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New Developments In The Law On Insurable Interest

Law360, New York (August 10, 2009) -- Historically, U.S. state insurance laws have required that a life insurance policy may be procured only by a person with an insurable interest in the continuation of the life of the insured. Such persons typically include the insured, the insured's spouse and the insured's other close relatives.[1]

State law has consistently condemned, as a wagering contract which violates public policy, the purchase of life insurance by a party whose only interest is in the early death of the insured.

Accordingly, a policy purchased by a party without an insurable interest may, depending on relevant state insurance law, be void or voidable by the issuing insurance company.[2]

In most states, if a life policy is successfully contested for lack of insurable interest, the coverage is retroactively canceled and all premiums paid are returned to the holder of the policy.

Although it is well-accepted that an individual may sell his or her life insurance policy,[3] if that person purchases insurance on his or her own life for the benefit of a party which does not have an insurable interest, the purchase may be viewed as a sham and in violation of the relevant law.

With the development of the life settlement industry, which involves the sale of unwanted policies by owners to unrelated persons for cash, and various related premium financing structures designed to assist the owner in purchasing insurance and paying the premiums,[4] the debate has intensified as to the appropriate criteria for determining insurable interest.

One side argues that the mere subjective intent on the part of a policy owner to sell the policy at some future date should be sufficient to void the policy on insurable interest grounds.

The other argues that the owner, at the time of the policy's inception, must have actually entered into an agreement to sell or transfer the policy in order for the arrangement to violate the insurable interest requirement.

Several recent cases have examined the insurable interest question where there is evidence that the insured contemplated selling the policy prior to inception.

In December 2008, in Sun Life Assurance Company of Canada v. Paulson,[5] the federal district court for the District of Minnesota confronted a situation where an 80-year-old man had purchased 30 life insurance policies with the intent to sell them to third parties upon the termination of the contestability period.

Under Minnesota law, the mutual intent of the parties determines whether a policy is void ab initio for lack of insurable interest.

Although Sun Life could not produce evidence of an express agreement between the insured and a third party, Sun Life argued this was "unnecessary to establish mutual intent because evidence of [the insured's] intent to sell the policies permits an inference that another party intended to buy the policies at the time they were issued."

The court disagreed, concluding that an insured's intent alone, even when it can be proven that the insured intends to immediately sell the policy to a third party with no insurable interest, is insufficient to void the policy.

The court stated, "[an insured's] intent is irrelevant without facts suggesting that a [specific] third party lacking an insurable interest intended, at the time [the insured] procured the policies, to acquire them upon expiration of the contestability period."

Subsequent cases in other jurisdictions have also required evidence of an arrangement between the insured and an identifiable third party in order to void the policy.

In February 2009, the U.S. Fourth Circuit Court of Appeals affirmed a lower court decision in First Penn-Pacific Life Insurance Company v. William Evans,[6] holding, in effect, that insurable interest is not negated solely because the owner plans to sell a policy at the time of purchase.

The insurance company had appealed a 2007 decision by the U.S. District Court of Maryland denying it permission to rescind a $2 million policy it issued to the late Stanley Moore of Arizona.

The district court had held against First-Penn on the grounds that the insurer had failed to take action within the two-year contestability period.

The appellate court found that Moore had attempted to exploit the viatical settlement industry[7] in 1997 when he obtained seven life insurance policies valued at a total of $8.5 million, based on its determination that Moore falsely claimed to be terminally ill when he discussed selling the policies with a broker and that he intended to sell all or most of the policies at the time he applied for them.

The court stated, however, that "no third-party participated in the procurement of Moore's policy and therefore no one was 'wagering' on Moore's life in violation of public policy."

The court, citing an amicus brief filed by the Life Insurance Settlement Association, stated that "evaluating insurable interest on the basis of the subjective intent of the insured at the time the policy issues ... would be unworkable and would inject uncertainty into the secondary market for insurance."

While the Sun Life and First Penn courts clearly articulated the standard used to determine the existence of insurable interest, reviewing courts are not always so explicit.

In May 2009, the U.S. Sixth Circuit Court of Appeals reversed and remanded a lower court decision in Wuliger v. Manufactures Life Insurance Co.[8]

In Wuliger, a receiver appointed to marshal the assets of Liberte Capital Group for the benefit of defrauded investors (Liberte had been sued by the SEC for fraudulently acquiring insurance policies and fraudulently inducing investors to purchase shares in the policy pool) sued ManuLife for the repayment of the purchase prices and premiums for three polices.

These policies had been purchased by elderly insureds in exchange for cash payments by Liberte and the receiver argued that the policies were therefore void ab initio.

ManuLife argued that because the policies had been procured by the insureds, who had valid insurable interests in their own lives, the policies were valid.

On the issue of insurable interest, the Court of Appeals reversed the lower court only to the extent that it found that procurement of the policies through a straw purchaser made the policies voidable at the issuing insurance company's option (the lower court had ruled that the policies were void ab initio); most of the analysis of insurable interest comes from the lower court.

In parts of its decision, the district court used language suggesting it was applying a subjective standard: for example, when ManuLife argued that policy purchasers have an insurable interest in their own lives, the court stated, "What complicates this generally valid legal assertion is that the viators in this case were predisposed to assign their policies in return for a fee."

The term "predisposed" indicates that the court was concerned only with the state of mind of the prospective insured and not with whether an actual agreement with a third party had been reached.

However, when announcing its holding, the court reasoned that “each of the viators took out policies of insurance to transfer for a fee to Liberte which, in turn, marketed them to their investors.

As the procurement of these policies was tantamount to wagering contracts, the court finds that the policies at issue are void ...”

The court’s reliance on the agreement with Liberte to reach its conclusion suggests that the court actually applied an objective standard to determine whether an insurable interest existed at the policies’ inception.

These cases illustrate the complex relationship between the issue of insurable interest and the phenomenon of “stranger-owned” (or “stranger-originated”) life insurance (“STOLI”), linked with illegal wagering arrangements, particularly in situations where the policy owner is offered a premium finance loan to facilitate purchase of the insurance contract.

Given the ambiguities in state law concerning insurable interest, certain participants in the life settlement and life insurance industries, as well as state legislators, have sought, as an element of new laws regulating life settlements proposed in the last few years, to include a statutory definition of STOLI and to classify it as unlawful activity.

Many of the legislative proposals have included premium finance arrangements within this definition.[9]

The same question, however, has plagued this initiative as has complicated the law on insurable interest: Is the mere subjective intent on the part of the policy owner at the time of purchase to transfer a life policy to an unrelated party illegal, or must there be an actual agreement to do so?

A California court recently issued a ruling temporarily defining the role that premium financing programs may play within the state.

In July 2009, the U.S. District Court for the Central District of California decided the case of Lincoln National Life Insurance Company v. Gordon R.A. Fishman Irrevocable Life Trust.[10]

Lincoln National, the issuing insurance company, challenged two policies purchased on the life of Dr. Gordon Fishman by a trust he set up naming his children as beneficiaries, alleging that they were actually obtained for the benefit of the Mutual Credit Corporation (MCC), the company that financed the purchase of and premium payments on the policies.[11]

Under the terms of MCC’s loans, Dr. Fishman received a “premium reserve” — the sum of two years of policy premiums plus the origination cost of purchasing the policies — in exchange for an agreement to repay the loans at the end of their two-year terms together with a “finance charge.”

The finance charge was comprised of a 10 percent annual fee and an amount that varied depending upon the secondary market values of the policies.

At loan origination, MCC received a collateral assignment of each policy and at the loans’ maturity, Dr. Fishman had the option to either surrender the policies to MCC in full satisfaction of the debt or to repay the amount due and retain ownership of the policies.

The court noted that of the 80 plus policies issued by Lincoln National and financed by MCC, not a single trust had retained ownership of the policies after the loans matured.

Lincoln National argued that under these facts, the life policies it had issued to the Fishman trust were procured at the behest of or for the benefit of parties possessing no insurable interest in Fishman’s life.

The court summarized the insurable interest law of California by stating that a valid insurance policy, “must, at its inception, have been held by someone ... who has an interest and advantage in ‘the continued life, health or bodily safety of’ the insured and who would suffer a ‘consequent loss’ where any of those situations come to pass.”

The court then noted that under California law, the fact that an insurance policy has been assigned as collateral for a valid loan does not impact the determination of the existence of insurable interest, concluding that because a properly formed trust whose beneficiaries were family members of the insured had an insurable interest in the insured, the insurable interest requirement had been met.

The court stated, however, that “defendants may have found a loophole in the law barring a STOLI finding, but it is clear to the court that this whole arrangement with the Fishmans was nothing but a more creative version of the same.”

The court concluded its opinion by suggesting that to clearly prohibit STOLI schemes using premium financing agreements, the state legislature should amend California’s insurance law.

New life settlement laws have recently been proposed in both New York and California which include definitions of STOLI, although neither law has yet been adopted.

In the meantime, uncertainty remains in situations where there is evidence that a policy owner, at the time the policy was issued, intended to transfer it to an unrelated third party, and it is up to the courts in these states to determine whether an insurable interest exists.

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[1] Some jurisdictions also provide that entities such as the insured's employer, a trust formed by the insured for the benefit of a person or entity with a valid insurable interest, or charitable institutions with which the insured is affiliated have an insurable interest.

[2] Under the vast majority of state laws, an issuing insurance company's right to contest a policy for fraud expires upon the second anniversary of the issue date, although the carrier retains the right thereafter to raise the insurable interest issue as a defense to the payment of the death benefit upon the death of the insured. By contrast, in New York, the carrier's legal right to challenge the validity of a policy, either for fraud or for lack of insurable interest, terminates after two years.

[3] Grigsby v. Russell, 222 U.S. 149 (1911).

[4] In 2008, more than $16 billion in life settlement transactions occurred, according to the Life Insurance Settlement Association.

[5] 2008 WL 5120953.

[6] 2009 WL 497394.

[7] A viatical settlement is generally similar to a life settlement except the insured is chronically or terminally ill.

[8] 2009 WL 1478965.

[9] As of June 5, 2009, approximately 21 states have adopted laws including definitions of STOLI which link it with premium financing schemes.

[10] 2009 WL 2330771.

[11] There was a dispute among the parties as to whether the agreement with MCC was entered into before or after the policy's inception.