Case 11: Outwitting Insurers

Some people liken the securities industry to legalized gambling because the industry profits from the investment of money, assumption of risk, and attempts by the investor to foresee the future.[1] Like gambling, the stock market often provides fixed rules, like the odds on a given bet, which are meant to give some degree of transparency and fairness to the system and entice people to participate. Thus, many securities come with long prospectuses or contracts that will help identify the rules of the game. The entities selling securities set those rules. And then there are the purchasers, some of whom want to find a way to beat the system by using the rules to their advantage. Such is the case with a recent scandal involving variable annuities.

The Wall Street Journal recently reported on what some call an "insurance scam": a lawyer and investors recruited terminally ill patients, provided the money for the purchase of variable annuity contracts, used those patients' names, and listed themselves as beneficiaries.[2] They paid the terminally ill individuals and/or their families for their participation—often a small fraction of the overall proceeds.[3] When the patients died, the contracts were cashed in for the benefit of the investors.

In gambling, counting cards turns what should be a game of chance into a calculation that allows gamblers to gain a leg up on the casino—they look at the cards that have been played, and can with greater certainty predict what will come next and bet accordingly. Casinos prohibit counting cards. Similarly, insurance companies wish to limit the purchase of variable annuities by strangers who essentially "count cards" by looking at the most profitable way to use the products and finding the perfect customers to make that profit happen. Thus, the purchase of variable annuities for strangers is frowned upon by insurers, and these companies are increasingly fighting the claims by such investors. Even people with no stake in the variable annuity scheme may find the arrangements reprehensible simply because the endeavors profit off of the illness of others.

The investors argue that insurance companies draft the contracts that govern how the variable annuities will work. The investors who take advantage of such arrangements have carefully reviewed the contracts to avoid violating any contractual terms. They see no reason why they should be limited simply because they are business-savvy. The companies do not want to restrict their customers' freedom to choose who may benefit from their annuity. For instance, a paramour or dear friend should not necessarily be excluded for want of a sufficiently valid tie. But the true stranger should be excluded. As such, the insurance companies see themselves as bound, wanting to provide the greatest freedom for their customers but at the same time wanting to limit "stranger-originated" contracts that game the system.[4]

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[1] See "Gambling with the Economy," Roger Lowenstein, *The New York Times*, Op-Ed, Apr. 19, 2010, http://www.nytimes.com/2010/04/20/opinion/20lowenstein.html; "Investing Versus Gambling," Clifford G. Dow, 1999, http://www.dows.com/Publications/investing%20versus%20gambling.htm.

[2] "Investors Recruit Terminally Ill to Outwit Insurers on Annuities," Mark Maremont & Leslie Scism, http://www.radeylaw.com/investors-recruit-terminally-ill-to-outwit-insurers-on-annuities/, reprinted from *The Wall Street Journal*, http://online.wsj.com/article/SB20001424052748704479704575061392800740492.html, Feb. 16, 2010.

[3] In one case, the patient was paid $5,000 for a $100,000 policy. Note that the investor paid the premiums and set up the annuity, so the patient was being paid only for his participation and not for any investment of his own money.

[4] For more about the regulation of securities, see the Financial Industry Regulatory Authority at www.finra.org.