowners and responds to documented evidence of anti-consumer market conduct of life

insurers that impairs policyowners' access to information and assistance about the value of their life insurance and about life settlements. The proposed amendments:

a. Ensure that policyowners are aware of the market value of their life insurance policy whenever they are faced with the lapse or surrender of the policy and under other limited circumstances;
b. Ensure that policyowners are able to receive information and assistance from their trusted life insurance agent, as the law currently prescribes life agents are authorized and qualified to assist policyowners with life settlements;
c. Prohibit life insurers from interfering with Hawaii consumers' property right to assign their life insurance, including life settlements, or from issuing false and misleading information about life settlements.

6. The proposed amendments clarify the Hawaii Legislature intent under the current law that duly licensed life insurance producers are deemed to meet all the requirements as a settlement broker, provided that they notify the Commissioner and acknowledge that they will comply with the provisions of this Act. Contrary to the Hawaii Act, the NCOIL Model Act and the model act of the National Association of Insurance Commissioners, the Department of Insurance has not followed this mandate and has required duly licensed life insurance producers to submit full applications for a life settlement broker license, which has resulted in a restriction on the availability of life settlements to Hawaii consumers.

Thank you for your consideration of these comments.

Respectfully Submitted,
Michael Freedman
Senior Vice President, Government Affairs

LIFE INSURANCE AND PROPERTY RIGHTS IN HAWAI'I LAW

Introduction/Summary

Hawai'i law is clear with respect to life insurance, insurable interest, and property rights, explicitly recognizing that:

- Any person may take out a policy on his own life and do with it as he pleases.
- Any other potential policyowner must have a valid insurable interest, which attaches specifically at policy inception in order for the arrangement to be valid.
- Once properly formed with insurable interest, the owner may alienate the policy on the open market to whomever she wishes for the best price available, regardless of whether the purchaser has an insurable interest or not.
- Life insurance policies are to be treated like other property in order to maximize their value for consumers.
- Wager policies where in investor funds premiums and takes control of the death benefit from policy inception are against public policy.

This is no academic concern. As many as 90% of life insurance policies lapse without paying a claim, and many policies marketed as an investment are, according to a leading life insurance industry actuary, sold with "grossly inadequate" cash surrender values. The secondary market remedies this market defect for the benefit of consumers by allowing them to capture the true value of their policies created by their premium payments. Legislation regulating this market should foster rather than impede the exercise of these property rights.

The Insurable Interest Statute Attaches At Policy Inception Only

The Hawai'i insurable interest statute allows any person to take out a policy on his own life and do with it as he pleases. HI Stat. § 431:10-204(a) ("Any individual of competent legal capacity may procure or effect an insurance contract upon the individual's own life or body for the benefit of any person.")

The statute requires that, in order to take out a contract on another, the purchaser must have insurable interest. This requirement explicitly only attaches at policy inception. HI Stat. § 431:10-204(b) ("No person shall procure or cause to be procured any insurance contract upon the life or body of another individual unless the benefits under the contract are payable to the individual insured or the insured's personal representatives, or to a person having, ***at the time the contract was made***, an insurable interest in the individual insured") (emphasis added).

Insurable interest in Hawai'i is statutory and mirrors the categories in the common law and other States' statutes, including "individuals related closely by blood or law"; individuals with "a lawful and substantial economic interest in having the life ... of the individual insured continue"; business partners; and certain charities. *See* HI Stat. § 431:10-202.

The Well-Established Property Rights In A Life Insurance Policy In Hawai'i

The property rights in a life insurance policy were established nearly a century ago by Hawai'i's highest court. Citing and quoting at length the seminal U.S. Supreme Court case of *Grigsby v. Russell*, Hawai'i's high court explained:

> In *Grigsby v. Russell*, 222 U.S. 149, 154, the court says: "Of course the ground suggested for denying the validity of an assignment to a person having no interest in the life insured is the public policy that refuses to allow insurance to be taken out by such persons in the first place. A contract of insurance upon a life in which the insured has no interest is a pure wager that gives the insured a sinister counter interest in having the life come to an end. * * * But when the question arises upon an assignment it is assumed that the objection to the insurance as a wager is out of the case. * * * This being so, not only does the objection to wagers disappear, but also the principle of public policy referred to. * * * The danger that might arise from a general license to all to insure whom they like does not exist. Obviously it is a very different thing from granting such a general license, to allow the holder of a valid insurance upon his own life to transfer it to one whom he, the party most concerned, is not afraid to trust. * * * So far as reasonable safety permits it is desirable to give to life policies the ordinary characteristics of property."
>
> If a man can assign a policy of life insurance to one having absolutely no interest in his life, it would be absurd to assert that a man may not insure his own life in favor of one who has no insurable interest in it. This conception of the position of the parties is fully sustained by the authorities.

Rumsey v. New York Life Ins. Co., 25 Haw. 141 (1919).

The Practical Importance Of Property Rights As A Remedy To Insurers' Anti-Consumer Cash Surrender Practices

By specifically quoting *Grigsby's* key formulation that "[s]o far as reasonable safety permits it is desirable to give to life policies the ordinary characteristics of property," Hawai'i law has long established the basic property rights in a life insurance policy which form the legal and intellectual underpinnings of the secondary market for life insurance.

This market has sprung to life in an institutional manner in the last decade as life insurers began to emphasize sales of products with, as a leading insurer actuary described it, "grossly inadequate cash values." This is of great practical importance, because it is estimated that as many as 90% of life insurance policies lapse without paying a claim, leaving the consumer with only cash value—or the opportunity to seek market value through a life settlement.

In an influential article published in 2000 in *Best's Review*, Northwestern Mutual chief actuary William Koenig explained that it has become common in many life insurance products for "someone who surrenders a cash-value policy in the early years [to] receive[ ] a cash value (or nonforfeiture benefit) far less than premiums paid." These policies "depend on lapse-supported pricing," a "pricing method ... unfair to consumers" since "[t]he vast majority of policyholders who lapse their policies before death are the 'losers.' They receive much less at surrender than what any reasonable person would perceive as acceptable value."

Koenig warned that—because of the market defect caused by insurers' "unfair" treatment of consumers—policyowners would seek a market solution which would allow them to receive a fair return on their investment. "The current environment suggests that if an issuing company does not provide fair value, policyholders will proceed directly to a secondary market—presumably, a viatical company—to get a better deal. There will be a secondary market for these contracts, and this will not be good for

the life insurance industry."

That is precisely what has happened. Responding to consumer demand, the secondary market is now well established, paying out billions of dollars a year over cash surrender value to consumers who would otherwise have lapsed their policies. Consumers have benefited from competition, and life insurers have lost a source of profits (lapsed policies where they pay out no death benefit and instead a "grossly inadequate" cash surrender). This explains why carriers are today seeking protectionist legislation from the States to, in effect, codify their "unfair" practices by insulating them from competition from the secondary market. These efforts by life insurers should be rejected because regulation of commerce in the public interest is supposed to remedy—not perpetuate—market defects.

Ensuring Property Rights While Preventing Wager Policies

Good legislation would give honor to both of the key instructions in *Grigsby v. Russell*, the recognized law of the land passed down by the U.S. Supreme Court and specifically followed by Hawai'i courts.

In *Grigsby*, Justice Oliver Wendell Holmes aggressively articulated the importance of recognizing and honoring the property rights in a life insurance policy—key to which, he said, is the ability to alienate the policy on the open market to any willing buyer, regardless of that purchaser's insurable interest.

> [L]ife insurance has become in our days one of the best recognized forms of investment and self-compelled saving. So far as reasonable safety permits, it is desirable to give to life policies the ordinary characteristics of property.... To deny the right to sell except to persons having such an [insurable] interest is to diminish appreciably the value of the contract in the owner's hands.

Grigsby v. Russell, 222 U.S. 149.

Holmes also reaffirmed the importance of insurable interest at policy inception as a means of preventing wager policies which are against public policy. "And cases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith." *Id.* Holmes explained what constitutes "a cloak to what is, in its inception, a wager": "the policy having been taken out for the purpose of allowing a stranger association to pay the premiums and receive the greater part of the benefit, and having been assigned to it at once." *Id.*

The National Conference of Insurance Legislators (NCOIL), in its recently adopted amendments to its Life Settlements Model Act, specifically codified this formulation of what constitutes a violation of insurable interest, and otherwise followed *Grigsby's* teachings. Legislation in Hawai'i should likewise codify these established rules, best articulated by the U.S. Supreme Court, pertaining to insurable interest and property rights:

- The law should foster, rather than impede the principal that life insurance policies should be given "the ordinary characteristics of property."

- Limiting the right of resale "is to diminish appreciably the value of the contract in the owner's hands."

- Schemes where investors pay premiums and receive immediate assignment of the policy are "a cloak to what is, in its inception, a wager."

STATE STATUS AS OF DECEMBER 8, 2008

- THE **OVERWHELMIING MAJORITY OF STATES** that have taken up life settlement/anti-STOLI legislation in 2008 **CONSIDERED AND REJECTED THE NAIC MODEL and ADOPTED NCOIL MODEL BASED PROVISIONS.** According to an October 2008 report by the NAIC, of twenty six states that introduced settlement/anti-STOLI legislation in 2008, only two adopted the NAIC Model Act.

- The NCOIL Model or NCOIL Model provisions that were adopted in 2008 were almost universally amended to strengthen the administration and enforcement of the laws and to address scrivener's errors and operational matters.

- THE ACLI and its subsidiary organizations supported nearly every bill that adopted the NCOIL Model or amended NCOIL Model provisions.

- A growing number of state insurance regulators have supported the adoption of the amended NCOIL Model or amended NCOIL Model Provisions, including Kansas, Connecticut, Indiana, Maine, Kentucky and Rhode Island. Likewise, the insurance regulators in New York, Washington State, Idaho and the District of Columbia rejected the 5 year ban while supporting other NAIC provisions.

- The so-called "new NAIC/NCOIL" or "hybrid" bill is like lipstick on a pig, since the NAIC Model was a near total failure in 2008 because it is anti-consumer and protectionist, as has been determined by NCOIL members, the NAIC's own consumer advocates and numerous state legislatures.

TO DATE in 2008:

NCOIL Bills that PASSED:

Kansas, Indiana, Maine, Connecticut – Introduced NAIC Model, but passed NCOIL anti-STOLI provisions.

Hawaii – Introduced NAIC Model, but passed NCOIL Model.

Oklahoma – Introduced NAIC Model, but passed NCOIL anti-STOLI provisions.

Kentucky – Introduced and passed NCOIL Model provisions.

Arizona – Introduced NCOIL STOLI definition, passed amended STOLI definition.

Rhode Island – Introduced NCOIL; Passed with no amendments. Vetoed.

California – Introduced NCOIL Model; PASSED BOTH CHAMBERS, Vetoed

NAIC and so-called "hybrid" Bills:

Nebraska and West Virginia – Introduced and passed NAIC Model without consideration of NCOIL model.

Ohio and Iowa – Adopted NAIC with NCOIL provisions. Ohio's 5 year ban unique (not NAIC).

Other 2008 Action to date (including actions for 2009):

New York – NY Insurance Superintendent introduced a unique bill with no 5 year ban; Senate Passed modified NCOIL bill; Identical Bill on the Floor of the Assembly, awaiting a vote.

Georgia – Introduced NCOIL; Passed Senate; no action in House; modified bill expected for 2009.

Washington – Introduced NCOIL; Held for consideration; NCOIL modified bill pending for 2009.

North Carolina – Introduced NAIC in 2007, died in committee; in 2008 attempted NCOIL without amendments and bill was not heard by the committee.

Massachusetts – NAIC introduced and study bill introduced – both sent to study till 2009.

District of Columbia – Commissioner introduced NAIC Model, without the 5 year ban or anti-premium finance provisions; strong consumer protections. Did not pass. NCOIL to be introduced in 2009

Illinois and Minnesota– Both NAIC and NCOIL introduced; no action taken.

Idaho – Commissioner proposing NAIC without 5 year ban or anti-premium financing provisions for 2009.

Wyoming – Interim Committee rejected hybrid for 2009.

Arkansas – Department rejected NAIC and is proposing NCOIL for 2009.

Utah – Interim Committee pulled hybrid bill from consideration for 2009.

Alaska – Department proposed 5 year ban; Department pulled regulation.

Wisconsin – Department proposed hybrid for 2009; pulled from immediate action pending further study.