

Variable Annuity with a No-lose Death Benefit Is Not Subject to the Statutory and Common Law Insurable Interest Requirement

September 11, 2015

Rhode Island Law Applied

Western Reserve Life Assurance Co. of Ohio v. ADM Associates, LLC, 116 A.3d 794 (R.I. 2015) **Case at a Glance**

In a case of first impression, the Rhode Island Supreme Court held that a particular variable annuity with a no-lose death benefit, where the annuitant had no relationship to the owner, was not subject to the common law and statutory insurable interest requirements applicable to life insurance, and that a contractual provision providing for incontestability, effective immediately upon the issuance of the annuity, was valid and enforceable, precluding claims based on the lack of an insurable interest.

Summary of Decision

There is an expanding body of case law concerning the need for the owner of a life insurance policy to have an insurable interest in the life of the insured, and the circumstances under which a life insurance policy may be voidable or void *ab initio* for lack of an insurable interest. Some courts have considered whether to apply these concepts to annuities. Annuities which have a death benefit may present a more compelling case for the application of such principles than annuities which do not include a death benefit, since they are more closely dependent upon the life of the annuitant. This case considers the applicability of the insurable interest principal to a variable annuity which has a death benefit as one of its features. The analysis was heavily dependent upon the provisions of the annuity contract at issue. **Background**

Western Reserve Life Assurance Co. of Ohio issued a variable annuity which included a death benefit provision. The contract benefits (both annuitization payments and the death benefit) were calculated with reference to the life of the annuitant. The contract permitted the owner to name anyone as the annuitant – no familial or other relationship was required between the owner and the annuitant. While statutory incontestability requirements for life insurance policies typically provide for a two-

year period before the policy becomes incontestable, this annuity had an incontestability provision which became effective immediately upon the issuance of the annuity. Rather than permitting only a single premium, the contract permitted multiple premium payments over a period of time, with a maximum aggregate premium of \$1 million. Since this was a variable annuity, the contract owner had the right to direct how the premiums paid would be invested, with an opportunity to realize gains based upon the performance of the selected investments. The death benefit guaranteed that upon the death of the annuitant, the beneficiary would receive the greater of (1) the highest market value of the policy at a specified anniversary date or (2) a return of all of the premiums paid into the policy plus five percent per annum interest. A lawyer, Joseph Caramadre, who the court described as someone “who specialized in finding loopholes in insurance and annuity products that would be personally lucrative to him” concluded that the death benefit provisions in this annuity contract provided him a no-lose situation - an opportunity to speculate aggressively in the stock market to realize substantial gains while receiving 100% of his premium back with 5% interest if his trading decisions resulted in a market loss. Caramadre sought terminally ill persons to serve as annuitants, implementing this scheme multiple times. He used LLCs as the applicants for the annuities. The propriety of his recruitment of annuitants was questioned, and according to the First Circuit he was indicted on 67 counts of fraud, conspiracy, identity theft and money laundering. Caramadre paid a stranger \$5,000 to be the annuitant for the contract at issue in this case, for which Caramadre made an initial premium payment of \$250,000. After the contract was issued Caramadre made an additional premium payment of \$750,000. His strategy was to invest aggressively with an expectation of a death benefit being payable within a relatively short period of time. The shorter the life of the annuitant, the greater the potential for profit for Caramadre. Western Reserve sued in United States District Court, seeking rescission of the policy or a declaration that the policy was void because the owner did not have an insurable interest in the life of the annuitant, and monetary damages for fraud, civil liability for crimes and offenses, and civil conspiracy. The court granted the motion of the LLC owner to dismiss, concluding that the lack of an insurable interest in the life of the annuitant did not render the contract void, and that the incontestability provision “serve[s] to deflect claims to rescind the annuities or have them declared void because of fraud.” Western Reserve appealed, and the First Circuit found that the outcome of the appeal was “controlled by important questions of Rhode Island law and public policy as to which [they had] found no dispositive precedent.” Therefore, it certified two questions to the Rhode Island Supreme Court for guidance. *Western Reserve Life Assurance Co. of Ohio v. ADM Associates, LLC*, 737 F.3d 135 (1st Cir. 2013).

The Certified Questions

The Rhode Island Supreme Court answered two certified questions posed to it by the First Circuit:

- (1) If the owner and beneficiary of an annuity with a death benefit is a stranger to the annuitant, is the annuity infirm for want of an insurable interest?
- (2) Does a clause in an annuity that purports to make the annuity incontestable from the date of its issuance preclude the maintenance of an action based on the lack of an insurable interest?

The Ruling of the Rhode Island Supreme Court

In a 5-2 opinion, the Rhode Island Supreme Court answered question #1 No, and answered question #2 Yes. With respect to the first question, the Court began by stating that “we consider an annuity policy with an elective death benefit to be separate and distinct from a life insurance policy.” The Court noted that whether the insurable interest concept should be extended to annuities was an issue of first impression. It concluded that the annuity was not void due to the lack of an insurable interest based upon its analysis of three potentially independent factors. First, the Court considered the Rhode Island insurance code, noting that the Rhode Island legislature had adopted some sections of the life insurance code which specifically mentioned both life insurance and annuities, while other sections mentioned only life insurance. The insurable interest section appeared to be limited, by its terms, to life insurance. To apply the statutory insurable interest requirement to annuities, in the Court’s words, “would strain the clear and unambiguous language thereof and would violate well-established rules of statutory construction.” Second, the Court considered the Rhode Island Life Settlements Act, noting that the Act clearly and unambiguously prohibited stranger originated transactions in life insurance but was silent as to stranger transactions with annuities. The Court concluded that it could not extend the Act to cover annuities. Third, the Court considered whether an annuity with the features of this annuity, when owned by someone who did not have an insurable interest in the life of the annuitant, should nonetheless be classified as a wagering contract and be void as a matter of public policy. The Court rejected such a classification because it found that the way in which this annuity was structured presented the investor with a no-lose situation, so that it was not a purely speculative contract on the life of another. The Court left open the question of whether it might have reached a different result with respect to this portion of the analysis had the annuity presented the owner with a real risk of loss that was related to the life of the annuitant. With respect to the second certified question, the Court noted that incontestability provisions are normally found in life insurance policies and that such a provision bars claims that a policy was procured by fraud. However, the Court found that whether an incontestability provision that takes immediate effect is enforceable was an issue of first impression. The Court found no reason not to enforce the contractual provision, which was drafted by the party seeking its invalidation. The Court found that the practical impact of the provision was to require that the insurer be careful and conduct an investigation into the application for the policy for possible fraud before rather than after the issuance of the policy. Since the provision was enforceable, it would preclude all causes of action that seek to invalidate the policy, including claims of fraud. After the Rhode Island Supreme Court provided its response to the two certified questions, the First Circuit affirmed the ruling of the District Court. *Western Reserve Life Assurance Co. of Ohio v. ADM Associates, LLC*, 793 F.3d 168 (1st Cir. 2015). *Reprinted with permission of Thomson Reuters, Inc. All rights reserved.*

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