LIFE INSURANCE AND THE EROSION OF THE INSURABLE INTEREST REQUIREMENT

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Introduction

Third party ownership of life insurance policies is a concept whose time has come, and it's among the hottest issues within the industry. However, will it have the staying power to survive the negative public policy implications? Clever investors armed with complicated programs, which, in theory and form, resemble traditional estate planning vehicles, whereby parties or entities unrelated to the subject insured own, usually indirectly, majority interests in life insurance policies on insureds, are finding a niche in the investment marketplace. These products are often purchased at a price well below the face value of the policy, creating the potential for returns that are significantly higher than many other investment vehicles. Investors take comfort in knowing death is certain, and life insurance policies written by established companies are secure investments. There is additional comfort in knowing the policies can usually be sold in the secondary market.

Currently, all states permit third party ownership of life insurance polices, whether initial ownership by trusts for various purposes or secondary ownership via the viatical and life settlement markets. This article focuses on the direct or indirect purchase of life insurance by third parties who have no relationship to the insured, which is prohibited in most states

The key analysis in each and every life insurance issuance transaction is whether the owner of the policy has a valid, insurable interest in the life of the insured. Without such an insurable interest, the transaction is deemed to be mere gaming – betting on the death of the insured – and arguably could have a deleterious effect on his continued life. Key states, for insurance regulatory purposes –Florida and Texas – treat the concept in very different ways, and many states are considering proposals to modify their insurable interest requirement. We will look at how these two states treat the concept and how they compare to other states.

We will also examine how erosion of the insurable interest requirement could affect consumers. For instance, what the impact will be on the insured's ability to plan for his own estate is an important, but to date overlooked, risk of third party ownership programs. Finally, will state regulators alter their actions to be more consistent? If not, will the federal government move toward intervention in what is the state's regulatory purview? However, before exploring these questions, some historical background is helpful to put the issues in perspective.

Historical Background

For thousands of years, life insurance generally stayed true to its original purpose – a safety net to provide support for the family in the event of the death of a spouse or parent. However, by the 18th century in England life insurance had diverged from its original purpose becoming little more than gaming. Often policies were purchased on insureds without their knowledge.[1] Policies were also purchased on the lives of public figures as a wager that the insureds would not live beyond the coverage period.[2] To address this concern, Parliament enacted one of the first insurable interest laws.[3] The law was meant to address public policy concerns stemming from the premise that insurance should provide a safety net, not a windfall, and prohibit wagering on death, which can produce nefarious results.

The seminal case in the United States involved a gentleman who entered into an agreement with an association. The association agreed to pay the expenses and premiums for a life insurance policy and would pay a 10% death benefit to the insured in exchange for an assignment of the insured's interest in the policy. The Court stated:

> It is not easy to define with precision what will in all cases constitute an insurable interest, so as to take the contract out of the class of wager policies. It may be stated generally, however, to be such an interest, arising from the relations of the party obtaining the insurance, either as a creditor of or

> surety for the assured, or from the ties of blood or marriage to him, as will justify a reasonable expectation of advantage or benefit from the continuance of his life. It is not necessary that the expectation of advantage or benefit should be always capable of pecuniary estimation; for a parent has an insurable interest in the life of his child, and a child in the life of his parent, a husband in the life of his wife, and a wife in the life of her husband. The natural affection in cases of this kind is considered as more powerful - to protect the life of the insured - than any other consideration.
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> But in all cases there must be a reasonable ground, founded upon the relations of the parties to each other, either pecuniary or of blood or affinity, to expect some kind of benefit or advantage from the continuance of the life of the assured. Otherwise the contract is a mere wager… [4]

Today, most state laws require that the owner or beneficiary of a policy have an insurable interest in the insured at the time of purchase. A person is generally considered to have an insurable interest when that person has an identifiable and historically acceptable interest in the person being insured.[5] People are always considered to have an insurable interest in their own lives. Interest can also be engendered by love and affection, by blood relationship or when a lawful and substantial economic interest in the continued life of the insured exists. Business partners may have an insurable interest in each other, and a corporation may have an insurable interest in its employees' lives. Charities may have an insurable interest in major contributors.

The Push to Carve Out Exceptions to the Insurable Interest Requirement

There has been a push in recent years, particularly in the last year, for states to broaden the definition of insurable interest or to entirely eliminate the requirement and, thus, to permit third party investors to own life insurance on individuals who are essentially strangers. The push has been initiated to permit a charity or other organization to which tax-deductible contributions can be made to delegate its legitimate interest in the lives of its donors to unrelated third party investors.[6] In most states, charities may purchase life insurance on contributors; an individual may assign the ownership of the life insurance policy to the charity or make the charity the beneficiary on a policy that the person already owns. The changes proposed would allow the charity to assign its ability to purchase policies to a third party, usually a trust.

Some proposals have been promoted by investors with a plan to purchase life insurance through a charity. The insureds are not necessarily contributors to the charity, nor do they purchase the policies. They "donate" their insurable interest to the charity. The charity provides the investors with the names of individuals willing to donate their insurable interests. In exchange for the "use" of an insured's life, the charity is paid something up front or given a promise of future income from a trust. The investors set up a trust funded from contributions. The trust purchases the policies for the benefit of the investor, who reaps the lion's share of the returns.

In most states the plan would not be permitted under existing laws which require that at the time of initial purchase the purchaser or beneficiary of a life insurance policy have an insurable interest in the insured. Insurable interest is generally defined as the financial or emotional interest that a person or entity has in the continued life of the insured. Many states permit charities to purchase insurance on an individual with the person's consent, but the charity cannot assign its right to purchase the policy to a trust – even a trust set up for the benefit of the charity.

Nearly a dozen states have considered proposals to broaden the charity insurable interest exception to permit trusts to purchase and hold such policies. To date, only North Carolina, Tennessee, Texas and Virginia have passed laws broadening the insurable interest exception, but no state has gone as far as Texas.

Texas, Florida: Different Ways of Treating the Insurable Interest Requirement

Texas is usually considered to be a state that takes a proactive approach to insurance regulation, and California, New York and Florida generally have very similar regulations. The legislatures of Texas and Florida have recently considered proposals to broaden the insurable interest exception with very different outcomes. The Florida proposal died in committee. The Texas proposal passed, creating what is perhaps the broadest exception to the insurable interest requirement to date.

The Texas law states:

> An individual of legal age may in a single written document:
> (1) consent to the purchase of or application for an individual or group life insurance policy by a third party; and
> (2) designate or consent to the designation of any individual, partnership, association, corporation, or legal entity as:
> (A) a beneficiary of the policy;
> (B) an absolute or partial owner of the policy; or
> (C) both a beneficiary and an absolute or partial owner of the policy.[7]

There are no known cases interpreting the statute, but the meaning is clear. The statute allows anyone with written consent to have an insurable interest in any other person. Clearly, the program described above where investor funded trusts purchase policies on individuals supplied by charities is permitted in Texas.

As a result of the change, there will no doubt be a flurry of investment groups setting up shop in Texas. These groups may purchase policies on residents of states other than Texas. It will be interesting to see if the purchases will withstand legal challenges that are sure to come from insurers and heirs and to see which law the court will apply – Texas law or the law of the insured's state of residence.

Florida does not have a specific statute expressly requiring the purchaser of a life insurance policy to have an insurable interest in the life of the insured. However, there are number of related statutes that reference such a requirement making it apparent that the requirement exists.[8] Florida courts have also made it clear that such a requirement exists. The Florida Supreme Court succinctly stated in a case pertaining to life insurance that "Florida law prohibits issuance of an insurance policy to one who has no insurable interest in the thing insured."[9] Indeed, Florida public policy has historically required the beneficiary of either a life insurance or property policy to have an insurable interest in the life or property of the insured and has condemned as mere wager contracts such policies where an insurable interest did not exist.[10]

Florida has carved out an exception to the insurable interest requirement that permits charitable organizations meeting the requirements of s.501(c)(3) of the Internal Revenue Code of 1986, as amended, to own or purchase life insurance on an insured who consents to the ownership or purchase of that insurance.[11] However, the law does not permit a trust set up for the benefit of the charity to purchase life insurance.[12] During the 2005 legislative session, the legislature considered a proposal that would have broadened the definition of charitable organizations to include trusts, but the proposal died in committee. Thus, in Florida, as in most states, third party investor trusts cannot purchase life insurance through a charity.

Conclusion

We have seen a rise in third party investment in life insurance policies via the secondary or viatical/life settlement market. As we know, these transactions are permissible because the insurable interest requirement only applies at the time the policy is purchased. In this article we looked at efforts by groups to convince states' legislatures to change their insurable interest requirement and enable third party investors to purchase life insurance through charities. Despite these efforts, most states have laws similar to Florida, where the insurable interest requirement prohibits the practice. However, Texas passed what could be characterized as a radical reform that virtually eliminates the insurable interest requirement for life insurance.

The rise in third party ownership of life insurance could ultimately adversely affect the insured's estate. All insurance companies look at the individual's amount of current coverage as part of their underwriting analysis to determine if the applied for coverage is excessive. We know of at least one insurer that has amended its application, requiring it to be made clear that any policies that have been sold in life settlements are to be listed as current in-force coverage. It is a very real possibility that companies will begin to include policies held by third parties in their calculation of the amount of current in-force coverage and conclude that the issuance of additional coverage would make the applicant over-insured and, thus, deny the applicant. This could potentially result in individuals with valid needs for coverage being unable to obtain it.

Third party ownership of life insurance also creates a public policy dilemma for state regulators. Insurance has historically been a safety net, providing protection against foreseen and unforeseen risks. Permitting third party ownership of life insurance changes the nature of the insurance product. Investors with no interest in the life of the insured stand to receive significant gain when that person dies. This has the potential to exacerbate the ills that the insurable interest requirement was intended to address.

Finally, proposals to broaden the insurable interest requirement have drawn negative attention from some federal law makers. In a May 26, 2004 letter to the president of the American Council of Life Insurers, United States Senators Gordon Smith (R-OR) and Kent Conrad (D-ND) outlined their concern, stating that they "believe the laws allowing unrelated third party investors to profit from an unrelated person's death runs counter to good public policy and important insurance principles."[13] The Bush Administration's proposed 2006 federal budget and legislation include proposals which would use excise tax to effectively stop these investment arrangements. In a press release, Senators Grassley (R-IA) and Baucus (D-MT) expressed disapproval that state legislation is being sought to permit these arrangements.[14]

There are still many questions as to how third party ownership of life insurance will evolve and how the evolution will affect consumers. Will we see more states follow the Texas lead and broaden the insurable interest exceptions? If this happens, will it impact consumers' ability to purchase life insurance? Will it affect the costs? If insurable interest requirements erode, will the federal government pass laws making life insurance a less attractive investment? Only time will tell.

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[1] "Insurable Interest Rules of Charities – What's it all about?" by Matt Donovan July 2004
[2] *Id*.
[3] 14 Geo. III, Chap. 48.
[4] *Warnock v. Davis*, 110 U.S. 775, 779 (1881).
[5] "Insurable Interest: An Essential Element of Life Insurance Underwriting," Statement of ACLI, NAIFA and AALU at NAIC (A) Committee Hearing on Investor-Owned Life Insurance
[6] *Id*.
[7] Title VII, Subchapter B, Section 1103.056, Texas Insurance Code.
[8] For example Section 626.798, Florida Statutes, prohibits life insurance agents from being the beneficiary on a life insurance policy unless the agent is a family member of the insured or has an insurable interest in the life of the insured. Section 627.404(1), Florida Statutes, states that an insurer is entitled to rely upon all statements of an applicant of insurance relative to insurable interest such applicant has to the insured. Section 624.406, Florida Statues, states that a minor of the age of 15 years or more may contract for insurance on the life of another in whom the minor has an insurable interest. Section 627.512, Florida Statutes, states that an insurer has the option of refusing to recognize the naming of a beneficiary who does not appear to the insurer to have an insurable interest in the life of the insured.
[9] *Life Insurance Company of Georgia v. Lopez*, 443 So.2d 947 at 948 (1983), *rehearing denied.*
[10] *Meerdink v. American Insurance Co*., 137 Fla. 587, 188 So. 764 (1939); *Knott v. State ex rel. Guaranty Income Life Insurance Co*., 136 Fla. 184, 186 So. 184, 186 So. &88 (1939); *National Benefit Life Insurance Co. v. Brown*, 103 Fla. 758, 139 So. 193 (1931); *Airvac, Inc. v. Ranger insurance Co*., 266 So.2d 178 (Fla. 4th DCA 1972); *Aetna Insurance Co. v. King*, 265 so.2d 716 (Fla. 1st DCA 1972); *Flynn v. Prudential Insurance Co. of America*, 223 So.2d 86 (Fla. 3d DCA 1969); *Peninsular Fire Insurance Co. v. Fowler*, 166 So.2d 206 (Fla. 2nd DCA 1964).
[11] Section 627.404, Florida Statutes (2005) – During the 2005 legislative session, Florida lawmakers considered a bill that would have broadened the insurable interest exception. It died in committee.
[12] Staff Analysis for HB 1145CS – The Florida House of Representatives, April 19, 2005.
[13] NAIC (A) Committee Hearing on Investor-Owned Life Insurance. Statement of ACLI and AALU. "Insurable Interest: An Essential Element of Life Insurance Underwriting."
[14] *Id*.