Presentation

HUSCH BLACKWELL

Update on Insurable Interests

Presented by Kenneth W. Kingma at the Michigan Institute of Continuing Legal Education, 2007

Kenneth W. Kingma
314.480.1631
ken.kingma@huschblackwell.com

Table of Contents

Introduction	1
The Insurable Interest Requirement	2
The *Chawla* Decision and SOLI Programs Raise Insurable Interest Issues	4
Dealing with the *Chawla* Decision and SOLI Programs in Your Practice	17
Exhibits	
Exhibit 1	23
Exhibit 2	29
Exhibit 3	32
Exhibit 4	33
Exhibit 5	35

Introduction

What Practioners Already Know — Life Insurance Is a Valuable Planning Tool

Life insurance has long been a valuable tool for estate and business planning purposes. It can provide financial security when loved ones die or provide funds to purchase a decedent's interest in a business.

Michigan case law recognizes that life insurance is also one of the most recognized investment vehicles. *Secor v. Pioneer Foundry Co., Inc.*, 20 Mich App 30, 34; 173 NW2d 780 (1969).

When a life insurance policy is transferred to or acquired by a properly drafted irrevocable life insurance trust (ILIT), federal transfer tax benefits can be achieved. Federal transfer taxes can be reduced or eliminated with respect to an ILIT by using "Crummey withdrawal rights" for gift tax purposes, by preventing the settlor from having any "incidents of ownership" or "retained interests" in trust assets for estate tax purposes, and by allocating the senior's "GST exemption" to trust assets for generation-skipping transfer tax purposes.

What Practitioners Need to Know — The Insurable Interest Requirement

Two recent events have demonstrated that the estate and business planning practitioner must be knowledgeable not only of the liquidity, business, tax and investment benefits of life insurance and ILITs, but also of state insurable interest law with respect to life insurance. Awareness of state insurable interest law is important because a life insurance policy will be valid only if the policy owner has an insurable interest in the life of the insured.

One event highlighting the importance of state insurable interest law was the decision in *Chawla v. Transamerica Occidental Life Ins. Co.*, No. 03-1215, 2005 US Dist LEXIS 3473 (ED Va Feb 3, 2005), *aff'd in part and vacated in part*, 440 F3d 639 (4th Cir 2006). This decision has caused various state legislatures to amend their insurable interest statutes to allow an ILIT to acquire life insurance on the life of a settlor and, in some instances, on the lives of others. For a discussion of *Chawla* and a review of Michigan insurable interest law, *see* Kingma, *Michigan Irrevocable Life Insurance Trusts after the Chawla Decision*, Mich Prob. & Est. Plan. J., Vol. 25, Summer 2006, No. 3, at 6, which is attached as **Exhibit 1 ("Kingma Article")**.

Another event highlighting the importance of state insurable interest law has been the rapid spread of stranger-owned life insurance (SOLI or STOLI) (a/k/a investor-initiated life insurance (IILI) or investor-owned life insurance (IOLI)), company-owned life insurance (COLI) (a/k/a employer-owned life insurance (EOLI)), bank-

owned life insurance (BOLI), charitable-owned life insurance (CHOLI), trust-owned life insurance (TOLI) and partnership-owned life insurance (POLI), together with the increased purchase of "wet ink" insurance policies by viatical and life settlement companies. The proliferation and settlement of such insurance has triggered the issuance of insurance department opinions/ bulletins, judicial decisions, articles and commentaries on insurable interest issues, other insurance law issues, the ethics of marketing arrangements associated with such insurance, and the enactment of federal tax legislation. For an extensive discussion of all of these matters, *see* Leimberg, *Investor-Initiated Life Insurance: Really a "Free Lunch" or Prelude To Acid Indigestion*? 41 Heckerling Inst. on Est. Plan. ¶300 (2007) ("**Leimberg Article**").

This presentation explains the insurable interest requirement, reviews insurable interest issues generated by the *Chawla* decision and SOLI programs, and provides comments on dealing with ILITs and SOLI programs in one's practice. This presentation also discusses legislation needed to address insurable interest issues raised by the *Chawla* decision and SOLI programs.

The Insurable Interest Requirement

It Has Prevented Gambling Policies and Protected Human Life for Centuries

The insurable interest requirement arose to curb the use of gambling or wager policies that speculate upon the early death of the insured. *Dow Chemical Co. v. United States*, 250 F Supp 2d 748, 757 (ED Mich 2003), mod 278 F Supp 2d 844, rev'd on other grounds 435 F3d 594 (CA6 2006) (where Dow, having an insurable interest in employees' lives under MCL 500.2210, purchased COLI policies on employees lives but was denied interest deductions claimed on loans secured by such policies because its COLI plan lacked economic substance for federal income tax purposes).

The most famous definition of insurable interest was penned by Justice Field in *Warnock v. Davis*, 104 US 775, 779 (1882):

> "[I]n 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 benefit or advantage from the *continuance* of the life of the assured. Otherwise the contract is a *mere wager*, by which the party taking the policy is directly interested in the early death of the assured. Such policies have a tendency to create a desire for the event. They are, therefore, independent of any statute on the subject, condemned, as being against public policy." (emphasis added).

According to Justice Field, the insurable interest requirement not only curbs the use of gambling or wager policies that speculate upon the early death of the insured, but also protects human life by preventing untimely deaths.

Insurers Rely Upon the Insurable Interest Requirement

The insurable interest requirement also benefits life insurance companies that base premiums on actuarial life expectancies. This effort is frustrated if the owner, insured or beneficiary can control to any meaningful extent the probability of the insured's death. The mere existence of insurance can have the perverse effect of increasing the probability of loss, and this is precisely where the concept of insurable interest finds its importance as a safeguard and counterbalance.

The insurer's primary objective in requiring an insurable interest is economic—to be certain that parties to a life insurance policy are not morally likely to adversely affect the odds or accelerate the end of the life in question more rapidly than its natural course. At this level, the insurer's insistence of an insurable interest at the inception of the contract can be seen as an effort to preserve the integrity of the risk pool and the avoidance of adverse selection. That same motivation also causes an insurer to escape responsibility under a policy at the death of the insured if subsequent facts indicate a lack of insurable interest. *See* Leimberg Article, ¶305.1.

Only Insurers May Enforce the Insurable Interest Requirement, and They Do!

In Michigan, only the insurer may assert the lack of an insurable interest and the insurer does not waive this defense by accepting premiums. *See* Kingma Article, p. 7. Michigan based insurers are not hesitant to question whether there is a lack of insurable interest. *See*, *e.g., Hastings City Bank v. Jackson Nat'l Life Ins. Co.*, 2005 Mich App LEXIS 708 (2005) (unpublished), where the policy owner stated on the life insurance application that an insurable interest existed to secure a loan between the policy owner and the insured. The Michigan Court of Appeals ruled that an insurable interest never existed there because the loan never closed. The Court also noted that the policy could have been issued as "key man" insurance because the insured was an employee of the owner, but the policy owner failed to state that relationship on the application and therefore could not rely upon that insurable interest.

Michigan Incontestability Statutes Limit Insurer Review to Two Years

In Michigan, life insurance policies are, by statute, incontestable after two years except as to certain defenses that do not include fraud or lack of an insurable interest. *Sun Life Assurance Co. v. Allen*, 270 Mich 272, 281; 259 NW 281 (1935). *See also* Kingma Article, p. 10, n. 14, discussing how Michigan's incontestability statutes for life insurance differ in operation.

The incontestability statutes do not condone fraud or the lack of insurable interest; rather, they merely operate as a statute of limitation. Thus, if a life insurance policy and an insurance application disclose no violation of public policy, the insurer generally has two years within which to determine if fraud or lack of insurable interest exist. "[S]uch contests shall no longer be tolerated after a reasonable time for full investigation has passed without protest." *Bagacki v. Great-West Life Assurance Co.*, 253 Mich 253, 256-258; 234 NW 865 (1931). In other words, incontestability statutes are viewed as "wise statutes of limitation" because "Insurance companies should not be permitted with shut eyes to receive in silence the profits of their contracts and to grow articulate only when called upon to pay." *Id* quoting *Harrison v. Provident Relief Ass'n.,* 141 Va 659, 674; 126 SE 696 (1925).

The *Chawla* Decision and SOLI Programs Raise Insurable Interest Issues

The *Chawla* Decision — Can an ILIT Satisfy the Insurable Interest Requirement?

The *Chawla* case (which is further discussed in the Kingma Article at p. 6 and the Leimberg Article at ¶336) dealt with an irrevocable trust that was the owner and beneficiary of a life insurance policy on the life of the settlor. Upon the settlor's death, the insurer rescinded the policy, refunded the premiums and alleged that material misrepresentations had been made in the life insurance application and that the trust lacked any insurable interest in the settlor's life. The life insurance policy was governed by Maryland law, which provided that the trust, as beneficiary, had to have an insurable interest in the settlor's life. Maryland law, at that time, provided that an insurable interest existed if one is "related closely by blood or law" or has "a lawful and substantial economic interest in the continuation of the life, health, [or] bodily safety of the individual." The trial court ruled that the trust could not satisfy either test and stood to merely enhance its value by reason of the settlor's death and suffered no detriment, pecuniary or otherwise, upon the decedent's death. On appeal, the insurable interest ruling was vacated, but not reversed, thereby leaving the issue unresolved.

The insurable interest issue raised by *Chawla* is also an issue under Michigan law. The Michigan insurance code of 1956 has a short list of insurable interests, none of which provide that a trust has an insurable interest in the life of an individual settlor or beneficiary. *See* Kingma Article, p. 7-8. Furthermore, it is unclear currently whether Michigan common law on insurable interests supplements the insurance code. *See* Kingma Article, p. 8-9 as to whether the legal maxim *expressio unius est exclusion alterius*—the expression of one thing is the exclusion of another—prevents the expansion of insurable interests via common law. However, if Michigan common law on insurable interests supplements the insurable interests listed in the insurance

code of 1956, the common law test that would apply is whether an ILIT has, when purchasing a policy on the settlor's life, a reasonable expectation of some economic benefit or advantage from the continuance of the settlor's life. *Id*. An ILIT, according to the trial court in *Chawla*, cannot satisfy that test.

The Leimberg Article at ¶336.4 notes that some commentators have scoffed at the vacated decision in *Chawla*. However, other commentators assert that *Chawla* should not be ignored:

> "Now that the issue has been widely discussed ... the risk that a trust may not have insurable interest must be addressed; the chance that the insurer will not pay the promised death benefit, or that the IRS will treat the death benefits as taxable income, cannot be ignored by a competent practitioner."

Mancini and Zaritsky, *Insurable Interests: Apres Chawla, le Deluge?* 32 ACTEC J. 194 (2006).

SOLI Programs — Can They Withstand Insurable Interest Challenges?

The Leimberg Article at ¶345 summarizes the current SOLI phenomenon as follows:

> "Harry Truman said, 'The only thing new in the world is the history you don't know.' This quote certainly applies to investor-initiated life insurance—and to attempts to avoid the long held public policy requiring insurable interest.
>
> Some things change. Some things remain the same. Still others merely appear to change. Some schemes scores or even hundreds of years old are invented anew for the first time. Too good to be true ideas are often like vampires, they die hard and inevitably and repeatedly dig themselves up from the grave century after century. Investor-Initiated Life Insurance with its many aliases and constantly mutating forms is just such an 'undead' Dracula that, like the fabled vampire, reappears after rising up from the casket, a prime example of the never-ending quest to do indirectly what centuries of insurable interest statutes and cases will not allow directly; speculators purchasing life insurance on the lives of individuals who are by blood, business relationship and economically, strangers."

Speculation in human lives is not new. Examples provided in the Leimberg Article at ¶347 include the following:

> *Warnock v. Davis*, 104 US 775 (1882): A "free" insurance case where the insured contracted with the Scioto Trust Association to acquire a $5,000 policy on his life in exchange for the Association paying all of the premiums and transferring one-tenth of the death proceeds to the insured's wife.

Colgrove v. Lowe, 343 360; 175 NE 569 (1931) cert den 284 US 639 (1931): A speculative arrangement where 100 individuals agreed in writing to take out policies on their lives and designate the same trust as a common beneficiary for a term of five years, during which the proceeds of any policy maturing during that term was paid 75% to the estate of the insured and 25% to the surviving parties to the contract who kept their policies in force. Each individual essentially "bet" 25% of his insurance proceeds to participate in the death benefits of the other participants.

According to the Leimberg Article at ¶350, SOLI programs vary and are known to change names and some features, but some common features are as follows:

- **Two years free insurance**. The purported major benefit of "free" insurance is that the insured is led to believe that a SOLI program makes it possible to obtain "free" insurance for a limited period of time, typically the incontestability period of two years.
- **Insinuation of free profit when policy sold**. Promoters hint at the potential for "free" profit on selling the policy for which the individual never paid for and took little or no risk to obtain.
- **Additional incentives**. Some promoters offer luxury cars, free cruises, cash (often expressed as a percentage of the face amount of insurance purchased), and other up-front signing bonuses (often called "advances"). Advances are often part of the loan obtained to acquire the policy, which must be repaid. On the surface, 47th Annual Probate and Estate Planning Institute, May 17-19, 2007 the SOLI arrangement appears to be very attractive because the insured obtains a windfall of insurance proceeds if death occurs within the first two years, with no downside economic risk or cost assuming premium financing is, in fact, nonrecourse.
- **Borrowing to pay premiums**. The insured, or often a trust established with the promoter's assistance, utilizes loans from a lender arranged indirectly by the promoter or investors to purchase life insurance that is often transferred to the lender in exchange for extinguishing the debt (which will then sell it to the investors), or is sold directly to a life settlement company. Formerly, loans were typically two years, but in response to carrier prohibitions on two year programs, the loans are often five to 10 years. Moreover, loans have gone from non-recourse to recourse. When recourse financing is involved, carriers are now asking whether a life expectancy calculation is required for the financing. A life expectancy calculation is a good indicator that the transaction is investor-initiated because it is not required by traditional premium financing methods. Interest is almost always charged at "Libor plus" or "prime plus" and can be quite high. There may be contingent interest and creation or termination fees on the loans. A high interest rate is an indicium that the lender/promoter is

intending to force the insured/trustee's hand to sell the policy rather than pay back the borrowed money and all accrued interest.

- **Option to repay loan and interest as cover**. A third option at the end of the two, five or 10 year term is to repay the loan plus interest and any other charges. The insured may or may not be aware that the program may be carefully structured to economically discourage loan repayment or encourage divestiture so that the policy is transferred directly or indirectly to investors.

The following chronology of the underwriting process for SOLI is derived from the Leimberg Article at ¶351:

Step 1. The prospective insured is promised one or more of the following upon qualification:

- Two years free life insurance;
- An up-front cash payment of 1.5-3.0% or other enticements (such as a car);
- A portion of the net profits realized from the anticipated sale of the policy after two years or more.

Step 2. The prospective insured authorizes disclosure of medical information to the life settlement company—not the insurer—to see if the prospective insured is a "candidate". The Life Expectancy review (commonly referred to as an "LE") is a *sine qua non* for investor-initiated life insurance and, if it is a pre-requisite to the transaction, is a clear sign of investor intent. Generally, investors are looking for insureds having a projected life expectancy of 120 months (10 years) or less. Leimberg Article, ¶368.11.

Step 3. The proposed insured qualifies for a permanent death benefit life insurance policy of typically $5 million or more.

Step 4. A third-party investor group, through an arrangement with a special purpose lender, makes (or guarantees) a loan to a "non-grantor" ILIT created to purchase the policy.

Step 5. The ILIT collaterally assigns the policy to the lender.

Step 6. After two years or longer (to avoid a state's "wet ink" laws and to hopefully satisfy the policy's incontestability provision), the insured must choose to repay the loan, sell the policy, or transfer ownership to the lenders in full satisfaction of the loan.

Whether SOLI Programs Satisfy the Insurable Interest Requirement Will Be Determined Under "Substance Over Form" and "Intent of the Parties" Tests

Courts in the United States review life insurance arrangements under "substance over form" and "intent of the parties" tests. Michigan courts employ the "substance over form" test in determining the "real party to the contract." According to the Michigan Supreme Court in *Dolan v. Supreme Council Catholic Mutual Benefit Ass'n.*, 152 Mich 266, 271; 116 NW 383 (1908):

> "[T]he rule of public policy which forbids one insuring a life in which he has no insurable interest, does not prevent his being made a beneficiary in an insurance policy secured by the insured. And it should be added, too, that for the purpose of determining whether the transaction is prohibited, courts in accordance with well-settled principles will look not at its form, but at its substance. Thus, insurance obtained in the name of the insured payable to one having no insurable interest will be void if the beneficiary was the real party to the contract." Elliott on Insurance, §59.

Thus, per the *Dolan* decision, a person may insure a life in which that person has an insurable interest and may designate a beneficiary having no insurable interest in that life, but if the substance of the transaction reveals that the beneficiary was the real party to the contract, then the policy will be void. Similarly, Michigan common law allows a person having an insurable interest to assign a life insurance policy to a person having no insurable interest, provided the assignment is not in substance a wager contract. *See Prudential Ins. Co. v. Liersch*, 122 Mich 436; 81 NW 258 (1899) (citing *Olmsted v. Keyes*, 85 NY 598 (1881), which held that a person with no insurable interest may be the beneficiary or assignee of the policy provided "the policy was not procured or the assignment made as a contrivance to circumvent the law against betting, gaming and wagering policies." 85 NY at 600).

The substance of a SOLI transaction will be determined by reviewing the intention of the parties at the time a life insurance policy is purchased.

> "Generally speaking, it may be stated that the test for determining whether or not the assignment is valid is the intention of the parties at the time of the procurement of the policy. If, at this time, the parties intended to speculate on the changes of human life, choosing the form of an assignment as a mere scheme to avoid the law against wagering contracts, the assignment is invalid. If, on the other hand, the life insurance policy was taken out in good faith by the insured and there is no evidence that the parties attempted to circumvent the law against wagering contracts, an assignment will be held valid. This general principal, it is submitted, is the test applied, either consciously or unconsciously, by all the courts which do not consider an assignment to a person without an insurable interest invalid as a matter of law." Anno: *Validity*

> *of assignment of life insurance policy to one who has no insurable interest in insured*, 30 ALR 2d 1310, §30 ("**ALR Article**").
>
> "The standard for determining whether the presumption of validity has been successfully rebutted is the 'intentions of the parties' test. Pursuant to this standard, courts examine a number of factors in the quest to determine whether the assignment was a subterfuge for a wagering contract. However, no single factor alone has been identified as controlling on the issue. Each factor must be considered in combination with the underlying facts and circumstances of the case." Parker, *Does Lack Of An Insurable Interest Preclude An Insurance Agent From Taking An Absolute Assignment Of His Client's Life Policy?,* 31 U Rich L Rev 71, 87-88 (1997)(footnotes omitted) ("**Parker Article**").

Factors that courts can use to determine the parties' intentions in a SOLI program are set forth in the Leimberg Article at ¶¶16.2 and 339.7, the ALR Article at §§31-38 and the Parker Article at p. 87, n. 40, and include the following:

- **Preconceived Plan to Assign Policy**. If a policy owner intends, at the time a life insurance policy is purchased, to assign the policy immediately or at some future time to a person having no insurable interest in the life of the insured, that fact alone does not invalidate the policy for lack of an insurable interest. The leading case on assignments intended at the inception of a life insurance policy is *Grigsby v. Russell*, 222 US 149, 156 (1911), where Justice Holmes stated:

> "[C]ases in which a person having an [insurable] 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*." (emphasis added).

Under *Grigsby*, both the person with an insurable interest (the future assignor) and the person without an insurable interest (the future assignee) must participate" in a plan to purchase a life insurance policy as a cloak or cover for speculation. Decisions since *Grigsby* are in accord:

> "The assignment was in point of time very close to the issuance of the policy, and it may well have been (although there is no evidence on the point) that, when the insured took out the policy intended to assign it to the plaintiff. This, however, would not be sufficient. If it is to be shown that he, in the words of Mr. Justice Holmes, lent himself to one without an insurable interest as a cloak to a gambling transaction, it must appear that the assignee participated in some way." *Lawrence v. Travelers Ins. Co.*, 6 F Supp 428, 430 (ED Pa 1934).
>
> "As there is nothing in the record before me which can justify a finding that Reiziz [the assignee] had anything to do with the original transaction or that

> Moszewskas [the insured/assignor] procured the policy pursuant to a preconceived plan to assign the same, it cannot be held that the transaction was entered into as a mere cover for a wager or gambling transaction." *Travelers Ins. Co. v. Reiziz*, 13 F Supp 819, 821 (ED NY 1935).
>
> "It does not necessarily follow, however, that, where a policy is taken out upon one's life for the benefit of another, and is assigned to a third party, who pays the premium, it stamps the transaction as a wagering device, but it depends upon the good faith of the transaction; that is, whether the policy was in fact intended to be what it purports to be, or whether the form was adopted as a cover for a mere wager...." *Brett v. Warnick*, 44 Ore 511; 75 P 1061, 1065 (1904).

Parties to a SOLI program usually have an understanding at the time a life insurance policy is issued that the policy can be assigned at some future time. Participation in the program by the future assignee or by persons related to or affiliated with the assignee could be treated as a factor against the validity of the assignment.

- **Length of time between issuance and assignment**. The longer the time period between policy issuance and assignment of the policy, the greater the chance a court will uphold the assignment. ALR Article, §33a; Parker Article, p. 87, n. 40. As noted above, some SOLI programs are lengthening the time period between policy issuance and assignment with the intent to withstand an insurable interest challenge.
- **Premium payment history**. Michigan courts review the premium payment history in determining the real party to the life insurance contracts. For example, in *Dolan v. Supreme Council Catholic Mutual Benefit Ass'n.*, 152 Mich 266, 272; 116 NW 383 (1908), the Michigan Supreme Court stated:

> "In *Mutual Benefit Ass'n. v. Hoyt* [46 Mich 473], the beneficiary, Hoyt, not the insured, paid the premiums. The real party to the contract was the beneficiary, not the insured. ...Both the *Hoyt* case and the *Pinch* case [80 Mich 332] are then cases where the insurance, though in form procured by the insured, was in reality procured by the beneficiary, who had no insurable interest."

Furthermore, the Michigan Supreme Court in *Prudential Ins. Co. v. Liersch*, 122 Mich 436 (1899), after noting that the insured paid the premiums on the policy there for first three years but could not continue making the payments, held that public policy permitted the insured to assign the policy to his housekeeper who had no insurable interest in his life and who continued paying the premiums. The exigencies behind an assignment, such as the owner's inability to continue making premium payments, reduce concerns that the assignee will murder the insured or

is participating in a wager on the insured's life. According to *Brett v. Warnick*, 44 Ore 511; 75 P 1061, 1065 (1904):

> "There is abundant authority for holding that a life policy valid in its inception may be assigned to one not having an insurable interest in the life of the assured when not used as a cloak for a wager or mere speculation in the life of another. The exigencies attending such a transaction are strongly set forth in *Murphy v. Red*, 64 Miss. 614, 681 ... where the court say[s]: 'A man may have the best of reasons for wishing to dispose of the policy on his life. The exigencies of business or absolute necessity may require him to do so. He may have paid large sums in premiums and afterward become unable to pay more, and, if he is not allowed to sell or assign on the best terms he can make, the policy may be lapsed and lost. To impair the value and utility of his policy, or require him to lose it on the ground that, if he were to sell or assign it, the assignee or purchaser would have a motive to kill him, or that any sale or assignment he might be able to effect with one who had no insurable interest in his life would be tainted with the vice of gambling, is, as matters of law, extremely fanciful and unsatisfactory.'"

Based on the authorities above, a SOLI program will not be treated as a wager contract merely because an insured has the right to assign the policy. The validity of a SOLI program will depend, in part, on the reasoning for making an assignment (e.g., whether premium financing arrangements were intended to force the insured/owner to assign the policy in time) and an analysis of who is really paying the premiums or is responsible or liable for paying the premiums.

- **Adequacy of consideration for the assignment**. A body of case law exists indicating that the adequacy or inadequacy of consideration is an indication of gambling motive. For example, in *Brett v. Warnick*, 44 Ore 511; 75 P 1061, 1065 (1904), the consideration there was the assignee's promise to take care of the insured during his life and to pay his funeral charges, which indicated to the court that the agreement "was entered into in good morals" as opposed to a wagering contract. To overcome an indication of gambling motive, a SOLI program might have to show that consideration paid to the assignor of a policy was adequate. However, as discussed below, consideration paid to the assignor may violate state law that prohibits payment of financial inducements or rebates to the assignor/ insured.
- **Absence of statutory or policy restrictions**. In *Prudential Ins. Co. v. Liersch*, 122 Mich 436, 438 (1899), discussed above, the Michigan Supreme Court ruled that, absent a statute, policy provision or insurer bylaw to the contrary, a life insurance policy may be assigned to one having no insurable interest.

State Regulators Are Challenging SOLI Programs and Helping Insurers Revise Insurance Applications to Ferret Out Investor-Initiated Transactions

Although promoters of SOLI contend that their products withstand insurable interest and "wet ink" challenges and obtain the benefit of the two year contestable period, state insurance regulators are challenging those positions by looking both at the substance of the transaction and the intent of the parties. For example, New York Insurance Department — Opinion dated December 19, 2005 (copy attached as **Exhibit 2**) — reviewed an insurance program involving (i) third-party bank "loan providers," (ii) a "put option" for the insured that, when exercised, required a hedge fund serving as "put option provider" to purchase the policy, and (iii) a bank serving as a "guarantee provider" to guarantee performance of the put option if exercised. After reviewing the program, the Department concluded that the program:

- Appears to be intended to facilitate the procurement of policies solely for resale,
- Appears to lack a legitimate insurable interest in each insured's life,
- Involves the procurement of insurance solely as a speculative investment for the ultimate benefit of a disinterested third party and
- May involve rebating violations because policy premiums might be effectively rebated to the insureds upon the sale of the policy, resulting in cost free coverage for the incontestability period, which is arguably an inducement to enter into the transaction.

On July 10, 2006, the Utah Insurance Commissioner issued Bulletin 2006-3 (copy attached as **Exhibit 3**) to remind persons licensed in Utah of the insurable interest requirement for life insurance. The facts there were simply stated as follows:

> "The Utah Insurance Department has received several inquiries regarding the legality of a life insurance transaction that involves the purchase of a life insurance policy, premium financing through a non-recourse loan, the sale of the policy in the secondary market and a payment to the applicant."

The Commissioner noted that an insurable interest exists for persons not closely related by blood or law when there is "a lawful and substantial interest in having the life, health and bodily safety of the person insured continue." In determining whether an insurable interest existed there, the Commissioner advised that "the department will look at the entire transaction and will not limit its review to only that part of the transaction that relates to applying for the life insurance policy."

In the Commissioner's opinion, a third party initiated and arranged the transaction there and ultimately expected to receive the life insurance proceeds. Consequently, the third party had no insurable interest because there was a substantial interest in

having the insured's life cease rather than continue. Thus, the settlement process described there was not compliant with Utah law.

In Bulletin No. 06-05 issued by the Louisiana Commissioner of Insurance on September 5, 2006 (copy attached as **Exhibit 4**), the Commissioner stated that certain investors were initiating the creation of life insurance policies for the purpose of settlement in contravention of Louisiana law and are paying consideration (in addition to amounts loaned to take out and sustain coverage) to induce the insured to take out a policy and sell it later to the investor. The Commissioner advised that those arrangements may violate Louisiana insurance law, including the following:

- Insurable interest law;
- Prohibition on wager policies;
- Prohibition on rebating;
- Prohibition on "wet ink" life settlements;
- Premium finance law; and
- Usury.

To assist insurers in dealing with those arrangements, the Bulletin lists questions that the insurer may or may not ask to determine if a life insurance application is investor-initiated. Questions that insurers **may** ask are as follows:

- Whether the applicant has been offered a cash advance or other consideration as inducement to purchase the life insurance policy;
- Whether the applicant has been offered "free insurance;"
- Whether the applicant has entered into a finance arrangement which arranges a life settlement with a particular investor;
- Whether the applicant has entered into a finance arrangement that entitled a lender or investor to a portion of the death benefit above and beyond the repayment of principal and interest on the loan; and
- The total amount of life insurance the applicant currently has in force.

Questions insurers may **not** ask (because insurers in Louisiana cannot discriminate against applicants solely on their intention to sell a life insurance policy in the future) are as follows:

- Whether the applicant intends to premium finance the policy;
- Whether the applicant has previously converted a life insurance policy via the life settlement provisions; and

- Whether the applicant is cognizant that he is vested with a property right to settle a life insurance policy in the future.

On April 2, 2007, the Idaho Department of Insurance issued Bulletin No. 07-03 (copy attached as **Exhibit 5**) regarding SOLI or investor-initiated life insurance arrangements. The Bulletin advises persons in Idaho that life insurance arrangements entered into with the intent of assigning policy benefits to investors may be illegal under Idaho law. Insurance arrangements considered there were as follows:

> "[A] typical program involves a loan to the insured for the policy premium and requires or allows the policyholder/insured to assign the policy to a third-party investor after a certain period of time. In consideration of the assignment, the premium loan will be forgiven or premium payments reimbursed and the insured may also receive additional compensation. Variations of these types of arrangements may include formation of a partnership or other joint endeavor for the sole purpose of establishing an apparent insurable interest in order to permit a third party to become the beneficiary to insurance on the life of another."

In determining whether an insurable interest exists under those arrangements, the Bulletin advised that the Idaho Department of Insurance will review the arrangement in its entirety:

> "Factors the Department will consider in that regard are as follows: solicitation materials; who initiates the transaction and how it progresses; the terms of all written agreements and related documents; the time elapsed between inception and assignment; all consideration associated with the transaction, including incentives for assignment and promises of future compensation; and who ultimately pays the premium."

The Bulletin ends with the following warnings:

- Rebates or inducements in excess of $50.00 (e.g., offers to pay premiums, forgive premium loans or promise future cash payments to induce a person to purchase an insurance policy) may be illegal if the rebate or inducement is not included in the terms of the policy filed with the Idaho Department of Insurance.
- Any person considering whether to offer, purchase or invest in a life insurance arrangement is strongly encouraged to contact both the Idaho Department of Insurance (to determine whether the arrangement satisfies applicable insurance law) and the Idaho Department of Finance (to determine whether the arrangement complies with state securities and financing laws).

Insurers Are Challenging SOLI Programs by Rescinding Policies

On July 5, 2006, New York Life and Annuity Corporation served notice on the trustee of a trust holding a $1,000,000 life insurance policy that it intended to rescind the policy because it learned that the trust was created at the behest of one or more investors who were beneficiaries of the trust and who had no familial or economic interest in continuing the insured's life. The trust provided that 90 percent of the death proceeds were payable to those investors and 10 percent of the death proceeds were payable to the insured's family. Litigation commenced but the case was "dismissed without prejudice" under a settlement where the premiums were refunded with statutory interest. The insurance agent that submitted the application in that case also submitted other applications that had a similar split of the death benefits. New York Life also rescinded those policies and paid back the premiums with statutory interest. New York Life fired an undisclosed number of agents for selling investor-initiated policies because they were issued to satisfy the speculative investment goals of those investors. *See* Leimberg Article, ¶370.3.

Life Insurance Commissioners Have Moved to End SOLI Programs

On December 10, 2006, the Life Insurance and Annuities Committee of the National Association of Life Insurance Commissioners (NAIC) moved to end investor-initiated insurance and strengthen consumer protection in the life settlement area by making a number of amendments to the Viatical Settlements Model Act (Model Act). A summary of those amendments is contained in *Steve Leimberg's Estate Planning Newsletter* #1064 (December 15, 2006) at http://www.leimbergservices.com.

Once the amendments to the Model Act have been approved by the NAIC, it will be up to each state to determine whether and how to enact those amendments or the Model Act itself. Representatives of the Office of the Michigan Insurance Commissioner have advised the author that the Insurance Commissioner intends to support the introduction and enactment of the Model Act as amended through December 10, 2006, which would likely replace the existing Michigan Viatical Settlement Contracts act enacted by Public Act 386 of 1996, MCL 550.521 **et**.seq. The existing act pertains only to policy settlements involving policy holders who have a terminal illness or condition.

Changes resulting from the Amendments adopted on December 10, 2006, include the following:

- The Model Act now applies to all life settlements, not just investor-initiated transactions.
- Settlement brokers are prohibited from acting with settlement providers if they are under "common control".

- Enhanced disclosure rules exist regarding proposed settlements, affiliations, and compensation.
- Enhanced disclosure rules exist regarding broker fiduciary duties to a policy owner.
- New bonding requirements exist for brokers and providers.
- New continuing education requirements exist for brokers.
- Certain advisors such as attorneys, CPAs and financial planners are exempt from licensing requirements.
- An expanded definition of fraudulent activity exists, which includes attempts to change an owner's state of residence or the situs of a life insurance trust.
- Insurance commissioner can suspend or revoke viatical settlements licenses upon a showing of "bad faith conduct."
- Life settlement marketing materials must be filed with the state insurance commissioner and may not use the term "free insurance."
- Any settlement "plan, transaction or series of transactions" within the first five years of a policy's issuance must be fully disclosed to the insurance carrier.
- Rescission rights were expanded in favor of policy owners (earlier of 60 days after settlement contract is executed or 30 days after settlement proceeds paid).
- New limits exist on contacting an insured for health updates (once quarterly if life expectancy is more than one year).
- Five year ban on the assignment or settlement of a life insurance policy except if (i) the owner or insured is terminally or chronically ill, (ii) the owner's spouse dies, (iii) the owner becomes divorced, (iv) the owner retires, (v) the owner becomes mentally disabled, or (vi) policy conversion rights are exercised.
- A policy of less than two years may be sold only if (i) premiums are paid with unencumbered assets or are financed with recourse loans; (ii) no agreement or understanding exists to guarantee any liability or assume a loan, and (iii) neither the insured nor the policy has been evaluated for settlement.
- Definition of viatical settlement contract was expanded to include premium finance loans where (i) loan proceeds are used other than to pay premiums, (ii) a guarantee of a future viatical settlement exists, and (iii) the policy owner or the insured agree on the date of the loan to sell the policy or any portion of it.
- Prospective effective date.

Dealing with the *Chawla* Decision and SOLI Programs in Your Practice

Points to Consider When Advising Clients About ILITs

Practitioners with clients who have or want an ILIT and desire to have the ILIT acquire a life insurance policy governed by existing Michigan law should consider the following when advising clients:

- Michigan law is unclear currently as to whether an ILIT has an insurable interest in the life of the client/settlor. Consequently, if an ILIT purchases a life insurance policy on the client/settlor's life, the policy may be void.
  - An insurer is likely to contest a policy based on insurable interest grounds only if other grounds exist for challenging the policy, such as fraud or misrepresentation in the underwriting process. The importance of properly preparing a life insurance application and correctly answering questions about one's medical history should be stressed.
  - If the policy is a group policy, the insurer cannot rescind a policy for lack of an insurable interest after two years from the date of issue. Death of the insured within the two-year term does not bar completion of the incontestability period. For all other policies, the insurer cannot rescind a policy for lack of an insurable interest after the policy has been in force during the lifetime of the insured for two years. Death of the insured within the two year period bars completion of the incontestability period because the policy must be in force for two years during the insured's life. *See* Kingma Article, p. 10, n. 14 for a discussion on Michigan's incontestability statutes for life insurance.
- Assuming Michigan common law on insurable interests supplements the Michigan insurance code of 1956, a client may purchase a life insurance policy on his or her life and then transfer the policy to his or her ILIT, absent any statute, policy provision, or insurer bylaw to the contrary. *Prudential Ins. Co. v. Liersch*, 122 Mich 436, 438 (1899).
  - The assignment should not be treated as part of a gambling or wager transaction if it is in the form of a gift and if the client continues to contribute cash to the ILIT to enable it to pay premiums. In *Harrison v. Northwestern Mutual Life Ins. Co.*, 78 Vt 473, 477; 63 A 321 (1906), the Supreme Court of Vermont stated the following in connection with a gift assignment of a life insurance policy to one having no insurable interest where (i) the insured procured the policy with the intent to immediately assign it, and (ii) the insured continued to pay policy premiums after the assignment:

> "This is not a wagering policy, as claimed by the defendant, for by the law of this State, as shown by *Fairchild v. North-Eastern Mutual Life Association*, 51 Vt. 613, a policy procured by a man on his own life, in which he has an insurable interest, for the benefit of one named therein who has no such interest, and who makes no outlay in the matter, is not a wager; and by parity of reason, such a policy assigned to such a person, though taken out for that purpose, is no wager."

- The Probate and Estate Planning Section of the State Bar of Michigan has a committee working on legislation to amend the Michigan insurance code of 1956 to address issues resulting from the *Chawla* decision. The committee is considering the following changes:
  - A statute providing that an ILIT has an insurable interest in the settlor's life and in the life of another individual in whom the settlor has an insurable interest;
  - A statute providing that an ILIT may be treated as the real party to (or owner of) an insurance contract even though the policy or its premiums are the subject of a gift (e.g., when premiums are being paid directly or indirectly by the settlor);
  - A statute clarifying how existing creditor protection law regarding life insurance impacts an ILIT that holds a life insurance policy;
  - A statute codifying certain long-standing common law in Michigan (e.g., law that allows one to name a beneficiary or to assign a policy to one having no insurable interest or law that allows one who is dependent upon another for support to have an insurable interest in that person's life);
  - A statute enabling a person to insure his or her life or the life of another in whom he or she has an insurable interest under the code or at common law;
  - A statute describing family relationships in which a person has an insurable interest (e.g., spouse, grandparent, descendant of such spouse or grandparent, and the spouse of such grandparent or descendant);
  - A statute providing that a guardian or conservator has an insurable interest in the life of the individual for whom the guardian or conservator was appointed;
  - A statute providing that insurable interests recognized in the insurance code are in addition to and are supplemented by insurable interests at common law.

Points to Consider When Advising Clients About SOLI Programs

Practitioners with clients who are interested in a SOLI program or who want a trust prepared in connection with a SOLI program should consider the following when advising clients:

- Existing SOLI programs must be carefully reviewed as they may violate state insurance law. In Michigan, the real party to a life insurance contract is based on the facts of each case. When a policy is issued with a view toward assigning it at a future date to one having no insurable interest in the insured's life, one should carefully consider whether the policy will be treated as life insurance or as a wager contract. This will depend on the parties' intent at the inception of the policy.
- State insurance commissioners are challenging certain SOLI programs and are assisting insurers in revising their insurance applications to catch investor-initiated schemes.
- Insurers will attempt to rescind a SOLI policy if an investigation reveals that the policy was issued as a speculation on the insured's life.
- The Viatical Settlements Model Act adopted by the National Association of Life Insurance Commissioners on December 10, 2006 will not protect clients in Michigan until it is enacted by the Michigan legislature.
- Lifetime settlement of insurance policies issued through SOLI programs may be subject to securities regulation. *See* Leimberg Article, ¶366. As a result of the decision in *SEC v. Mutual Benefit Corp.*, 408 F3d 737 (CA1 1 2005), the Leimberg Article at ¶366.5 warns:

  > "Representations made to the hedge fund by the client, trustee or promoters may give a cause of action to the hedge fund and its ultimate investors as in the Mutual Benefits decision. Also, any misrepresentations can give rise to a claim of securities fraud by the insurer, lender or third-party investors....
  >
  > "The precedent of the Mutual Benefits case creates a cavalcade of securities issues for everyone in the chain of the investor-initiated life insurance contract. Any potential insured will need competent securities counsel as part of the team assessing the risk of any non-recourse premium loan or life settlement transaction."

- Income tax issues exist regarding the tax treatment of "free" insurance transactions. *See* Leimberg Article, ¶368. Incentives in SOLI programs such as free cruises, cars or cash should be treated as taxable income to the recipient. Leimberg Article, ¶368.2. What is less certain is the taxation of the "free" insurance before the policy is settled or transferred to the lender. *Id.*

It is possible that the IRS will treat the "free" life insurance as a "life insurance rebate" that is taxable to the recipient. In that event, the IRS might tax the insured on the full amount of the first two years' premiums based on the class of the policy involved. Leimberg Article, ¶368.3, citing, among other cases, *Sutter v. Commissioner*, TC Memo 1998-250 (1998). Alternatively, the IRS might argue that the enjoyment of the "free" insurance that the insured never paid for is a taxable benefit governed by the split-dollar regulations, with annual reportable income determined under either the economic benefit regime or the loan regime for each year that the death benefit is provided until the loan is repaid or cancelled. Leimberg Article, lp 6 8.

- Income tax basis issues exist if the insured (or the insured's trust) walks away from the transaction after two years or more and allows the lender to take the policy in exchange for extinguishing the loan, or if the insured sells the policy to a life settlement company at that time. In the former situation, any gain to the insured (or the insured's trust) would likely be measured by the difference between the total debt and other liabilities discharged and the policy owner's basis in the policy. Leimberg Article, ¶368.7. In the latter situation, the amount realized by the insured (or the insured's trust) would likely be the net amount the seller receives for the policy, and the gain, if any, would be the excess of the sales proceeds over the trust's basis in the policy. Leimberg Article, ¶368.8.

Although the starting point for calculating basis in a life insurance policy is the aggregate amount of the premiums paid, the IRS might contend under PLR 9443020, ILM 200504001 and Treas. Reg. §1.61-22(0(2) that the cost of all the insurance protection provided up to the date of the sale must be totaled and then subtracted from total premiums paid to arrive at the seller's investment in the contract. Leimberg Article, ¶368.9. Some commentators assert that subtracting the cost of insurance protection from total premiums paid runs counter to regulations under section 72(e) of the Internal Revenue Code (IRC) and at least three cases. Id. Because of the uncertainty in calculating basis, the following advice is worth noting:

> "If, as the IRS has suggested, the participant's basis in the life insurance policy must be reduced by the entire acquisition cost [of life insurance protection], the basis is likely to be very low at the two-year point—indeed, near zero—since most of the premium is typically devoted to such costs during the policy's early years. So the attractiveness, if not the feasibility, of the premium financing technique may well depend on the basis-computation question."

Leimberg Article, ¶368.7, quoting from Gans and Soled, *A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference*, Fla Tax Rev, Vol. 7, No. 9, 2006.

- Estate tax issues may also exist. One should review whether the mechanics of the premium financing loan or any powers or options that the insured may hold over the trust constitute incidents of ownership under IRC section 2042. If section 2042 applies, then IRC section 2035 might also apply when the policy is transferred to the lender or sold to a settlement company. Leimberg Article, ¶368.11.
- If you represent the estate of a deceased client who previously held a life insurance policy issued under a SOLI program, and if the program is determined to constitute a wager transaction but the insurer is still willing to pay the death benefit without protest, the estate should consider whether to sue to obtain the insurance proceeds less the amount paid by the assignee to acquire the policy from the deceased client. This remedy may be of particular interest if the deceased client incurred significant tax liabilities in participating in the transaction. According to Grismore, *The Assignment of a Life Insurance Policy*, 42 Mich L Rev 789, 791-792 (1944) ("Grismore Article"):

  "(I)f there is reason to believe that the assignment is part of a preconceived plan of the assignee to indulge in a speculation on a life in which he has no insurable interest, and on which he could not, therefore, have taken out a policy of insurance in his own name, the assignment will be held to be invalid.

  "Moreover, if the insured was a party to the illegal plan and if the illegal design was in contemplation at the time the contract of insurance was procured, the case is dealt with just as if the assignee were himself the insured. In such a case the result is that the contract of insurance is itself held to be illegal and unenforceable against the insurer because of the want of insurable interest in the assignee. The court properly looks through the form of the transaction to get at its substance and deals with it accordingly.

  "However, *if the insurer is willing to pay or has paid without protest, the tendency is to hold that the representatives of the insured or his properly designated beneficiaries are entitled to the proceeds less any advances made by the assignee in connection with the transaction, and that a suit may be brought by one against the other if necessary to bring about this result. It is said that the illegality here existing does not involve moral turpitude and, consequently, does not call for application of the general rule that the court will not aid either party to an illegal transaction, but will leave them where it finds them. This holding would seem to be commendable in view of the fact that the deceased's beneficiaries are not themselves parties to the illegal transaction and it is better that they receive a windfall than that the assignee profit from his illegal venture.* The argument that, if the insurer wishes to make the assignee a gift by paying him something which it is under no legal obligation to pay, no one else has any claim on the fund, scarcely merits consideration.

> "On the other hand, if the illegal design was not formed until *after* a valid contract of insurance had been consummated in favor of an insured who had an insurable interest, *the tendency is to hold that the representative of the insured or his properly designated beneficiary is entitled to recover the proceeds just as if there had been no assignment, the assignee, however; being reimbursed, on equitable grounds, any consideration or premiums which he had paid.* While this result may also be somewhat inconsistent with the generally accepted rule that the law will not aid either party to an illegal transaction where the parties are in *pari delictu*, it can perhaps be justified on the ground that, since it is only the assignment that is tainted with illegality, the beneficiaries of the deceased do not need to rely on the illegal agreement to make out a case." (emphasis added; footnotes omitted).

Before asserting the remedy recommended above, a practitioner should take into account *Secor v. Pioneer Foundry Co., Inc.*, 20 Mich App 30; 173 NW2d 780 (1969). The insured's estate there contended that public policy against speculation on the life of another required the insured's prior employer (which was the owner and beneficiary of the life insurance policy there) to receive only its investment in the policy and that the balance should be paid to the insured's estate. The Michigan Court of Appeals held in favor of the former employer by following the majority rule that the insurable interest requirement has to be satisfied only when the policy is issued, not at the insured's death. The Court determined that an insurable interest existed when the policy was issued because the decedent was a "key man" employee at that time.

This case, however, does not answer the question whether the relief requested there would have been granted had there been no insurable interest when the policy was issued. The case intimated, but did not hold, that any challenge regarding the existence of an insurable interest might be rejected on the grounds that Michigan follows the rule that only an insurer can assert the nonexistence of an insurable interest. 20 Mich App 30 at 34. Although insurable interest issues exist in SOLI programs, the primary issue is whether they constitute wager or gambling contracts. Consequently, the remedy suggested in the Grismore Article above for an insured's estate might be successful if the insured's estate challenges a SOLI program as an illegal wager or gambling policy and not as a void insurance policy for lack of an insurance interest.

- If a life insurance policy was not issued as part of a SOLI program, then a life settlement of the policy may be a viable and lucrative option for the policy holder. For a recent discussion on the life settlement process and its benefits, see Feldman, *The Hidden Power of Life Settlements*, Laches, January 2007, No. 492, published by the Oakland County Bar Association, Oakland County, Michigan.

MICHIGAN PROBATE & ESTATE PLANNING Summer 2006

Michigan Irrevocable Life Insurance Trusts After the *Chawla* Decision: Satisfying the Insurable Interest Requirement

By Kenneth W. Kingma

Introduction

The irrevocable life insurance trust (ILIT) is a valuable and commonly used estate planning tool. An ILIT can be beneficial for clients having liquidity needs at death due to support obligations for dependants or transfer taxes imposed on assets held outside the ILIT.

Federal transfer tax issues with respect to an ILIT have been settled for years. Thus, with proper drafting, federal transfer taxation can be reduced or eliminated by (1) using Crummey withdrawal rights for federal gift tax purposes,[1] (2) preventing the settlor from having any "incidents of ownership" or "retained interests" in trust assets for federal estate tax purposes,[2] and (3) allocating the settlor's "GST exemption" to trust assets for federal generation-skipping transfer tax purposes.[3] However, a recent decision has startled estate planners by questioning whether the trustee of an ILIT has an insurable interest under state law when acquiring a life insurance policy on the settlor's life.

The *Chawla* Decision

In *Chawla v Transamerica Occidental Life Insurance Co*,[4] the decedent, Harald Geisinger, applied for a $1 million life insurance policy on May 4, 2000, and listed his close friend and business associate Vera Chawla as owner and beneficiary of the policy. The insurer refused to issue the policy because Chawla did not have an insurable interest in decedent's life. Decedent changed the owner and beneficiary of the policy to the Harald Geisinger Special Trust, a preexisting irrevocable trust. Decedent and Chawla were co-trustees of the trust and were also its income and remainder beneficiaries, respectively. Decedent died on September 23, 2001, at which point the insurer rescinded the policy, refunded the premiums, and alleged that material misrepresentations had been made in the life insurance application and that the trust lacked any insurable interest in decedent's life.[5]

The United States District Court ruled in favor of the insurer on both counts. The court noted that, under Maryland law, the trust, as beneficiary, had to have an insurable interest in decedent's life. An insurable interest exists under Maryland law if one is "related closely by blood or law" or has "a lawful and substantial economic interest in the continuation of the life, health, [or] bodily safety of the individual."[6] The trust, according to the court, could not satisfy the economic interest test because it stood to merely enhance its value by reason of decedent's death and suffered no detriment, pecuniary or otherwise, upon decedent's death.

The United States Court of Appeals for the Fourth Circuit affirmed the district court on the material misrepresentation count but vacated its decision on the insurable interest count. According to the Fourth Circuit, the lower court's reasoning could be interpreted to mean that a trust can never possess an insurable interest in a person's life under Maryland law, a ruling that could significantly impact how life insurance companies transact business in Maryland. The Fourth Circuit determined that the district court's alternative ruling on insurable interest was unnecessary, and that the court should have exercised judicial restraint when faced with a novel state law issue of vital concern.

However, as one commentator has noted with respect to *Chawla*, the Fourth Circuit's decision to vacate the district court's insurable interest ruling expresses no view on the substantive law and therefore leaves unresolved the issue of insurable interest.[7] Consequently, *Chawla* is causing estate planners to revisit the insurable interest requirement under applicable state law

and to press for clarifying or remedial legislation when necessary.[8] This article reviews Michigan insurable interest law and discusses why clarifying or remedial legislation should be enacted with respect to an ILIT.

Public Policy on Wagering Contracts

Life insurance policies that constitute wager policies are against public policy. A wager policy is a mere speculative contract upon the life of the insured where there is a direct interest in the policy's early termination. In other words, if the party taking the life insurance policy is directly interested in the early death of the insured, the policy has a tendency to create a desire for the event. That policy, independent of any statute on the subject, is condemned as being against public policy.[9]

The concept of insurable interest arose to curb the use of wager policies.[10] A life insurance policy issued to one who has no insurable interest in the life of the insured is void in Michigan as a wager policy.[11] Only the insurer, however, may assert the lack of an insurable interest,[12] and the insurer does not waive this defense by accepting premiums.[13]

Whether an insurable interest exists with respect to a life insurance policy is mitigated in two respects. First, life insurance polices are, by statute, incontestable after two years, except as to certain specified defenses that do not include lack of an insurable interest.[14] Thus, if the trustee of an ILIT acquires an insurance policy on the life of the settlor or any other person and the incontestability period is satisfied, an insurable interest is deemed to exist. Second, section 2207(2) of the Michigan Insurance Code of 1956 (the Insurance Code)[15] appears to allow a beneficiary or assignee of a life insurance policy to be any person, including one with no insurable interest in the life of the insured.[16] This statute seems to follow the holdings of the Michigan Supreme Court in *Dolan v Supreme Council Catholic Mutual Benefit Ass'n* and *Prudential Insurance Co v Liersch.*[17] Accordingly, it appears that a trustee of an ILIT may be a beneficiary or assignee of a life insurance policy on the settlor's life regardless of whether the trustee has an insurable interest in the settlor's life.

However, whether a trustee can purchase a life insurance policy on the settlor's life depends on whether the trustee has an insurable interest in the settlor's life.[18] Generally speaking, an insurable interest is based on (1) an expectation of an advantage or benefit that can be computed monetarily, or (2) natural affection that is considered more powerful at protecting the life of the insured than any other consideration.[19] In the words of Justice Field, "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 benefit or advantage from the *continuance* of the life of the assured."[20]

Michigan Insurable Interest Law

In determining what an insurable interest is in Michigan, the Insurance Code must be consulted, particularly Chapter 22, "The Insurance Contract,"[21] which lists the following insurable interests:

1. A husband may insure his life for the benefit of his wife or any of his children;[22]
2. A married woman, individually or "in the name of any third person as her trustee," may insure the life of her husband or "any other person;"[23]
3. An employer may insure the lives of its officers, directors, management, non-management, and retired employees, subject to the employee's consent;[24] and
4. A 501(c)(3) organization may insure the life of an individual who gives written consent to the ownership or purchase of a policy on his or her life.[25]

This list of insurable interests is narrow. It fails to address, for instance, whether an unmarried

or uncle supports a niece or nephew, or an in-law supports another in-law.

4. When one desires to purchase life insurance on another person's life but is neither related to nor supports the other person, an insurable interest exists if it can be shown that the person acquiring the insurance has a reasonable expectation of some benefit or advantage from the continuance of the insured's life. This does not need to be capable of pecuniary measurement.[35]

Based on the list above, a trustee of an ILIT would have to show, when purchasing a life insurance policy on the settlor's life, that the trustee has a reasonable expectation of some benefit or advantage from the *continuance* of the insured's life. However, as the United States District Court noted in *Chawla*, an ILIT has no interest that would be promoted by prolonging the settlor's life and stands to merely enhance the value of its assets at the settlor's death because it would suffer no economic detriment, pecuniary or otherwise, as a result of the settlor's death. That rationale views an ILIT as an entity for insurable interest purposes rather than as an aggregation of beneficial interests,[36] although there is no Michigan case law viewing a trust as an aggregation of beneficial interests for insurable interest purposes. If such law were to exist, a beneficiary, rather than a trustee, would need an insurable interest in the settlor's life when an ILIT purchases insurance on the settlor's life. That may be difficult to show in certain situations unless the beneficiary is being supported by the settlor. Consequently, remedial legislation appears to be appropriate to clarify the insurable interest issue in Michigan with respect to an ILIT. Other states have already addressed this issue by enacting remedial legislation.[37] Remedial legislation would preserve the ILIT as a viable estate planning tool and would prevent a trustee of a Michigan ILIT from having to purchase life insurance on the settlor's life in other states whose laws grant the trustee an insurable interest in the settlor's life.

Conclusion

The *Chawla* case raises an issue to which many estate planners have not given much consideration in the past. Before *Chawla*, estate planners generally assumed that an individual could establish an ILIT and then have the trustee acquire insurance on the individual's life. Amending the Insurance Code to expressly grant an insurable interest in this context would facilitate the future use of an ILIT in Michigan and obviate the need for Michigan courts to resolve this issue.

Notes

1. *Crummey v Commissioner*, 397 F2d 82 (9th Cir 1968). *See also Estate of Cristofani v Commissioner*, 97 TC 74 (1991).

2. *Headrick v Commissioner*, 918 F2d 1263 (6th Cir 1990).

3. IRC 2631, 2632.

4. No 03-1215, 2005 US Dist LEXIS 3473 (ED Va Feb 3, 2005), *aff'd in part and vacated in part,* 440 F3d 639 (4th Cir 2006).

5. Thus, the insurer, not the court, raised the issue regarding the lack of any insurable interest.

6. 2005 US Dist LEXIS 3473 at *17.

7. Sebastian V. Grassi, Jr., *A Practical Guide to Drafting Irrevocable Life Insurance Trusts* § 12.9 (2d ed 2003).

8. *Id.*

9. *Warnock v Davis*, 104 US 775, 779 (1882). *See also Crossman v American Ins Co*, 198 Mich 304, 308, 164 NW 428 (1917) ("Policies of insurance founded upon mere hope and expectation and without some interest in the property, or the life insured, are objectionable as a species of gambling, and so have been called wagering policies. All species of gambling policies were expressly prohibited in England by Stat. 19 Geo. II, chap. 37, and have been treated as illegal in this country upon the principles of that statute, without acknowledging it as authority. Here, such contracts of insurance are treated as contravening public policy, and are therefore void").

10. *Dow Chem Co v United States*, 250 F Supp 2d 748, 757 (ED Mich 2003), *modified,* 278 F Supp 2d 844, *rev'd on other grounds,* 435 F3d 594 (6th Cir 2006).

11. *Dolan v Supreme Council Catholic Mut Benefit Ass'n*, 152 Mich 266, 269, 116 NW 383 (1908) ("There is no doubt that Guerold had no insurable interest in the life of Dolan, and had he himself obtained the insurance under consideration, the contract would have been a wagering

individual with no children may insure his or her own life for the benefit of his or her estate, or whether a husband can insure the life of his wife. One might conclude that common law should fill the gap regarding other possible insurable interests, but rules on statutory construction may not allow the expansion of insurable interests through common law.

A court might apply the legal maxim *expressio unius est exclusio alterius*—the expression of one thing is the exclusion of another—and prevent the expansion of insurable interests via common law. According to the Michigan Supreme Court, this maxim is a rule of construction that is a product of logic and common sense. No maxim is more uniformly used to properly construe statutes;[26] moreover, it is applied when statutes are deemed to regulate a matter of public interest or confer on a public body the power to perform acts that concern the public interest.[27] The Insurance Code appears to regulate an area of public interest and confers authority on the Commissioner of the Office of Financial and Insurance Services, including the power to determine the reasonableness of insurance contracts.[28]

For example, a court might apply this maxim to the Insurance Code because the Code provides a short list of insurable interests that is easily justified under public policy against wager contracts. A court might also apply this maxim to the Insurance Code because the Code expressly allows a wife, but not a husband, to use "any third person as her trustee" to procure insurance on the life of her husband or "any other person." This authorization arguably excludes similar authorization with respect to a husband. Consequently, a court could apply this maxim to prevent a husband from having a trustee procure insurance on his life or the life of another person. Similarly, the Insurance Code expressly provides that a trust established by an employer has an insurable interest in the lives of the employer's directors, officers, managers, nonmanagement employees, and retired employees.[29] Under the maxim, the authorization granted to an employer and a married woman to use a trust to obtain insurance arguably excludes similar authorization for any other person.

There are, however, compelling reasons why the maxim should *not* be applied to prevent common law expansion of the list of insurable interests. For instance, if the maxim were applied, it would prevent an unmarried individual with no children from insuring his or her own life for the benefit of his or her estate, and would also prevent a husband from insuring the life of his wife, because neither scenario is expressly authorized in the Insurance Code. The Michigan Legislature could not have intended that result. Rather, the Legislature must have intended for common law expansion of the list of insurable interests, which is arguably shown by (1) a wife's ability to procure life insurance on the life of "any other person," and (2) the ability of a person under section 2207(2) of the Insurance Code to effect insurance "on his own life *or on another life* in favor of a person other than himself."[30] In other words, the Insurance Code does no more than define what constitutes an insurable interest in certain circumstances. It neither attempts nor purports to list all forms of insurable interests.[31]

Assuming the Insurance Code allows common law to expand the list of insurable interests, the list of insurable interests in Michigan would likely expand as follows:

1. An individual would have an insurable interest in his or her life in favor of his or her estate.[32]
2. A husband would have an insurable interest in his wife.[33]
3. An individual who is dependent on another for his or her support has an insurable interest in the life of the person upon whom he or she is dependent.[34] This is particularly useful for many of today's families where a stepparent supports a stepchild, an aunt

one and void on the ground of public policy"); *Crossman*, 198 Mich at 304.

12. *Hicks v Cary*, 332 Mich 606, 612, 52 NW2d 351 (1952); *Secor v Pioneer Foundry Co*, 20 Mich App 30, 32–35, 173 NW2d 780 (1969).

13. *Sun Life Assurance Co v Allen*, 270 Mich 272, 284–286, 259 NW 281 (1935).

14. A group life policy is incontestable "after 2 years from its date of issue." MCL 500.4432. Any other life insurance policy is incontestable "after it shall have been in force during the lifetime of the insured for 2 years from its date." MCL 500.4014, .4208. Those incontestability periods are fundamentally different. Under a group term policy, death of the insured within the two-year period does not bar its operation. Under any other life insurance policy, death of the insured within the two-year period bars its completion because the policy must be in force for two years during the insured's life. *Sun Life* at 282–284. *See also* Michigan Civil Jurisprudence *Insurance* § 381, at 389.

15. MCL 500.100 et seq.

16. MCL 500.2207(2) provides in part, "If a policy of insurance, or contract of annuity (whether heretofore or hereafter issued) is effected by any person on his own life or on another life *in favor of a person other than himself*, or (except in cases of transfer with intent to defraud creditors) if a policy of life insurance is *assigned or in any way made payable to any such person*, *the lawful beneficiary or assignee thereof* (other than the insured or the person so effecting such insurance, or his executors or administrators) *shall be entitled to the proceeds and avails (including the cash value thereof)* against the creditors and representatives of the insured and of the person effecting the same, (whether or not the right to change the beneficiary is reserved or permitted and whether or not the policy is made payable in the event that the beneficiary or assignee shall predecease such person, to the person whose life is insured or the person effecting the insurance) …" (emphasis added).

However, it is possible that the statute might be construed, for example, as being primarily for the protection of creditors. In that event, the clause "lawful beneficiary or assignee" would have to be construed narrowly (i.e., a beneficiary or assignee is "lawful" if that person has an insurable interest). Nevertheless, the term "lawful" was probably inserted to pertain solely to assignments or beneficiary designations that were free from any intent to defraud creditors, which MCL 500.2207(2) expressly requires.

17. *Cf. Dolan*, 152 Mich at 269, 274–275 (adopting the prevailing rule that, in the absence of a statute to the contrary, a person may insure his or her life for the benefit of another who has no insurable interest), and *Liersch*, 122 Mich at 438 (upholding an assignment of a policy to a person having no insurable interest when there was no statute, insurer bylaw, or policy provision prohibiting the assignment and when the insurer assented to the assignment), with *Michigan Mut Benefit Ass'n v Rolfe,* 76 Mich 146, 151–152, 42 NW 1094 (1889) (a statute authorizing the issuance of a life insurance policy in favor of a specific class of beneficiaries was treated as requiring a beneficiary *and* an assignee of that policy to have an insurable interest as a member of the class). For authorities similar to *Dolan* and *Liersch*, see *Bristol v Mutual Benefit Health & Accident Ass'n*, 305 Mich 145, 151, 9 NW2d 38 (1943); 3 Lee R. Russ et al, Couch on Insurance 3d, § 41.19, at 41-37, 41-38; 44 Am Jur 2d *Insurance* § 978, at 242; 14 Michigan Civil Jurisprudence §§ 112, 267, at 119–120, 278. For authorities similar to *Rolfe*, see 3 Couch on Insurance 3d, § 41.20, at 41-38–41-40.

18. For example, MCL 500.3462, which deals with third-party ownership of a policy, provides in part that "a person other than the insured with a proper insurable interest" may apply for and own an insurance policy on the life of the insured.

19. *Warnock*, 104 US at 779.

20. *Id.* (emphasis added).

21. The application of Chapter 22 to life insurance policies issued or delivered in Michigan by any life insurer doing business within the state is shown by MCL 500.2226, which describes certain required provisions for such policies and further references the standard provisions required by chapters 40, 42, and 44 that deal, respectively, with life insurance generally, industrial life insurance, and group life insurance.

22. MCL 500.2207(1).

23. *Id. See also* MCL 500.2209. The "other person" would have to be one in whom a married woman has an insurable interest or else the public policy against wager contracts would be violated. This interpretation coincides with MCL 500.2211(1), which provides that "[a]ny individual *who has an insurable interest in the life of another human being* shall not insure that other human being's life for the individual's benefit unless the human being whose life is to be insured consents to be insured in writing" (emphasis added).

24. MCL 500.2210. See *Dow Chem Co*, 250 F Supp 2d at 782, where the deductibility of premiums paid for policies acquired pursuant to this statute was at issue for federal income tax purposes.

25. MCL 500.2212, *enacted by* 1996 PA 572.

26. *Hoerstman Gen Contracting, Inc v Hahn*, 474 Mich 66, 711 NW2d 340 (2006), which applied this maxim in holding that section 3311 of the Michigan Uniform Commercial Code (MCL 440.3311) preempted common law on accord and satisfaction involving negotiable instruments.

27. 29 Michigan Law & Practice *Statutes* §§ 94, 111.

28. In *Rory v Continental Insurance Co*, 473 Mich

457, 474–476, 491, 703 NW2d 23 (2005), the Michigan Supreme Court determined, among other things, that (1) the Commissioner is "charged with reviewing and approving insurance polices," (2) "the explicit 'public policy' of Michigan is that the reasonableness of insurance contracts is a matter for the executive, not judicial, branch of government," and (3) that a determination of reasonableness is subject to judicial review only with respect to abuse of discretion.

29. MCL 500.2210(2), (3).

30. MCL 500.2207(2) (emphasis added).

31. See *Buckner v Ridgely Protective Ass'n*, 131 Wash 174, 229 P 313 (1924), where the Washington Supreme Court applied the same reasoning when analyzing a statute that generally defined the term "insurable interest" in the context of a beneficiary. The court ruled that the statute did not require every beneficiary to have an insurable interest; rather, it provided guidance on the meaning of that interest. The court then applied the prevailing rule that an insured could designate any person as beneficiary, regardless of whether the person had an insurable interest in the insured's life. *Id.* at 182, 183.

32. 44 Am Jur 2d *Insurance* § 978, at 242 (citing *Smith v Coleman*, 184 Va 259, 267, 35 SE2d 107 [1945]). This scenario should be allowed because Michigan case and statutory law already appear to allow an individual to insure his or her life and designate any beneficiary, including one with no insurable interest.

33. 3 Couch on Insurance 3d § 43.1, at 43-2, 43-3, providing that most jurisdictions today recognize an insurable interest during marriage.

34. *Berdan v Milwaukee Mut Life Ins Co*, 136 Mich 396, 401, 99 NW 411 (1904). After setting forth the rule as described above, the Michigan Supreme Court applied it as follows: "In the case at bar, the beneficiary was generally known as the nephew of Miss Quick. He was dependent upon her. He had an insurable interest in her life. He was eligible to be named as a beneficiary in the defendant society. Whether he was named as a nephew, or as one having an insurable interest, would not affect the question of the desirability of Miss Quick as a subject of insurance." *Id.* at 404.

35. In *Indemnity Insurance Co v Dow*, 174 F2d 168, 170 (6th Cir 1949), the Federal Court of Appeals for the Sixth Circuit found, after reviewing *Sun Life Assurance*, 270 Mich at 272, and the cases cited there, that it is not necessary in Michigan to show that the death of the insured would result in a substantial loss to the insured; rather, "[i]t is sufficient that the beneficiary has a reasonable expectation of some benefit or advantage from the continuance of the life of the assured." The Sixth Circuit then affirmed the jury verdict in the lower court in favor of a man named Dow, who entered into a commercial airplane venture with a woman named Kruger and purchased insurance on Kruger's life. Dow supplied funds for the business and Kruger ran the business. The only return Dow was to receive was half of the profits from the business. The Sixth Circuit noted, when upholding the lower court jury verdict, that it was not necessary that Dow's expectation of benefit be capable of pecuniary measurement.

36. For further information regarding a trust as an entity or as an aggregation of beneficial interests for insurable interest purposes, see Grassi, n7 *supra*, and cases cited there from other states.

37. *See, e.g.*, Del Code Ann tit 18, § 2704(c)(5); Ga Code § 33-24-3(c); SD Codified Laws Ann § 58-10-4(6); Va Code § 38.2-301.B.5; and Wash Rev Code § 48.18.030(3)(c).

STATE OF NEW YORK
INSURANCE DEPARTMENT
25 BEAVER STREET
NEW YORK, NEW YORK 10004

George E. Pataki
Governor

Howard Mills
Superintendent

The Office of General Counsel issued the following opinion on December 19, 2005 representing the position of the New York State Insurance Department.

Re: Life Insurance Transactions

Questions

1. Does a valid "insurable interest" exist in the described transactions under the New York Insurance Law?

2. Would the below-described transactions (and, in particular, the put provision assignment) be permissible under the New York Insurance Law, especially N.Y. Ins. Law § 3205(b)(1)?

Conclusions

1. No, a valid "insurable interest" does not exist in the transactions described.

2. No, the below-described transactions are not permissible under the New York Insurance Law.

Facts

The inquirer's inquiry seeks the Department's views regarding certain transactions involving life insurance policies. The transactions in question are essentially structured as follows.

Third party banks ("Loan Providers") propose to loan money to high net worth individuals ("Clients") to purchase insurance policies ("Policies") from life insurance companies and pay premiums due under an option agreement ("Put Option") to sell such Policy to a third party on a predetermined date ("Exercise Date"), which will be at least two years from the date of the loan. The full recourse loans ("Loans") provided to the Clients by the Loan Providers would mature on a date on or after the Exercise Date and be secured by the Policies and by the rights of the Clients under the Put Option. In the event that the Client dies before the maturity (or repayment, as described below) of the Loan, the Loan would be repaid out of the Policy's death benefit, with the remainder paid to the beneficiary of the Policy or the Client's estate.

Under the Put Option, the put provider, a hedge fund ("Put Option Provider"), would commit to purchase the Policy from the Client (if the Client so requests) on the Exercise Date. The exercise price of the Put Option would be equal to a pre-determined formula, the sum of which would cover the repayment of the Loan by the Client, as well as Loan interest. However, if the Client elects not to exercise the Put Option, he or she would be fully liable for repayment of the Loan (and interest thereon) and would continue to be the owner of the Policy (and responsible for future premiums under the Policy). In such a case, the Put Option would lapse unexercised and the Put Option Provider's rights would terminate. The Policy would be assigned to the Put Option Provider (at the earliest two years from contracting) only if the Client exercises the Put Option.

In summary, should the Put Option expire unexercised, the Client would be responsible for annual interest payments on the Loan following the Exercise Date. Should the Put Option be exercised, the Client would be responsible to repay the Loan amount plus interest on or about the Exercise Date (upon receiving the exercise price of the Put Option). No payments under the Loan would be due prior to the Exercise Date.

In addition to the above, a licensed bank ("Guarantee Provider") would, for a fee paid by the Put Option Provider, provide to the Client a guarantee ("Guarantee"), whereby it would guarantee the obligations of the Put Option Provider towards the Client under the Put Option. Thus, should the Put Option Provider not be able to meet its obligations under the Put Option, the Guarantee Provider would assume all obligations and benefits of the Put Option Provider under the Put Option (if exercised by the Client). The Guarantee Provider and the Put Option Provider would regulate their internal relations under a separate agreement.

Analysis

The provision of the New York Insurance Law governing the issue raised herein is N.Y. Ins. Law § 3205(b), which provides, in pertinent part, as follows:

> (b) (1) Any person of lawful age may on his own initiative procure or effect a contract of insurance upon his own person for the benefit of any person, firm, association or corporation. Nothing herein shall be deemed to prohibit the immediate transfer or assignment of a contract so procured or effectuated.
>
> (2) No person shall procure or cause to be procured, directly or by assignment or otherwise any contract of insurance upon the person of another unless the benefits under such contract are payable to the person insured or his personal representatives, or to a person having, at the time when such contract is made, an insurable interest in the person insured.

N.Y. Ins. Law § 3205(b) (McKinney Supp. 2005).

The term "insurable interest" is in turn defined under the New York Insurance Law as follows:

> (1) The term, "insurable interest" means:
>
> (A) in the case of persons closely related by blood or by law, a substantial interest engendered by love and affection;
>
> (B) in the case of other persons, a lawful and substantial economic interest in the continued life, health or bodily safety of the person insured, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the insured.

N.Y. Ins. Law § 3205(a)(1) (McKinney Supp. 2005).

The Department has been presented in the past with proposals similar to the one herein. Although it is not expressly stated in the inquirer's description, based on our review of the transaction it appears that the arrangement is intended to facilitate the procurement of policies solely for resale. It is our view that a plan of this nature does not conform to the requirements of the New York Insurance Law. First, the policies obtained by the Clients herein are arguably not obtained "on [their] own initiative" as required by N.Y. Ins. Law § 3205(b)(1). Secondly, the potential transferees do not appear to have a legitimate "insurable interest" in the lives of the Clients.

While it is true that N.Y. Ins. Law § 3205(b)(1) expressly allows an individual to procure and immediately transfer or assign to another a policy on his own life, irrespective of the existence of an insurable interest in the assignee [a position upheld by Hota v. Camaj, 750 N.Y.S. 2d 119 (2nd Dept 2002), which the inquirer cites in the inquirer's letter] it is the Department's view that the transaction presented involves the procurement of insurance solely as a speculative investment for the ultimate benefit of a disinterested third party. Such activity is readily distinguishable from the facts underlying Hota[1] , and is contrary to the long established public policy against "gaming" through life insurance purchases.

In addition, there may exist other potential problems, such as rebating violations, with the proposed transaction. Although not set forth in the inquirer's letter, it is foreseeable that some entity will be responsible for coordinating the plan and perhaps matching the Loan Providers, Put Providers, and Clients. Upon the sale of the Policy by a Client (following the exercise of the Put Option) it is conceivable that the policy premiums would be effectively rebated since the Client may well recoup from the proceeds of the Policy sale the amounts it borrowed and paid as policy premiums. Such a Client would thus receive cost free coverage for the two-year incontestability period, arguably an inducement to enter into the transaction.

In light of the above, the Department does not view the transaction as permissible.

For further information one may contact Supervising Attorney Michael Campanelli at the New York City office.

---

[1] In Hota , the court noted that the assignee of the policy did in fact possess an insurable interest in the life of the decedent by virtue of the fact that the assignee therein was a creditor of the decedent. In the proposed transaction, the Loan Providers will be the creditors of the Clients, but the indebtedness exists only in connection with the purchase of the insurance. Thus, theirs is "... an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the insured" under N.Y. Ins. Law § 3205 (a)(1)(B).

State of Utah

DEPARTMENT OF INSURANCE

D. Kent Michie
Commissioner

Jon M. Huntsman, Jr.
Governor

Gary R. Herbert
Lieutenant Governor

State Office Building, Room 3110
Salt Lake City, UT 84114
Telephone: (801)538-3800
Facsimile: (801)538-3829
www.insurance.utah.gov

Bulletin 2006-3

To: All Life Insurance Companies, Life Insurance Producers, and Viatical Settlement Providers Authorized to do Business in Utah
From: D. Kent Michie, Utah Insurance Commissioner
Date: July 10, 2006

Subject: Insurable Interest and Life Insurance

The purpose of this Bulletin is to remind licensees of the insurable interest requirement as it pertains to life insurance.

The Utah Insurance Department has received several inquiries regarding the legality of a life insurance transaction that involves the purchase of a life insurance policy, premium financing through a non-recourse loan, the sale of the policy in the secondary market, and a payment to the applicant.

The department's position regarding these life insurance transactions is that they are not compliant with the insurable interest requirement of this state. As stated in Utah Code Annotated (U.C.A.) 31A-21-104(2)(b), "[a] person may not knowingly procure, directly, by assignment, or otherwise, an interest in the proceeds of an insurance policy unless that person has or expects to have an insurable interest in the subject of the insurance." Insurable interest for persons other than those closely related by blood or by law, means "a lawful and substantial interest in having the life, health, and bodily safety of the person insured continue." U.C.A. 31A-21-104(1)(b)(ii).

To determine if an insurable interest exists, the department will look at the entire transaction and will not limit its review to only that part of the transaction that relates to applying for the life insurance policy. Regarding the transactions that have been described to us, a third party initiates, arranges the transaction, and ultimately expects to receive the proceeds of the insurance policy. The third party has no insurable interest in the person insured because a lawful and substantial interest does not exist in having the life of the insured continue; in fact, there is a substantial interest in not having the life of the person continue.

The business of viatical settlements (which includes life settlements) has been regulated by the Utah Insurance Department since 2003. We are fully aware that the citizens of Utah may benefit from having the opportunity to sell a life insurance policy that is no longer needed. All viatical settlements must be compliant with the Insurance Code and the described transactions are not compliant. All licensees are encouraged to review 31A-21-104 (Insurable Interest and Consent) and Title 31A, Chapter 36 (Viatical Settlements Act) and to conduct business in accordance with the Insurance Code.

DATED this 10th day of July 2006.

____

D. Kent Michie
Insurance Commissioner

Exhibit 4

LOUISIANA DEPARTMENT OF INSURANCE
JAMES J. DONELON, COMMISSIONER

P.O. Box 94214
Baton Rouge, Louisiana 70804-9214
Phone (225) 342-5900
Fax (225) 342-3078
http://www.ldi.state.la.us

BULLETIN NO. 06-05

To: **All Life Insurers Regulated by the Louisiana Department of Insurance**

From: **James J. Donelon, Commissioner**

Re: **Authorized and Unauthorized Questions for Use on a Life Insurance Application**

Date: **September 5, 2006**

As Commissioner of Insurance I hereby issue Bulletin 06-05 pertaining to life insurer underwriting practices in Louisiana. In furtherance of the proper administration of life insurance that falls under the jurisdiction of the Louisiana Insurance Code, and in furtherance of my authority to issue Bulletin 06-05, I specifically reference the following sections of the Louisiana Insurance Code, including, but not limited to: LSA R.S. 22:195; 22:613; 22:620; 22:642; 22:652; and 22:1214.

It has come to my attention that in the premium finance arena some investors, seeking to own policies insuring the lives of those in whom the investors lack an insurable interest, have begun to initiate the creation of life insurance policies for the purpose of settlement in contravention of controlling Louisiana law. In particular, such an improper initiation can be detected by, in the first two years of the policy, the payment of consideration (other than the amount loaned to take out and sustain coverage) in order to induce the insured to take out a life insurance policy and/or an agreement between the insured and a particular investor to sell the life insurance policy at some point in the future. These arrangements are also sometimes characterized by an investor or lender, contemporaneous with the initiation of the life insurance policy, taking an interest in the death benefit above and beyond the repayment of principal and interest.

Such arrangements may, depending on the facts, violate some or all of the following Louisiana Insurance Code provisions, or other Louisiana statutes or jurisprudence, including, but not limited to: insurable interest; prohibition on wager policies; rebating; prohibition on "wet ink" life settlements; premium finance; and usury. Sound life insurance underwriting will seek to apply these principles.

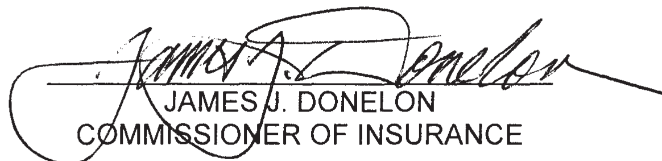
As a result of these arrangements certain practices regarding premium financing of life insurance policies have become a focal point of insurance underwriting, including application questions and decisions on whether or not to issue a life insurance policy. Life insurers have an obligation to ensure that an application does not violate the applicable provisions of the Louisiana Insurance Code, and life insurers can and should seek to ascertain whether life insurance applications are legally sound.

However, life insurance underwriting may not discriminate against applicants for life insurance based solely on the intention of the insured to subsequently sell the life insurance policy to a life settlement company or on the method of payment utilized by the insured to pay the premium. I find that such an underwriting decision would be a violation of the Louisiana Insurance Code. I further find that the following questions are the type that would be a form of unfair discrimination and shall not be approved for use in a Louisiana life insurance application and are not authorized for use in Louisiana, to wit: questions that inquire about the intention of the applicant to premium finance the policy; questions that inquire about the intention of the applicant to use the policy as collateral for a loan; questions that inquire about whether the applicant has previously converted a life insurance policy via the life settlement provisions; or, questions which inquire about whether the applicant is cognizant that he is vested with a property right to settle a life insurance policy in the future.

Recognizing the importance of this matter to both life insurers and insureds, I hereby advise that there are certain legitimate questions that are appropriate for use in Louisiana with regard to a life insurance application and life insurance underwriting. Those questions that are appropriate for use in Louisiana include: questions that inquire about whether the applicant has been offered a cash advance or other consideration as inducement to purchase the life insurance policy; questions that inquire about whether the applicant has been offered "free insurance"; questions that inquire about whether the applicant has entered into a finance arrangement which arranges a life settlement with a particular investor; questions that inquire about whether the applicant has entered into a finance arrangement that entitles a lender or investor to a portion of the death benefit above and beyond the repayment of principal and interest on the loan; or questions that inquire about the total amount of life insurance the applicant currently has in force.

If you have any questions regarding Bulletin 06-05 please contact Ms. Beth O'Quin, Assistant Director of Life and Annuity Policy Forms, at 225-342-6990 or by e-mail at boquin@ldi.state.la.us.

Baton Rouge, Louisiana this 5th day of September 2006.



JAMES J. DONELON
COMMISSIONER OF INSURANCE

State of Idaho

DEPARTMENT OF INSURANCE

C.L. "BUTCH" OTTER
Governor

700 West State Street, 3rd Floor
P.O. Box 83720
Boise, Idaho 83720-0043
Phone (208)334-4250
FAX # (208)334-4398

WILLIAM W. DEAL
Director

BULLETIN NO. 07-03

DATE: April 2, 2007

TO: All Life Insurance Companies and Life Insurance Producers

FROM: W.W. Deal, Director

SUBJECT: Stranger or Investor Owned Life Insurance Arrangements

---

The purpose of this bulletin is to alert licensees and others that life insurance arrangements entered into with the intent of assigning policy benefits to investors may be illegal under Idaho law.

The Idaho Department of Insurance has received reports that Idahoans are being solicited and offered financial compensation to purchase life insurance policies for the purpose of assigning the policies to investors. Sometimes referred to as "stranger owned" or "investor initiated" life insurance arrangements, a typical program involves a loan to the insured for the policy premium and requires or allows the policyholder/insured to assign the policy to a third party investor after a certain period of time. In consideration of the assignment, the premium loan will be forgiven or premium payments reimbursed and the insured may also receive additional compensation. Variations of these types of arrangements may include formation of a partnership or other joint endeavor for the sole purpose of establishing an apparent insurable interest in order to permit a third party to become the beneficiary to insurance on the life of another.

The Department believes these types of arrangements may violate Idaho laws that require an insurable interest in the life of an insured and that prohibit rebates or other inducements to purchase insurance unless the inducement is set forth in the policy.

Idaho's insurable interest requirement for personal insurance is set forth at Idaho Code § 41-1804. It provides in part, "no person shall procure or cause to be procured any insurance contract upon the life or body of another individual unless the benefits under such contract are payable to the individual insured or his personal representatives, or to a person having, at the time when such contract was made, an insurable interest in the individual insured." For persons who are not related closely by blood or law, an insurable interest means, "a lawful and substantial economic interest in having the life, health, or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the individual insured." Idaho Code § 41-1804(3)(b). The

provision permitting what has been referred to as "key-man" insurance appears at Idaho Code § 41-1804(3)(c) and should be limited to legitimate business relationships, rather than artificial relationships established merely to create the appearance of an insurable interest. (A separate provision, Idaho Code § 41-1805, permits life insurance where the irrevocable beneficiary is a charitable, benevolent, educational, or religious institution.)

In reviewing stranger owned or investor initiated life insurance arrangements, the Department will review the arrangement in its entirety to determine the underlying intent of the parties and whether the arrangement is designed to circumvent the insurable interest requirement. Factors the Department might consider in determining whether an arrangement violates Idaho's insurable interest law include: solicitation materials; who initiates the transaction and how it progresses; the terms of all written agreements and related documents; the time elapsed between inception and assignment; all consideration associated with the transaction, including incentives for assignment and promises of future compensation; and who ultimately pays the premium.

Idaho law also prohibits providing an actual or prospective policyholder rebates or inducements with a value greater than $50 if they are not a part of the policy terms. Idaho Code § 41-1314. This law prohibits offering anything of value to induce the purchase of an insurance policy except as specified in the policy. Offering to pay premiums, forgive premium loans or promising future cash payments to induce a person to purchase an insurance policy may violate this law if the incentive is not included in the terms of the policy filed with the Department of Insurance.

Any determination of whether a particular arrangement violates Idaho's insurable interest or rebate/illegal inducement laws will depend on the specific facts of the arrangement. Any person considering offering, purchasing or investing in a stranger owned or investor initiated life insurance arrangement is strongly encouraged to contact the Department of Insurance to discuss whether the arrangement is legal under Idaho law. Additionally, persons should also contact the Idaho Department of Finance to determine whether the arrangement complies with state securities and financing laws.