Insurable Interest

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Insurable interest

An insurable interest exists when an insured person derives a financial or other kind of benefit from the continuous existence of the insured object (or in the context of *living* persons, their continued survival). A person has an insurable interest in something when loss-of or damage to that thing would cause the person to suffer a financial loss or other kind of loss. Typically, insurable interest is established by ownership, possession, or direct relationship.

Concept of Insurable Interest

The idea of insurable interest has developed to eliminate the element of wagering from insurance contracts. Wagering contracts on individual lives was not addressed by statutory law until 1774. The development of the tenet of insurable interest as a prerequisite for the purchase of insurance distanced the insurance business from gambling, enhancing the industry's reputation and leading to its greater acceptance. The United Kingdom was a leader in that trend by passing legislation that prohibited insurance contracts if no insurable interest could be proven, notably the Life Assurance Act of 1774 which renders such contracts illegal, and the Marine Insurance Act of 1906 which renders such contracts void.

Property Insurance

Individuals have an insurable interest in their property up to the value of the property, but not more. The principle of indemnity dictates that the insured be compensated for a loss of property, but not for more than what the property was worth. A lender who accepts a house as a mortgage has an insurable interest on the property used as security; but the insurable interest is not in excess of the value of the loan.

Life insurance

In the case of a life policy insurable interest is:

- An interest based upon a reasonable expectation of pecuniary advantage through the continued life, health and bodily safety of another person, and, consequently, loss by reason of their death or disability; or
- A substantial interest engendered by love and affection if closely related by blood or by law.

Legal guidelines have been established in many jurisdictions which confirm the kinds of family relationships for which an insurable interest exists. The insurable interest of family members is assumed to be emotional as well as financial. The law allows insurable interest on the presumption that a personal connection makes the family member more valuable alive than dead. Thus, husbands/wives have an insurable interest in their spouse, and children have an insurable interest in their parents (and vice-versa). Brothers/sisters and grandchildren/grandparents are also assumed to have an insurable interest in the lives of those relatives. But cousins, nieces/nephews, aunts/uncles, stepchildren/stepparents and in-laws cannot buy insurance on the lives of others related by these connections.

As a next step and because insurance companies have a duty to exercise reasonable care in determining whether insurable interest exists and whether the consent of the insured has been obtained to avoid legal implications, underwriters look at the beneficiary's insurable interest. The presence of insurable interest must be established for every life insurance policy to make sure that the insurance contract is not challenged to be an illegal wagering agreement. If an insurable interest is not found at the time of underwriting the policy will not be issued. To determine insurable interest the following rule of thumb is followed 'Insurable interest exists when the proposed insured is likely to benefit if the insured continues to live and is likely to suffer some loss or detriment if the insured dies'. Underwriters screen every application for life insurance and make sure that the insurable interest requirement imposed by law in the applicable jurisdiction will be met when the policy is issued. Stated differently the underwriter must determine whether the beneficiary of the life insurance policy has an insurable interest in the proceeds of the insurance policy. A person is always deemed to have an unlimited insurable interest in one's life and health. Therefore the beneficiaries of the policies do not need to prove an insurable interest as long as they are deemed to be concerned with the insured life. Courts and state laws have established guidelines for those persons and entities deemed to have insurable interest in the proposed insured life. They fall into three categories, relations by blood or marriage, business relationship, and creditors.

Blood or Marriage:

People generally have an insurable interest in the lives of their spouses and dependents. Based on this relationship, the general rule of thumb is:

Insurable Interest	**No Insurable Interest**
Husbands and wives	Other relatives by marriage
Parents and children (including adopted children)	Nieces and nephews
Grandparents and grandchildren	Cousins
Brothers and sisters	Uncles and aunts
Engaged couples (some states)	Stepchildren and stepparents

Business Relationship

Someone who receives economic benefit from the continued life and good health of another also has an insurable interest in that person's life. For example, employers can take out key person life insurance on key employees, corporations can take out insurance on the lives of their officers, and business partners can take out life insurance on each other. Thus an insurable interest may be created in an otherwise non-insurable interest relationship by the existence of a financial dependency or a business relationship between the parties. As a result, an uncle may be deemed to have an insurable interest in a nephew because the nephew runs the uncle’s business and the venture is profitable.

Creditors

Creditors are allowed to take out life insurance on the lives of their debtors, with the debtors’ consent, up to the limit on the debt. Mortgage and credit insurance are examples of this type of insurance. An underwriter reviews non-medical aspects of the application to assess moral and physical risks such as;

• The purpose of the insurance is to protect and not create value. Thus the underwriter will look in the application form for a valid insurance purpose like estate planning, business or family protection.

• The occupation of the applicant is relevant because some occupations are hazardous and increase the risk of death, disability or accidental death.

• The income of the applicant is reviewed to determine if the amount of insurance applied for is justified.

• The use of tobacco or smoking is another important factor affecting mortality and morbidity as is the excessive use of alcohol.

• Aviation and foreign travel details are also important factors in the risk assessment process as these could also have an impact on mortality and morbidity.

Lord Mansfield and Insurable Interest

Going back a bit in time, eighteenth-century judge William Murray, Lord Mansfield (1705-1793), was developing the concepts of mercantile law, including law influencing insurance. His legal decisions promoted individual economic liberty and smooth operation of a market economy, modernizing concepts such as opinion and speech, consumption and contract. Mansfield was an important figure in integrating the laws of commerce with general law. Among other things, Mansfield helped ensure the rights of holders in due course to commercial paper, that it be treated as a negotiable instrument. Insurance law was developed through his take on the notion of good-faith disclosure and clarification of the definition of insurable interests.

Two English statutes from the 18th century created the requirement that the insured have an interest in an insured life or property. These two laws, from 1746 and 1774, did not define an insurable interest so it was left to the courts to communicate what an insurable interest was. Their reasoning in cases more than 200 years ago defined the contours of the debate that are still in use today. The basic disagreement came down to whether an insurable interest had to include a legal interest in the property or simply what one might call a factual expectation of possession of the property. Two cases help clarify the issue.

Factual Expectation

In *Le Cras v. Hughes* (99 Eng.Rep. 549 (KB 1782)), the Spanish ship *Santo Domingo* was taken by a British captain and crew in the war with Spain. Under English law (the "Prize Act"), the crew of a ship, under certain circumstances, actually could be vested

with title to the ship and its goods after return to England. With this hope the crew insured the ship and sailed it back from Spain to England. As fortune would have it, the ship was destroyed in a storm. The captain tried to collect on the insurance policy but his claim was denied by the insurance company because he did not yet have a legal right to the ship--i.e., it was only an expectancy. When the case got to the King's Bench, Judge Mansfield agreed that there was no legal expectancy here, because the Royal Navy might also be awarded title to the ship. Lord Mansfield's reasoning did not stop at that point; he found what he called a "factual expectancy" that was grounded in the past experience of the English people that "whenever a capture has been made, since the Revolution (1688), by sea or land, the Crown has made a grant: there is no instance to the contrary." This expectation was sufficient, for Mansfield, to support an insurable interest. His relevant words are:
"An interest is necessary, but no particular kind of interest is required. ….though not a vested interest, were held insurable. An agent of prizes may insure his profits though they are in contingency..."

The captain and crew had no recognized legal interest as of yet, it had happened in every case for nearly a century that such an interest would accrue when Parliament acted. But this simply had not happened yet because the ship was in transit. Thus, the "doctrine" of factual expectancy was no doubt created to handle this situation where justice would have been denied if the strict legal test were required. But what is that strict legal test? An 1805 case defines it most clearly.

Legal Interest
Twenty years later, in *Lucena v. Crawford* (127 Eng.Rep. 630 (1805)), Lord Eldon articulated a narrow conception of insurable interest that depended on the existence of a legal right. The facts of the case are similar to *Le Cras*. Lord Eldon would have held that there was no insurable interest in the ship until it reached an English port. His point was as follows. If the Commissioners (the Royal Commissioners who insured the captured ship this time) had an ability to insure a ship, when they had yet no recognized property interest in it, then *anyone* could have insured the ship, and the situation would be open to the problems of wagering once again. He said:
"..If they (the Commissioners) have a right so to insure, it seems to me that any person who is directed to take goods into his warehouse may insure...If moral certainty be a ground of insurable interest, there are hundreds, perhaps thousands, who would be entitled to insure. First the dock company, then the dock-master, then the warehouse-keeper, then the porter, then every other person who to a moral certainty would have anything to do with the property, and of course get something by it."

For Eldon it was the technical legal interest that created an insurable interest, even if it was virtually certain that the legal right would never have value. He gave the following famous hypothetical to illustrate his position:
"Suppose A be possessed of a ship limited to B in case A dies without issue; that A has 20 children, the eldest of whom is 20 years of age; and B is 90 years of age. It is a moral certainty that B will never come into possession, yet this is a clear interest. On the other hand, suppose the case of the heir at law of a man who has an estate worth

£20,000 a year, who is 90 years of age; upon his death-bed intestate, and incapable from incurable lunacy from making a will, there is no many who will deny that such an heir at law has a moral certainty of succeeding to the estate; yet the law will not allow that he has any interest, or any thing more than a mere expectation."

The former, with no "moral expectation" at all, would have an insurable interest, for Eldon, while the latter would not.

Of Wager Policies

Many are the contrivances which men have fallen upon for the gratification of their propensity to gaming.[1] And the uncertain events of maritime adventure afford an obvious and extensive field for the calculation of chances, and the decision of fortune. The practice of gaming, by nourishing a constant hope of gain, excites in the mind an interest: which engrosses the attention, and withdraws the exertions of men from useful pursuits. By pointing out a speedy, though hazardous mode of accumulating wealth, it produces a contempt for the moderate, but certain, profits of sober industry. It perverts the activity of the mind, taints the heart and depraves the affections. By frequent and great reverses of fortune, it becomes not only the source of great private misery, but suggests constant temptations to fraud and the perpetration of atrocious crimes. There are a few well-regulated governments in which gaming has not been laid under considerable restrictions. In this country ideas less rigid have prevailed. Innocent wagers have long had the sanction of the common law. They are only deemed illegal where they are prohibited by statute, where they tend to create an improper influence on the mind in the exercise of a public duty, where they are *contra bonos mores*[2], or in any other manner tend to the prejudice of the public, or the injury of third persons. And after all it must be owned, that the law greatly descends from its dignity, when it lends its aid to give effect to any wager, however innocent.

The spirit of gaming, which is always ready to insinuate itself into every transaction, and to assume the form of every contract, which depends upon uncertain events, long availed itself of insurance upon lives, as affording abundant opportunities for speculating upon chances. Wagers came to be daily made upon the duration of men's lives, in the form of insurances, by persons who were neither connected with the parties, nor in any manner interested in the duration of their lives nor did the insurers much concern themselves to know upon what interest, or for what reason, such insurances were made. Such practices were big with mischiefs of various descriptions; nor is it probable that even the lives, thus presumptuously insured, were always free from danger. The evil, however, at length became apparent to the legislature. But it being admitted, that insurances upon lives, under proper restrictions, might, in many instances, be highly beneficial to the public, it was determined, that such insurances

[1] Samuel Marshall, "A Treatise on the Law of Insurance" (1805) Book III Ch 3 p. 672
[2] This means 'contrary to good morals.' Used in law to describe an action or a contract considered harmful to the moral welfare of society.

ought not to be abolished, but only regulated. Therefore, by fiat. 14 G. III. c. 48, § 1, was enacted[3];

'That no insurance shall be made by any person or persons, bodies politic or corporate, on the life or lives of any person or persons, or on any other event or events whatever wherein the person or persons, for whose use or benefit, or on whose account, such policy or policies shall be made, shall have no interest or by way of gaming or wagering: And that every insurance made contrary to the true intent and meaning of this act, shall be null and void to all intents and purposes whatsoever.'

And (by § 2,) it is further enacted;
'That it shall not be lawful to make any policy or policies on the life or lives of any person or persons, or other event or events, without inserting in such policy or policies, the name or names of the person or persons interested therein, or for what use, benefit, or on whose account, such policy is so made or underwrote.'

And (by § 3,) it is further enacted;
'That in all cases, where the insured hath an interest in such life or lives, event or events, no greater sum shall be recovered, or received from the insurer or insurers, than the amount or value of the interest of the insured in such life or lives, or other event or events.'

The fourth section contains a proviso that this act shall not extend to insurances bona fide made on ships or goods.

The title of this statute is, 'An act: for regulating insurances upon lives, and for prohibiting all such Insurances, except in cases where the persons insuring shall have an interest in the life or death of the persons Insured.' From this title it would seem, that the framers of this bill originally intended to confine the operation of it to insurances upon lives only. But the words, 'or any other event or events whatsoever,' introduced both into the enabling parts and the preamble, plainly shew that the legislature meant, that the regulations of this act: Should extend to every species of insurance, except marine insurances ; to which, by the proviso in the 4th section, it is declared, that it shall not extend.

Very few questions have arisen upon the interest of the insured, in the life insured. A bona fide creditor has undoubtedly an interest in the life of his debtor, at least where he has only the personal security of the debtor and it has been holden by a great authority, that this interest is insurable within the statute. Thus: An insurance was made on the life of Lord Newhaven from the 1st of December 1792, to the 1st of December 1793. In an action on the policy, the only question made by the defendant was, as to the plaintiff's interest in the life insured which, it was contended, was not sufficient to take this case

[3] This Life Assurance Act was enacted by Parliament in April 1774. To put that in perspective, The Quartering Act, 14 G. III. c. 54, approved by Parliament a couple months later in June, 1774, required American colonists to house troops not only as previously required under an existing quartering act, but also in private homes. The Quartering Act is one of the Intolerable Acts that led to dissent in the American colonies.

out of the above statute. It appeared in evidence that Lord Newhaven was indebted to the plaintiff and a Mr. Mitchell in a large sum of money; part of which debt had been assigned by them to another person. The remainder being more than the amount of the sum insured, was, upon a settlement of accounts between the plaintiff and Mitchell agreed by them to remain to the account of Mitchell only.

Lord Kenyon, who tried the case (*Anderson v. Edie*, 1795, K. B. Trin. Term), was of opinion, that this debt was a sufficient interest. He said it was singular that this question had never been directly decided before: That a creditor had certainly an interest in the life of his debtor because the means by which he was to be satisfied might materially depend upon it and that, at all events, the death must, in all cases, in some degree, lessen the security. The jury found a verdict for the plaintiff.

From the above note of this case, though it seems to be rather a defective one, it may reasonably be supposed that the plaintiff had only Lord Newhaven's personal security for the debt, and that with him died all hopes of repayment from his estate. Upon this ground I think there could be no doubt but that the creditor had an insurable interest in Lord Newhaven's life, to the amount of the debt. But Lord Kenyon is stated to have said, that, "At all events the death must in all cases in some degree lessen the security." As an abstract proposition, this is, in general, true. But it cannot be inferred from this, that his lordship meant to lay it down, as law, that every creditor, however his debt may be secured, has an insurable interest in the life of his debtor, to the amount of the debt. Lord Mansfield in the case of *Stackpool v. Simon*[4] says that a policy may be considered as a collateral security for the debt clue to the insured. -And yet it would seem, that, even where the creditor has only the personal security of the debtor to rely upon for repayment, the insurer, before he pays the sum insured, might, perhaps, have a right to call upon the creditor insured, to shew that nothing could be recovered from the estate of the deceased debtor. Where the debt is amply and satisfactorily secured by mortgage or otherwise, the creditor can have but the shadow of an interest in the life of the debtor. But, by the third section of the above act, it is declared, that, "No greater sum shall be recovered from the insurer than the amount or value of the interest of the insured in the life insured.' Now, what can be the amount or value of the interest of the creditor, in the case put? Surely nothing that a jury could estimate.

When Must the Insurable Interest Exist?

Generally speaking, an insurable interest must exist at the time the contract of personal insurance becomes effective but need not exist at the time the loss occurs.

The almost universal rule of law in this country is that if the insurable interest requirement is satisfied at the time the policy is issued, the proceeds of the policy must be paid upon the death of the life insured without regard to whether the beneficiary has an insurable interest at the time of death.

[4] This case often cited as *Stackpole v. Simon* (Sitt. At Guild, Hil. Vac., 1779)

A majority of jurisdictions statutorily recognize the right of any individual of competent legal capacity to contract for life insurance upon his or her own life for the benefit of anyone. In the opposite situation, no person may procure an insurance contract upon the life of another individual unless the benefits under the policy are payable to the insured, his or her personal representative, or a person having, at the time the contract is made, an insurable interest in the life of the individual insured. Legislatures throughout the country have also codified the common-law rule which prohibits the making of a life insurance contract upon the life of another unless the insured applies for the policy or consents to it in writing. The sole exception to this prohibition is where the policy is being contracted for a person having an insurable interest in the insured. When someone other than a person having an insurable interest takes out a policy on the life of another without his or her consent or knowledge, courts have traditionally relied upon two theories to render the policy unenforceable: the policy is a wagering contract, or; such a policy presents an opportunity for crime.

Interest Broadly Defined

Both judicial case law and state insurance statutes broadly define this insurable interest requirement to include a "love and affection" insurable interest for persons "closely related by blood or law," and, "in the case of other persons, a lawful and substantial economic interest in the continued life, health, or bodily safety of the person insured." This generalized definition of an insurable interest in the life of another, being written in such overly broad language, leaves considerable room for judicial and scholarly interpretation. Concerning insurable interest, in 1918 Edwin Patterson observed in the *Columbia Law Review* that, "there exists great diversity of judicial opinion. Nor are the text writers agreed. Since life insurance is an everyday commercial transaction, a rule of certainty is highly desirable." A century later, and despite a significant amount of contemporary information on the subject, Professor Patterson's appeal for uniformity and predictability in this area of insurance law is still valid.

Borrowing Against the Policy

The owner of a life insurance policy can generally borrow money on a permanent life policy and use the proceeds for any purpose. Before taking a policy loan, policy owners should be sure to understand the loan and tax implications. An amount up to the policy's cash surrender value (less an adjustment for interest) can usually be borrowed from the insurer. The insurer will charge interest on the loan. There are misconceptions about whether the insurer charges interest on the loan against policy. Yes, it is just like a bank. The insurer is lending money to the policyholder and the policy's cash value is the loan collateral. The lending of money generates interest income for the insurer and this must be accounted for at tax time. If a repayment schedule is not adhered to by the policy owner/borrower, interest not paid is added to the amount of the loan. He or she ends up paying interest on interest (never a good thing).

Interest charged on a policy loan is usually not deductible for income tax purposes. There could be other adjustments as well under the contract; for example, a participating policy may restrict the payment of dividends while a loan is outstanding. The policyholder may not be required to repay a life insurance policy loan on a scheduled basis, but the life insurance policy loan can still be repaid at any time while the insured is alive. If the loan is not repaid, the cash surrender value eventually paid or the policy proceeds disbursed at death will be reduced by the amount of the loan (plus interest). The loan reduces life insurance protection. If the loan amount plus accrued interest ever equals or exceeds the cash surrender value, the policy can terminate if additional amounts are not paid into the life insurance policy.

Lapse or surrender of policy

An outstanding loan is generally treated as an amount received if a policy lapses or is surrendered and may result in taxable income. A policy can lapse if premiums are not paid and the policy terminates when any policy benefits are exhausted as a result. The policy owner can surrender the policy to the insurer in return for the policy's cash surrender value (as reduced by the amount of the loan plus interest). If the policy is surrendered or lapses, any gain realized is taxable at ordinary income tax rates. The gain is the excess of the amount received over the net premium cost. The net premium cost is the total premiums paid less any tax-free distributions received. An outstanding loan is generally treated as an amount received if a policy is surrendered or lapsed. Another section of the text has more on taxation.

Policy Assignment

Assignment refers to transfer by the policyowner of legal rights or interest in the life insurance policy. Life insurance contracts are everywhere assignable except as restricted by law, by the provisions of the policy, or by collateral agreement. The contract of life insurance has its own characteristics a unique feature of which is that the contract has as its beneficiaries the people who are to be protected in the event of the untimely death of a breadwinner. Life insurance is a contract between the insurer and insured for the benefit of persons not parties to the contract. Assignment of policy is associated with beneficiary rights; determining who will receive the proceeds when the cestui que vie dies.

Types of Beneficiaries

The owner of a life insurance policy has flexibility in naming beneficiaries. Remember that an insurable interest must exist at the time the policy is issued. Beneficiaries are typically categorized as primary and contingent. A primary beneficiary is entitled to the proceeds of the policy upon the death of the insured, but such rights expire if he or she dies before the insured. A contingent (or secondary) beneficiary is entitled to the policy proceeds if the primary beneficiary has predeceased the insured. Most designations are prepared to provide a one sum settlement to the primary beneficiary. Occasionally, an arrangement might stipulate that, if policy proceeds are being paid over time to a primary beneficiary who dies before collecting the entire amount, then the remaining proceeds will be payable to the contingent beneficiary. It is often desirable to have several levels of contingent beneficiaries.

Specific or Class

A beneficiary can be either specific (a person identified by name and relationship), or a class designation (a group of individuals such as the “children of the insured”). While the naming of specific beneficiaries is usually clear-cut, unintended complications can arise when designating classes of beneficiaries.

For example, if a policyowner names children as beneficiaries, it is important to clarify if the intent is to include only lawful children, adopted children or children by a former spouse. If the children are minors, it is also important to determine if the insurance company will in fact pay the proceeds to a minor beneficiary. Generally, insurers insist on paying proceeds to a legal guardian rather than to a minor. It can be wise to designate a custodian under the Uniform Transfers to Minors Act to act on behalf of the minor as this would eliminate the need to appoint a legal guardian. Consider the following hypothetical situation in which the policyowner’s intentions appear straightforward, but which could become complicated. Emily, who is 70 years old, has planned for the proceeds of her life insurance policy to be paid to her children (Jim, Jack and Rose) or her grandchildren. Now, suppose Jim and Rose die before their mother. Jim leaves two children and Rose has none. How will the proceeds of the policy be distributed when Emily eventually dies?

Methods of Distribution

Per stirpes and per capita are terms that describe methods of distributing property to family members and heirs. Per stirpes means “branches of the family,” and per capita means “by heads.” In the example above, under a per stirpes distribution, Jack (one branch) would receive one-half of the proceeds and Jim’s surviving children (the other branch) would divide the remaining half among themselves. Under a per capita distribution, Jim’s two children, along with Jack, would each receive one-third of the proceeds. Keep in mind that complications could arise if any of Jim's children are still minors when Emily dies and legal guardians have not been appointed.

Revocable or Irrevocable

Issues can also arise based on whether beneficiary designations are revocable or irrevocable. If a beneficiary designation is revocable, the policyowner reserves the right to change the beneficiary. A person designated as a revocable beneficiary has only an “expectation” of benefits, since the owner of the policy can exercise any of the policy rights without the consent of the revocable beneficiary.

An irrevocable beneficiary, however, cannot be changed without the consent of that beneficiary. While this arrangement is sometimes desirable for estate planning purposes, the legal status of an irrevocable beneficiary is uncertain. Some jurisdictions see an irrevocable beneficiary as similar to a “co-owner” of the policy. The beneficiary’s consent is needed to exercise any policy rights. The opposite view is that an irrevocable beneficiary's consent is needed only for exercising a change of beneficiary. The consent view can create problems for the beneficiary's rights if the policyowner exercises other rights, such as surrendering the policy or permitting it to lapse. This fuzzy legal status of an irrevocable designation often makes it preferable to use revocable beneficiary designations.

The distribution desired by a policyowner must be clearly set forth in the beneficiary designation. A change in family circumstances after a policy is initially written, such as a divorce, could leave the named insured with unintended beneficiaries. For example;

- In Maryland, like the majority of jurisdictions, upon divorce, the ex-spouse listed as beneficiary does not automatically waive their right to claim the insurance benefit if the beneficiary is not changed. See East v. PaineWebber, Inc., 131 Md. App. 302, 311 (Md. Ct. Spec. App. 2000). The only exception is if the Divorce Decree specifically revokes the right to inherit life insurance.
- Next door, Virginia holds that, upon divorce, "any revocable beneficiary designation contained in a then existing written contract owned by one party that provides for the payment of any death benefit to the other party is revoked." Therefore, upon divorce, the ex-spouse loses their right to inherit any life insurance proceeds on their former spouse. See Va. Code Ann. § 20-111.1.

Parties to the insurance contract should review the beneficiary designation regularly in order to take the steps necessary to make appropriate changes.

Types of Assignments

There are two types of conventional insurance policy assignments:

Absolute assignment- This is normally intended to give the assignee every right in the policy that the owner possessed prior to the assignment. When the transaction is completed, the owner will have no further financial interest in the policy. The terminology of absolute assignments differs from contract to contract. In essence, it transfers all rights, title, and interest in the policy to the assignee. Some insurance companies use an "ownership clause" to accomplish this transfer.

Collateral assignment- This is a more limited type of transfer. It is a security arrangement to protect the assignee (lender) by using the policy as security for repayment. After the indebtedness is repaid, the assignee releases his or her interest in the policy. The assignee will revert to the borrower/policy owner the rights transferred by the assignment. Under the usual procedure, if the collateral assignment is in force and the named insured dies, the assignee informs the insurance company of the remaining indebtedness, including interest, and receives that amount in a lump sum. Any excess proceeds are then payable to the named beneficiary in accordance with the beneficiary designation in the policy. To fully protect the assignee, notice must be given to the life insurance company that the assignment has been made. If a company with no notice of assignment makes payment of the proceeds to another assignee or to a named beneficiary, the insurance company cannot be made to pay a second time.

Policy Provisions

Some typical policy provisions concerning assignments may include the following:

- The assignment will not be binding until the original, or a duplicate thereof, is filed at the insurance company's home office.
- The insurance company assumes no obligation as to the effect, sufficiency, or validity of the assignment.
- The assignment is subject to any indebtedness to the insurance company on the policy.

It is important to ensure that an assignment is made properly, regardless of whether it is absolute or collateral.

Legality of Assignment

St. John v. American Mutual Life Insurance Co. Am. Mut. Life Ins. Co., 13 N.Y. 31, 39 (1855). is one of the earliest American opinions which addresses the issue of the legality of an assignment of a life policy to an individual who lacked an insurable interest in the insured. The insured executed to the plaintiff two life policies having combined death benefits of $4,000 for: (1) a consideration of $300; (2) continued payment of premiums by plaintiff; and (3) a promise to pay insured's wife $1,500 upon insured's death.

Judge Crippin, writing for the court, observed that an absolute sale, assignment, and transfer of a life policy, valid at its inception, to one having no insurable interest, was valid and entitled the assignee to the proceeds of the policy upon the death of the insured. This holding was clearly influenced by the fact that the defendant's policy provided for assignments and notice of same, as well as the existence of good faith in the execution of the assignment. Of equal significance was the fact "that without the right to assign, insurances on lives lose half their usefulness."

The rationale articulated in the *St. John* case significantly influenced the development of what has become known as the majority view on the subject. According to this view, an assignment of a life policy by the insured or beneficiary to an individual who lacks an insurable interest in the life of the insured is not void per se and will be upheld if the assignment was made in good faith and not merely intended to evade the law against wagering contracts. Two rationales have been advanced in favor of the majority rule that an assignment of a life policy to a person lacking an insurable interest in the life of the insured, if not tainted, is valid. The first is commercial in nature and grounded in the capitalistic philosophy which dominated the country's young industrial economy at the turn of the twentieth century. According to this rationale, life insurance policies are investment contracts of great commercial value. Consequently, the law should not restrict the transferability of a policy by limiting the class of purchasers to those having an insurable interest in the life of the insured. To do otherwise would impair the value and utility of the policy as an article of property and prevent the free sale of policies on the open market at the most advantageous terms.

The second rationale is purely legal in nature. It is premised upon the notion that a life insurance contract is a chose in action and should therefore be assignable absolutely or by way of security as with any other chose. Thus, it was observed by Judge Crippen in *St. John* that:

"I am not aware of any principle of law that distinguishes contracts of insurance upon lives, from other ordinary contracts, or that takes them out of the operation of the same legal rules which are applied to and govern such contracts. Policies of insurance are choses in actions; they are governed by the same principles applicable to other agreements involving pecuniary obligations."

As noted earlier, the view that an assignment of a life policy to an individual lacking an insurable interest in the life of the insured is not void as a matter of law does not necessarily mean that all such assignments are per se valid. Rather, this rule creates a prima facie case in favor of the validity of the assignment. The presumption in favor of validity is conditioned upon the transaction having been in good faith and the absence of intent to circumvent the law with regards to wagering contracts. Consequently, assignments tainted with either of these defects are treated as void *ab initio.*

Thus, in instances where a person lacking an insurable interest procures a policy on the life of another without consent, or where an insured makes an invalid assignment to an individual similarly situated, the insurable interest doctrine penalizes the parties by voiding the contract.

Life insurance as Chose In Action

Chose in Action is a claim or debt upon which recovery may be made in a lawsuit; not a present possession, but merely a right to sue, becoming a possessory thing only upon successful completion of a lawsuit. A chose in action is essentially a right to sue. It is an intangible personal property right recognized and protected by the law, that has no existence apart from the recognition given by the law, and that confers no present possession of a tangible object. Another term is a thing in action. This term denotes the right to enforce payment of a debt by legal proceedings, obtain money by way of damages for contract, or receive recompense for a wrong. Less accurately, money that could be recovered is frequently called a chose in action, as is also sometimes the document that represents a title to a chose in action, such as a bond or a policy of insurance (though strictly it is only the right to recover the money).

A policy of life insurance is a contract to pay money upon the happening of an event. It is a chose in action and the general principles of law relating to assignments of choses in action are applicable.

These and other characteristic features or provisions of the policy must be considered in applying general principles of law in respect to the assignment of choses in action. The problems presented to the insurer by assignments of policies generally involve some of these characteristics or special provisions of the contract.

Private Property

A life insurance policy is private property that can be sold at the will of the owner. This was established in the case of Grigsby v. Russell, 222 U.S. 149 (1911) in the U.S. Supreme Court. In 1911, Dr. A. H. Grigsby treated a patient named John C. Burchard, who was in need of a surgical procedure. Burchard offered to sell Dr. Grigsby his life insurance policy in return for $100 and for agreeing to pay the remaining premiums. Dr. Grigsby agreed to these terms. Burchard died about a year later and Dr. Grigsby tried to collect the benefits. An executor of Burchard’s estate, R. L. Russell, challenged the doctor's property rights in the policy and won. The case eventually reached the U.S. Supreme Court where Justice Oliver Wendell Holmes Jr. delivered the opinion of the court. Justice Holmes noted in his opinion that life insurance possessed all the ordinary characteristics of property, and therefore represented an asset that a policy owner may transfer without limitation. Wrote Holmes, “Life insurance has become in our days one of the best recognized forms of investment and self-compelled saving.” This opinion placed the ownership rights in a life insurance policy on the same legal footing as more traditional investment property, such as stocks and bonds. As with these other types of property, a life insurance policy could be transferred to another person at the discretion of the policy owner. This decision established a life insurance policy as transferable property that contains specific legal rights, including the right to:

- Name the policy beneficiary
- Change the beneficiary designation (unless subject to restrictions)
- Assign the policy as collateral for a loan
- Borrow against the policy
- Sell the policy to another party

Loans

It is clear that some consumers benefit from the outright liquidation of their insurance assets, but the irretrievable quality of a sale increases the risk of fraudulent or unfair transactions. Another way for a cash strapped consumer to deal with premium payments is to borrow against the insurance policy for those same amounts. Loans secured by life insurance mark a palatable halfway point between the extremes of outright sale of the policy on the one hand and continued premium payment (which may no longer be possible for some insureds) on the other. Policy-secured loans allow an insured to monetize this valuable asset without total loss of residual interest in the policy. If the borrower later regrets taking a loan against the policy, he or she may be able to repay the creditor and again own the proceeds in full. If the insured dies before having borrowed much of his or her line of credit, the surplus value above the debt belongs to a beneficiary or to the estate.

Loan Approval

Getting approval on a loan can sometimes depend on one or two very important issues. Lenders may ask borrowers, “How will this loan be repaid in the event of your death?” The answer may be to suggest assigning the life insurance policy. This useful feature of a life insurance contract can help provide the necessary comfort level and security for a lender. A life insurance policy can be freely assigned unless some limitation is specified in the contract. Through an assignment, a policy owner can transfer his or her rights to all or a portion of the policy proceeds to an assignee. The extent to which these rights are transferable depends on the assignment provisions in the policy, the intention of the parties as expressed in the assignment form, and the actual circumstances of the assignment. In general, no interest deduction is allowed when the indebtedness is used to purchase or carry a life insurance contract. However, there is an exception that will allow the interest deduction as long as the indebtedness is incurred in connection with a trade or business.

Making a Market for Policy Loans

Current legal structure discourages third-party creditors from offering loans on policy equity. Insureds must often borrow from their insurance company without being able to consider competing offers from other lenders. The bargaining power of the insured and the lending strength of an insurance company are not on equal footing. It may be that this inequality harms consumers and generally discourages consumers from borrowing against their insurance. Insurance companies provide loans pursuant to the terms of the particular insurance policy and applicable state laws. Insurance companies will often lend up to the surrender value of an insurance policy, which is the amount of cash the insurance company would pay to an insured who chooses to discontinue the policy. For a term-life policy, the surrender value is generally zero. For whole-life policies, which have an internal savings component, the surrender value, or the maximum borrowing amount, is generally no greater than the reserve set aside to fund the anticipated payment upon maturity. It is, in any event, set by statute or by the contract at the time the policy is originated. The surrender value at any given moment can be called the *ex ante* value of the policy, because it represents the current value as determined under a contract that does not account for intervening changes in facts. Third-party lenders could conceivably have an incentive to lend against the *ex post* value of the securing insurance policy, which accounts for subsequent changes in circumstances, while insurance companies do not have such an incentive.

UCC Article 9

The entire body of laws pertaining to commercial dealings is commonly referred to as business or commercial law. The broad scope of this category appears from the mere naming of the legal subjects considered in detail under the aegis of business law: contracts, agency, bailments, carriers, sales, products liability, partnerships, corporations, unfair competition, property, commercial paper, insurance, and bankruptcy. These laws developed from the *lex mercatoria,* the body of commercial law used by merchants throughout Europe during the medieval period. Eventually the 'law merchant' was absorbed into the common law and thus became part of American law. A significant development in this country has been the codification of large parts of commercial law. The **Uniform Commercial Code** (**UCC**) is a uniform act promulgated in conjunction with efforts to harmonize the laws of commerce in the several states. The Code has been a long-term, joint project of the National Conference of Commissioners on Uniform State Laws (now the Uniform Law Commission) and the American Law Institute. The goal of harmonizing state law is important because of the prevalence of commercial transactions that extend beyond one state. The objectives here can be seen as similar to those of the National Association of Insurance Commissioners.

Article 9 and Life Insurance

Article 9 of the Uniform Commercial Code excludes from its scope any transfer of an interest in a life insurance policy. Thus, any lender whose security is a life insurance policy may not look to the UCC to determine their rights.

The vast majority of policy loans are made by the issuing insurance company and without any serious competition from other lenders. This is in part because of difficulty and uncertainty in the law governing the assignments of life insurance policies. Though it is legal to sell or pledge a life insurance policy, life insurance policies may not serve as security for the purposes of an Article 9 lien. Revised Article 9 of the Uniform Commercial Code is governing law for almost all security interest transactions in all states. The product of extensive scholarly drafting and professional insights, the UCC is lauded for its clarity, coherence and logic. Despite its potential benefits, Article 9 excludes from its scope transfers of interests in insurance policies. Forty-eight of the fifty states follow the UCC in excluding insurance policies from the scope of their state‘s version of Article 9. A lender who accepts a life insurance policy as collateral to secure a debt may not look to Article 9 to determine his or her rights and responsibilities. But as states adopted Article 9, they repealed their other security statutes. So while the practice of borrowing on insurance policies grows exponentially, there is less statutory law than ever. In that absence of statutory law, the common law governs.

The insurance policy exclusion can be justified in that such transactions are often quite special, do not fit easily under a general commercial statute and are adequately covered by existing law. Since Article 9 of the UCC expressly excludes security interests in insurance policies, institutional lenders seek to obtain a security interest in a life insurance policy by a debtor's delivery of a written collateral assignment of the policy. A collateral assignment (or a copy) will be delivered to the insurer for its endorsement and recording on its records. However, such endorsement and recording are not necessary to create the security interest and may create rights only against the insurer. The owner's physical delivery of a policy to a creditor may also create a security interest. Many state regulation regarding lending practices require a written assignment of insurance policy and void an oral assignment; a pledge by physical delivery of the original policy need not be accompanied by a written assignment. It is prudent that the lender in such a case should obtain both a collateral assignment of the policy to be pledged as well as the actual policy itself.

Priority of Competing Liens

Suppose the debtor has delivered a prior collateral assignment of the policy (or delivered the original policy in pledge). Since, in the case of a written collateral assignment, recording the assignment on the insurer's books is not the equivalent of perfecting a security interest under the UCC by filing and, in the case of a physical delivery of a policy in pledge there may also be no public notice, which lien will have priority?

A life insurance policy is a chose in action. The general rule for a chose in action is first in time, first in right. Such prior assignment or physical delivery of the policy pledge would generally have priority over a subsequent recorded assignment. However, the doctrine of estoppel may result in a reordering of priorities.

Life Insurance Investment

Whether life insurance can be considered as an investment is a question that can be answered in several different ways. Most insurance regulators discourage referring to life insurance (whole life anyway) in such terms of an 'investment';
From "Understanding Insurance" at the Texas Department of Insurance
http://www.tdi.texas.gov/

> Some types of life insurance like whole life, universal life, and variable life, can build a cash value that you might be able to use for retirement income. **Agents and companies may not refer to life insurance as an investment** or retirement income source. If an agent or company tries to sell you a life insurance policy as a good investment, be wary. Also, don’t confuse life insurance with annuities. People often buy annuities for retirement because they can provide steady income over a long period.

In the opposing camp we have the words of Justice Holmes who noted in his opinion in the previously-cited *Grigsby v. Russell* that “Life insurance has become in our days one of the best recognized forms of investment and self-compelled saving.”

Both individuals and business entities can view life insurance as an investment contract. This view is based upon the proposition that the amount of the policy is rarely tied to a measurable loss. Rather, life insurance is a contract in which the insurer, for a certain sum of money or premium proportioned to the age, health, livelihood and other circumstances of the person whose life is insured, engages that if the individual dies within the policy period the insurer pays the contracted value to a beneficiary. In addition, life insurance, unlike its property counterpart, provides protection against an occurrence that is certain to occur. In property insurance there is no such certainty, only a possibility that the insured risk will result in loss.

Corporate-owned life insurance (COLI)

Also called business-owned life insurance, this is life insurance on employees' lives that is owned by the employer. Benefits are payable either to the employer or directly to the employees' families. COLI was originally purchased on the lives of key employees and executives by a company to protect against the financial cost of losing key employees to unexpected death, the risk of recruiting and training replacements of necessary or highly trained personnel, or to fund corporate obligations to redeem stock upon the death of an owner. This use is commonly known as "key man" or "key person" insurance.

In Business

Insurance is a significant vehicle for funding or providing employee benefits, as the following popular plans indicate;

Key-person Insurance- This insurance on a key individual's life is deductible only if the employer is not directly or indirectly the beneficiary. The premiums must be in the nature of compensation and not unreasonable.

Split-Dollar Insurance- The employee pays a portion of the premium to the employer under this life insurance plan, and that portion reduces the amount included in income. The amount includable in income would be the employer's share of the premium.

Group Term Life Insurance- This arrangement offers an employee an opportunity to acquire low-cost group life coverage. Under a group term life plan the employee can get up to $50,000 of insurance protection tax free. All premiums paid over that amount of insurance must be included as income to the employee. The plan must be a group term life plan. Permanent, whole life coverage does not qualify under this provision.

Business Usage

Consistent with this expanded use of business-owned life insurance; NAIC has observed that many products sold by life insurers have evolved to become primarily investment products. Also, consulting firms that specialize in business-owned life insurance transactions, life insurance brokers, and industry experts have emphasized the potential use of broad-based business-owned life insurance as a profitable long-term investment strategy to finance employee benefit costs and not merely as protection against financial losses that a business would incur in the event of the death of key persons.[5]

Business-owned life insurance is permanent life insurance, which has an insurance component and a savings component. The premium for a newly issued permanent life insurance policy pays for the insurance component, but the premium initially exceeds the cost of providing life insurance protection for the insured person. The excess amount is added to the policy’s cash value, which earns interest or other investment income- called inside buildup. The inside buildup is accrued income because the policyholder does not receive cash payment as the policy earns income. The Internal Revenue Code (IRC) allows for the deferral of income tax on the accumulated inside buildup on life insurance policies and some other investments that appreciate in value, such as stocks, some bonds, and real estate. However, the IRC provides for income tax-free death benefit payments on life insurance, so that unlike other investments, the accrued income is not taxed if the policy is held until the insured party’s death. However, if a policy owner surrenders a policy before the death of the insured, the owner may incur a tax liability to the extent that the policy’s cash surrender value exceeds its cost base and may incur a tax penalty. The cost base is equal to the total

[5] This section from *Business Owned Life Insurance,* General Accounting Office report GAO 04-303

premiums paid less dividends and withdrawals received from the policy. Also, if a business owns life insurance policies, the annual earnings and death benefit proceeds are among the factors that could make the business subject to the alternative minimum tax. In general, the alternative minimum tax is based on a corporation's regular taxable income adjusted for certain tax preference income items, such as exclusions, deductions, and credits. The amount due is the amount by which the tax computed under this system exceeds a corporation's regular tax.

To qualify as life insurance for tax purposes, a contract must qualify as a life insurance contract under applicable state law and meet one of two tests defined in IRC Sec. 7702 to ensure that the contract is not overly investment oriented. Under the first of the two alternative tests to qualify as life insurance for tax purposes under IRC Sec. 7702, the cash value of a policy cannot at any time exceed the net single premium that would have to be paid to fund the future benefits under the contract. This test is designed to exclude contracts with an investment orientation from the definition of life insurance. Under the second test, the cumulative premiums paid cannot exceed a limitation, computed at the time the policy is issued, and the ratio of the death benefit to the cash value of the policy can never fall below specified percentages. These tests are designed to restrict treatment as a life insurance contract to those contracts where policyholders make traditional levels of investment through premiums and to contracts that do not allow excessive amounts of cash value to build up in regard to the life insurance risk.

In addition, while policy owners may access the cash value of their policies by borrowing against them, policy owners' ability to deduct the interest on such loans in connection with policies covering employees, officers, and individuals financially interested in the business was limited to loans up to $50,000 per policy by the Tax Reform Act of 1986. The Tax Reform Act of 1986 disallowed interest deductions for interest on a loan in excess of $50,000 with respect to policies on the life of an officer, employee, or person financially interested in the business. This provision did not apply to policies purchased on or before June 20, 1986. The Health Insurance Portability and Accountability Act of 1996 provided that no deduction is allowed for interest on any indebtedness with respect to policies on any individual who is or has been an officer or employee or financially interested in any business carried on by the employer, regardless of the amount of debt with respect to policies covering the individual. An exception was provided for key persons where the indebtedness does not exceed $50,000. A key person was defined as an officer or 20-percent owner. The 1996 legislation applied generally to interest paid or accrued after October 13, 1995, with a phase in period. The legislation generally did not apply to policies purchased on or before June 20, 1986.

The Health Insurance Portability and Accountability Act of 1996 eliminated the interest deductibility for these individuals, except for policies on a limited number of key persons. The 1996 legislation also amended the IRC Sec. 264 to limit the number of policies on key persons for which interest remained deductible to the greater of;

- five individuals or
- the lesser of 5 percent of the total number of officers and employees of the business, or 20 individuals.

Leveraged Insurance

Before the limitations adopted in 1986 and 1996, some businesses purchased “leveraged business-owned life insurance,” in which they leveraged their life insurance ownership. This was accomplished by borrowing against the policies to pay a substantial portion of the insurance premiums and in doing so incurred a tax-deductible interest expense while realizing tax-free investment returns. In addition to the 1986 and 1996 legislation addressing leveraged business-owned life insurance policies, Internal Revenue Service (IRS) and the Department of Justice prevailed in three cases involving the deductibility of loan interest related to such policies. These plans covered over 55,000 employees. The courts found that the leveraged plans lacked economic substance, making the interest deduction unallowable (Among others, see *Am. Elec. Power v. United States*, 326 F.3d 737 (6th Cir. 2003), *Dow Chemical Co. v. United States*, 250 F Supp. 2d 748 (E.D. Mich. 2003)).

Interest incurred on indebtedness has historically been deductible, (although the deduction of "personal" interest was largely eliminated in 1986), and in the 1950s a type of "leveraged insurance" transaction began being marketed that permitted an insurance owner to, in effect, deduct the cost of paying for insurance by;
1) paying large premiums to create cash values
2) "borrowing" against the cash value to in effect strip out the large premiums, and
3) paying deductible "interest" back to the insurer, which was in turn credited to the policy's cash value as tax-deferred earnings on the policy that could fund the insurer's legitimate charges against policy value for cost of insurance, etc.

The advantage of being able to deduct interest, on the one hand, and yet not include in income the interest credited to the policy's cash value is a form of tax arbitrage. The IRS had early success in challenging the bona fides of these types of arrangements (Knetsch v. U.S., 1960) as creating legitimate debt and interest eligible to be deducted. However, subsequent court losses and IRC amendments weakened their position, appearing to permit tax-deductible borrowing to provide funds to pay insurance premiums, so long as such borrowing did not account for more than three of the first seven annual premiums on the policy (the "4 out of 7" test).

Life Settlements

The beginning of the new century has seen the development of the life settlements or viatical settlements industry. In these transactions, insureds sell their policies to investors who then pay the premiums and stand to collect at the insured's death.

Life settlement industry
An active secondary market for life insurance, sometimes referred to as the life settlement industry, has emerged. This secondary market allows policyholders who no longer need life insurance to receive necessary cash during their lifetimes. The market provides a favorable alternative to allowing a policy to lapse, or receiving only the cash surrender value. The secondary market for life insurance is subject to regulation; most states have enacted statutes governing secondary market transactions, and all jurisdictions permit the transfer or sale of legitimately procured life insurance policies. There is also universal proscription of the creation of life insurance policies by third parties for the benefit of those who have no relationship to the insured. These policies, commonly known as "stranger originated life insurance," or STOLI, lack an insurable interest and are thus an illegal wager on human life.

In a life settlement transaction, older policyholders sell in-force life insurance policies to independent third parties (known as “life settlement providers”) in a secondary market transaction. The process of selling one’s policy to a life settlement provider is referred to as either a viatical settlement or a life settlement. The only difference between the two terms is that viatical settlements deal with insured individuals who have a life expectancy of less than twenty-four months and life settlements deal with individuals who are expected to live more than twenty-four months. For legislative purposes, viatical settlements are treated the same as life settlements. Industry participants distinguish between viatical and life settlements because of the negative stigma surrounding viatical settlements. The mechanics of a life settlement transaction are straightforward. An elderly policyholder sells his or her life insurance policy to a life settlement provider for an amount that is lower than the death benefit, but higher than the surrender value. After the sale, the individual that is insured by the policy remains the same, but the purchaser of the policy (or its designee) becomes the new beneficiary of the policy. Upon the death of the insured person, the purchaser (or its designee) collects the death benefit from the policy. In return for purchasing the policy, the life settlement company receives the death benefit upon the insured’s death. From the purchaser's perspective, a return on investment is guaranteed so long as it continues to maintain the policy and the life insurance company does not go out of business. The rate of return on investment depends on the length of the insured’s life.

Around 2004, securitization emerged in the life settlement industry. Policies are pooled into an entity whose shares are then securitized in this investment format and sold to investors. Securitization substantially increased the demand for life settlements from the investor's point of view. Challenges to this market getting bigger include: 1) the difficulty in acquiring the critical mass of life settlements necessary for statistically stable cash flows; 2) significant insurable interest issues that must be addressed; 3) high transaction costs inherent in the acquisition of life settlements that make securitization economically impractical; 4) the wide range of opinions on life expectancies of legacy portfolios and the divergence of actual results to expected results for such legacy portfolios.

There have been no securitizations of life settlements registered with the SEC, although there have been some privately offered life settlement securitizations. Market participants believe a rating from a rating agency would be essential in order to be able to sell a securitization of life settlements. There have been only a very limited number of securitizations of life settlements that have ever received a rating. The Task Force was told by groups representing a wide array of market participants that it is unlikely that there will be an increase in securitizations of life settlements in the near future. Some rating agencies have also publicly highlighted multiple obstacles that would make it difficult to rate a life settlement securitization. Among those obstacles are: legal uncertainty surrounding the existence and transferability of insurable interests; the lack of experience and reputation of the prospective issuers of the securitization; the large number of policies needed for life settlements securitizations; questions regarding the reliability of medical reviews of the insured individuals; and the potential timing mismatch of cash flows. These are many of the same risks and challenges presented to anyone seeking to invest in life settlements generally.[6]

The American Council of Life Insurers (ACLI) is on record with the Securities and Exchange Commission (SEC) as being opposed to the securitization of life settlements. Such arrangements expose senior citizens and investors to increased risk of fraud.[7]

[6] Securities and Exchange Commission 'Life Settlements Task Force' report 07/10
[7] 10/06/2011 letter from ACLI to SEC Chairwoman Shapiro http://www.acli.com/Issues/Documents/letterSECsettlementstaskforcerecommendations100611.pdf