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Regulation Not Prohibition: The Comparative Case Against the Insurable Interest Doctrine

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Regulation Not Prohibition: The Comparative Case Against the Insurable Interest Doctrine

Sharo Michael Atmeh *

*Abstract: American law requires an insurable interest—a pecuniary or affective stake in the subject of an insurance policy—as a predicate to properly obtaining insurance. In theory, the rule prevents both wagering on individual lives and moral hazard. In practice, the doctrine is avoided by complex insurance transaction structuring to effectuate both origination and transfers of insurance by individuals without an insurable interest. This paper argues that it is time to abandon the insurable interest doctrine. As both the English and Australian experiences indicate, elimination of the insurable interest doctrine will have little detrimental pecuniary effect on the insurance industry, while freeing consumers considerably. Indeed, New York comes to the brink of eliminating the doctrine in its recent decision in *Kramer v. Phoenix Life Insurance Co.* by sanctioning an immediate life insurance assignment procedure that in effect eliminates the need for an insurable interest in the assignee. However, Delaware, in *PHL Variable Insurance Co. v. Price Dawe 2006 Insurance Trust* and *Lincoln National Life Insurance Co. v. Joseph Schlanger 2006 Insurance Trust*, breathes new life into an old doctrine. Overall, though, adhering to an arcane doctrine that prevents the value of an insurance policy from being realized without extreme legal burden both hampers the market and harms consumers, as the benefits of such transactions are both lessened by transaction costs and accrue to only a select few individuals.*

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I. INTRODUCTION

For hundreds of years, people have been trying to invest in the lives of other persons through insurance policies; meanwhile, the insurable interest doctrine has attempted to stop them and failed. In the United States, widely divergent insurable interest laws in the several states nominally prohibit taking out a life insurance policy on an individual without having a stake in the person's well-being.¹ The logic behind this rule is obvious: to prevent the creation of a futures market on a pool of individuals' lives. However, this paper argues that the rule does more harm than good. There are plausible policy reasons for such a rule, but those policies can be achieved with other more finely tuned, specific, and coherent rules. Laws preventing individuals from collecting improperly on life insurance or by fraudulently drawn wills already alleviate much of the problem of any potential futures market in individual well-being. The structure of the insurable interest rule is not only completely duplicative of laws preventing fraud in the field, but it also creates massive amounts of evasion by market actors and engenders substantial transaction costs.

While the insurable interest doctrine sounds like an age-old component of the common law, it is not. Prior to 1745, a pecuniary or emotional interest in the subject of an insurance policy was not a requirement for the receipt of a payout from that policy. Thus, insurance contracts were held valid, notwithstanding that the absence of an insurable interest gave the

¹ Leslie Scism, *Regulators Rein In Murky Life Policies*, WALL ST. J. (June 21, 2010), <http://online.wsj.com/article/SB10001424052748704324304575306440620747882.html?KEYWORDS=insurable+interest#printMode>.

transaction the characteristics of a wager.² The insurable interest doctrine developed in response to the common law's validation of such contracts in an effort to both prevent wagers on the lives of individuals and to quell attempts to destroy the subject of an insurance policy. Lacking more finely tuned regulatory tools, the insurable interest doctrine was developed by an English parliament trying to rein in such "wagers" in the mid-eighteenth century.

The doctrine is now effectively avoided by persons who structure their deals to escape its reach. Even before these evasion techniques were developed, as discussed below, the doctrine was expanded via statute to the point where the purported barrier became meaningless to sophisticated parties. Well-informed parties can simply thwart the doctrine through the creation of a "cloak" that tricks insurance firms into thinking an insurable interest does exist in an insurance policy. A common cloak works by making it nominally appear that the person taking out the insurance policy has an interest in the subject of the insurance, because the cloak makes it look like it is the insured herself taking out the policy. Further, a statutory loosening of the insurable interest doctrine expanded the definition of who may take out an insurance policy far enough that even the mildest pecuniary connection can qualify for an insurable interest alongside individuals with an affective or consanguine interest. Even before these modern evasions, however, at least one scholar in history claimed that the insurable interest doctrine was merely technical and should be eliminated because criminal, trust, and estate law otherwise protect an insured from being murdered by contemporaries holding an insurance policy on the insured's life.³

Reform in this area is particularly difficult, largely because companies promoting life insurance transferability resist regulation, as do the insurance firms that underwrite the policies. For example, because insurers benefit from an option to later invalidate insurance policies, they have an interest in maintaining the insurable interest doctrine, as it allows them to retain a last-ditch defense against the assignment of a policy. Furthermore, the firms that operate in the realm of transferring insurance policies by creating cloaks seek to retain the profits gained from fees charged to structure these transactions. Indeed, because of the complex structuring involved, much of the financial benefit from the industry in secondary life insurance does not accrue to either the insured or the person to whom the policy is transferred. Often times, the insured is forced to pay out insurance premiums on a poli-

² LEE R. RUSS & THOMAS F. SEGALLA, *COUCH ON INSURANCE* § 41:1 (3d ed. 2011).

³ Cf. Edwin W. Patterson, *Insurable Interest in Life*, 18 COLUM. L. REV. 381, 390 (1918) (citing FREDERICK H. COOKE, *THE LAW OF LIFE INSURANCE* §§ 58, 59 (1st ed. 1891) for the propositions that criminal law protects against murder; while "unjust enrichment" law protects beneficiaries from collecting on insurance policies which are triggered by their murdering the subject of the insurance—today these laws would be known as "slayer" laws).

cy that the insured has been told will be resold by an arranger—only to later find out that the policy is not salable. At other times, insurance companies will turn a blind eye to potential problems in insurable interest at the formation of a policy—only to later rely on the insurable interest doctrine as an affirmative defense when the policy is redeemable. Yet other times, individuals seeking to invest in the insurance market by purchasing other insurance policies are told that a policy will reap double-digit returns—only to realize that the arranger of a policy, like Life Partners Holdings Inc., has substantially understated the risk involved in such an investment.⁴ All of these market failures come about as a result of the insurable interest doctrine's existence.⁵

This paper will argue that the insurable interest doctrine no longer achieves the regulatory goals that it intends to achieve. I advocate for an elimination of the doctrine. As an affirmative defense, allowing insurance companies to invalidate an insurance policy many years after its inception it is too blunt a regulatory instrument. Developments in the modern market and other financial regulations, including the development of a modern regulatory environment for securities, obviate the need for an insurable interest doctrine. The idea that individuals should be free to alienate their own insurance policies is not new, and neither is the idea that the doctrine should be eliminated entirely. This paper takes the view that the American legal system should follow the lead of Australia to eliminate the insurable interest doctrine entirely for both property and life insurance, while creating a comprehensive national regulatory scheme that will streamline a market bloated with unnecessary actors and a thicket of burdensome and conflicting regulation.

Arguing for the elimination of the insurable interest doctrine in America through a comparative lens is unique to this paper. Part II will explore the parallels between development of the insurable interest doctrine in England and the United States. It will then explain the plethora of American laws and model codes that attempt to elucidate the doctrine, but which continue to fall short and lead to highly inefficient case-by-case determinations. Part III will explain how a highly complex market has developed with the sole purpose of getting around the insurable interest doctrine in the life settlement market. The section will then explain the policy reasons for the elimination of the doctrine, focusing on the elimination of transaction costs. Part III will highlight how the insurable interest doctrine harms the actors it was meant to protect: individual persons who are the subject of insurance policies and persons who seek to invest in such policies. Finally, Part IV will show that the natural experiment in Australia proves that the insurable

⁴ See Scism, *supra* note 1.

⁵ See *infra* Part III.E.2.

interest doctrine can be eliminated without any significant effect on the size or financial sustainability of the insurance industry, but with greater freedom for both consumers and investors to enter a regulated market. Indeed, the Australia example will show that the insurance market continues to grow, even in the absence of the insurable interest doctrine.

II. PRECEDENT & COMPARATIVE BACKGROUND ON THE INSURABLE INTEREST DOCTRINE

The insurable interest doctrine is, or was, a creature of statute in the United States,⁶ England,⁷ and Australia.⁸ Under very similar historical conditions in their respective insurance markets, these three nations developed an insurable interest doctrine that substantially emulated an original English doctrine. However, two of those three nations have either completely eliminated (in the case of Australia) or substantially abrogated (in the case of England) the insurable interest doctrine. In the field of insurable interest, America is the laggard in insurance law. This part of the paper will establish the historical similarity of the doctrine between England and the United States to provide the necessary background for understanding why the United States should follow the lead of England and Australia in eliminating the insurable interest doctrine.

A. What is the Insurable Interest Doctrine?

The insurable interest doctrine requires that someone taking out insurance either benefit from the preservation of the subject matter of the insurance or suffer a disadvantage from loss of the insured subject.⁹ The history behind this definition of the insurable interest in the three nations' doctrines can be traced back to two strands of English doctrine established by statute in 1745 for property and in 1774 for life insurance. The first strand, dealing with actual pecuniary losses for property, is the "indemnity" insurance strand.¹⁰ The second strand, dealing with life insurance and loss of life, is dubbed the "non-indemnity" insurance strand. Essentially, the insurable in-

⁶ See *infra* Part II.C.

⁷ See Life Assurance Act, 1774, 14 Geo. 3, c. 48, § I (Eng.).

⁸ See *Life Insurance Act 1995* (Cth) s 200 (Austl.).

⁹ RUSS & SEGALLA, *supra* note 2, § 41:17.

As a general rule, it can be stated that a person has an insurable interest in the life of another if he or she can reasonably expect to receive pecuniary gain from the continued life of the other person and conversely, if he or she would suffer financial loss from the latter's death

Id. See also LAW COMM'N & SCOTTISH LAW COMM'N, INSURABLE INTEREST: ISSUES PAPER 4, 4 (2008) (U.K.), available at http://www.scotlawcom.gov.uk/download_file/view/203/107/.

¹⁰ Patterson, *supra* note 3, at 386 (defining "insurable interest" as a person's "maximum possible pecuniary loss from the happening of the event.").

terest doctrine operates as a defense used by the insurer to estop insured individuals who lack an interest in the person or object insured from collecting on insurance policies after an insured event happens.

At common law—before the English legislature intervened with two statutes—a gambling contract was not illegal.¹¹ Thus, contracts “which were cloaked in the guise of policies of insurance were valid”¹² At the time, parties simply declared whether they had an interest by using terms like “interest or no interest” or “without proof of interest,” and, thus, delineated whether they were making an indemnity contract or a wager.¹³ Without the “interest” clause, courts would construe the contract as one of indemnity and give no remuneration to the insured unless she could prove an actual loss.¹⁴ However, after the enactments of the Marine Insurance Act of 1745¹⁵ and the Life Assurance Act of 1774,¹⁶ having an “interest”—whether pecuniary or consanguine—became a non-elective, mandatory term for the enforcement of any insurance contract.

B. History of the Insurable Interest Doctrine

1. England

In a sharp break with the common law, the Marine Insurance Act of 1745 invalidated insurance policies taken out on marine cargo if the person taking out the insurance had no pecuniary interest in the goods.¹⁷ The English Parliament came to require an insurable interest because it was found “by Experience, that the making Assurances, . . . without further Proof of Interest than the Policy, hath been productive of many pernicious Practices, whereby great Numbers of Ships with their Cargoes, have . . . been fraudulently lost and destroyed.”¹⁸ Indeed, going further, it was common in England at the time to “wager on another’s life, in the form of insurance, by persons in no way connected nor in any manner interested in the insured’s life.”¹⁹ In transactions that have parallels to today’s insurance industry:²⁰

Popular accounts of the period describe the practice of purchasing

¹¹ KENNETH SUTTON, *INSURANCE LAW IN AUSTRALIA* 504 (3d ed. 1999).

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ Marine Insurance Act, 1745, 19 Geo. 2, c. 37 (Eng.).

¹⁶ Life Assurance Act, 1774, 14 Geo. 3, c. 48 (Eng.).

¹⁷ Marine Insurance Act, 1745, 19 Geo. 2, c. 37, § I (Eng.).

¹⁸ *Id.*

¹⁹ Gary Salzman, *Murder, Wagering, and Insurable Interest in Life Insurance*, 30 THE J. OF INS. 555, 562 (1963).

²⁰ See *infra* Part III.A.

insurance on the lives of those being tried for capital crimes. These policies constituted naked wagers on whether the accused would ultimately be convicted and executed for the alleged offense. A related practice was the purchase of insurance on the lives of famous, elderly persons; the premium would be a function of what was known about the person's health, including any recent illnesses.²¹

Given these practices, the English Parliament developed a major concern over wagering not only on property but also on individual lives. Thus, less than 30 years after the establishment of the insurable interest doctrine for property, the doctrine was extended to life insurance contracts with the Life Assurance Act of 1774.²² The locus of the 1774 enactment was not necessarily a concern about hastening the death of these individuals, but rather about gambling on a morally prohibited subject. In a similar preamble to the 1745 enactment, Parliament states, “[i]t hath been found by experience that the making insurances on the lives or other events wherein the assured shall have no interest hath introduced a mischievous king of gaming”²³ Interestingly, Parliament seemed to have placed another limitation on the writing of insurance policies at the time by stating that “no greater sum shall be recovered or received from the insurer . . . than the amount of value of the interest of the insured in such life or lives, or other event or events.”²⁴ Thus, it would seem that the same principles underlying property insurance law—primarily in indemnity contracts—were applied to individual lives by simply applying the property policy to life insurance. Unfortunately, the English Parliament did not provide any guidance on what exactly constituted an insurable interest, and it was left to the courts to decide on a case-by-case basis through highly fact-dependent determinations.

As attitudes against gambling hardened, English law indirectly created an insurable interest obligation for various property indemnity contracts with the Gaming Act of 1845.²⁵ Section 18 of the 1845 Gaming Act created the requirement that a policyholder must be able to demonstrate an insurable interest in the subject matter of the insurance; otherwise, the contract is invalid as a “wager.”²⁶ Marine insurable interest laws were also strengthened with the passing²⁷ of the Marine Insurance Acts of 1906²⁸ and 1909.²⁹

²¹ ROBERT H. JERRY, II, *UNDERSTANDING INSURANCE LAW* 292 (3d ed. 2002); *see also* Peter Nash Swisher, *The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 *DRAKE L. REV.* 477, 481 (2005).

²² Life Assurance Act, 1774, 14 *Geo. 3*, c. 48 (Eng.).

²³ *Id.* pmb1.

²⁴ *Id.* § III.

²⁵ Gaming Act, 1845, 8 & 9 *Vict.*, c. 109 (Eng.).

²⁶ *Id.* § 18; *see also* LAW COMM’N & SCOTTISH LAW COMM’N, *supra* note 9, at 7–8.

²⁷ LAW COMM’N & SCOTTISH LAW COMM’N, *supra* note 9, at 8.

The 1906 Act defined someone as having an interest in a marine adventure when:

[H]e stands in any legal or equitable relation . . . to any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss, or . . . damage . . . or may incur liability in respect thereof.³⁰

While this definition provides some clarity about what an insurable interest *is*, it does not provide for *when* facts and circumstances affecting such an interest occur. The 1906 Act extended the penalties for taking out a marine insurance policy without an insurable interest and made such action a criminal offense, punishable by a fine or prison for up to six months.³¹ Evidently, though, no prosecutions ever occurred under this act.³² Even at this point, the English parliament again did not provide guidance on the insurable interest concept, and most of the heavy lifting with respect to defining and regulating an insurable interest was left to the courts.

Two major cases interpreted insurable interest legislation prior to 2005. First, in 1806, *Lucena v. Craufurd*³³ laid out the definition of insurable interest for England and all of its territories. Establishing what later became known as the beginnings of an economic “relationship” test, the House of Lords stated, “[t]o be interested in the preservation of a thing, is to be circumstanced with respect to it as to have benefit from its existence, prejudice from its destruction.”³⁴ Thus, if one’s position in life were either benefitted or damaged by an interest in a life or object, then an interest can be claimed in that subject. This logic seems mildly circular, as the existence of one legal right depends on the existence of other legal or equitable rights.

Over 100 years later, in 1925, *Macaura v. Northern Assurance*,³⁵ helped sharpen the definition of an insurable interest only somewhat. In *Macaura*, Lord Buckmaster indicated that no shareholder had any right to any company property because she (or, more likely at the time, he) had no legal or equitable interest.³⁶ According to *Macaura*, a shareholder’s relationship was to the company, not to the company’s goods, and thus any

²⁸ Marine Insurance Act, 1906, 6 Edw. 7, c. 41 (Eng.).

²⁹ Marine Insurance (Gambling Policies) Act, 1909, 9 Edw. 7, c. 12 (Eng.).

³⁰ Marine Insurance Act, 1906, 6 Edw. 7, c. 41, § 5 (Eng.).

³¹ Marine Insurance (Gambling Policies) Act, 1909, 9 Edw. 7, c.12, § 1 (Eng.).

³² See SUTTON, *supra* note 11, at 8 n.17.

³³ (1806) 127 Eng. Rep. 630 (H.L.) (appeal taken from Eng.).

³⁴ *Id.* at 643.

³⁵ [1925] A.C. 619 (H.L.) (appeal taken from N. Ir.) (Eng.).

³⁶ *Id.* at 626.

damage to the goods was not to the shareholder, but merely to a company's assets.³⁷ To at least one Lord adjudging the *Macaura* case, this difference in interests mirrored the separation of ownership and control in a corporation.³⁸ The *Macaura* court also indicated that a creditor does not have an insurable interest in a debtor's property, but an interest did exist in the life of that debtor.³⁹

More recently, in 1987, the Supreme Court of Canada called into question the legal interest test developed in *Lucena* through its decision in *Kosmopoulos v. Constitution Insurance Co.*⁴⁰ In *Kosmopoulos*, the court found no basis in public policy for a restrictive formalistic definition.⁴¹ Thus, overall, some economic relationship or concern in the subject of the insurance would be sufficient for an insurable interest.⁴² This economic interest test was said to fall in line with the majority of U.S. jurisdictions on the topic.⁴³ Uncertainty in both the definition and status of an insurable interest remained paramount in England until 2005.

The area of insurable interest law remained unchanged in England, at least legislatively, until the Gambling Act of 2005.⁴⁴ The Gambling Act intended to regulate new gambling ventures on the Internet and through technologies that helped such transactions occur outside British Law. “[The English] [g]overnment wanted to provide rigorous and effective protection for the public by creating a regulatory regime for gambling.”⁴⁵ The Gambling Act repealed Section 18 of the 1845 Gaming Act, and replaced it with the following language: “The fact that a contract relates to gambling does not prevent its enforcement.”⁴⁶ Thus, by making gambling legal in an effort to regulate it in the United Kingdom, the insurable interest doctrine was dealt a death knell—at least when it came to insurance relating to property. Meanwhile, for life insurance, the 1774 Life Assurance Act still controls. Thus, in England, the insurable interest doctrine was eliminated by accident.

³⁷ *Id.* at 630.

³⁸ *Id.* at 633.

³⁹ *Id.* at 626.

⁴⁰ [1987] 1 S.C.R. 2 (Can.).

⁴¹ *Id.* at 3.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ See Gambling Act, 2005, c. 19, §§ 334–35 (Eng.).

⁴⁵ LAW COMM'N & SCOTTISH LAW COMM'N, *supra* note 9, at 8 (citing British Gov't, Government Response to the First Report of the Joint Committee on the Draft Gambling Bill 2 (2004)).

⁴⁶ Gambling Act, 2005, c. 19, § 335 (Eng.).

2. *The United States*

While the insurable interest doctrine developed formally in England through statute, it appears to have developed with a public policy bent in the United States.⁴⁷ Mirroring the twin roots of the insurable interest doctrine in England, the United States seems to have developed insurable interest ideas separately for both property insurance (“indemnity contracts”) and life insurance (“non-indemnity contracts”). The earliest reference to these policies occurred in the property context in 1803 in *Pritchett v. Insurance Co. of North America*.⁴⁸ Treating insurable interest in property as a public policy dictate, the *Pritchett* court stated:

We have adopted the policy and principles which gave rise to . . . [The Marine Insurance Act of 1746] both in courts of justice and by commercial usage; but we are not prepared to say, that every particular provision or resolution under it, has been engrafted into our system of law. An insurance amongst us, is a contract of *indemnity*. Its object is, not to make a *positive gain*, but to avert a *possible loss*. A man can never be said to be *indemnified* against a loss which can never happen to him.⁴⁹

This very early passage is interesting in many respects. First, it directly cites to an earlier act of British Parliament, and says that it is adopting those policies as a matter of public policy (through the common law) in at least one of the states. Second, the court goes on to carve out precisely which of the policies from the English statute that it is adopting into American law. Judge Yeates chooses to peg the idea of an insurable interest to an actual loss being wrought to a person claiming proceeds under an insurance contract. Thus, the actual loss motive in this particular American judge’s mind seems to differ slightly from the anti-gambling motives envisaged by the British Parliament’s version of an insurable interest. These motives are clear for the property or “indemnity” contract version of insurance policies.

More than ten years after the insurable interest doctrine was elucidated for indemnity contracts, the insurable interest policy was applied to life insurance.⁵⁰ In *Lord v. Dall*, the Massachusetts Supreme Judicial Court stated that the law of insurable interest applied to a life insurance policy taken out by a sister to insure the life of her brother while he sailed on a cargo ship

⁴⁷ The history of the insurable interest doctrine is dealt with in greater depth and thoroughness elsewhere; this paper does not seek to replicate that research. Rather, the history provided here is selected to show the trajectory of the development of insurable interest laws and markets in the United States.

⁴⁸ 3 Yeates 458, 464 (Pa. 1803).

⁴⁹ *Id.* (emphasis in original).

⁵⁰ See *Lord v. Dall*, 12 Mass. (11 Tyng.) 115 (1815).

from December 1809 to July 1810.⁵¹ The court in *Dall* did not base its ruling—that insurable interest doctrine applied to life insurance—on the English statute. Rather, the court said that a life insurance policy without an insurable interest would be “contrary to the general policy of our laws. . . .”⁵² As to determining what an insurable interest truly is, the court found satisfactory nothing more than the “common understanding no one would hesitate to say, that in the life of such a brother the sister had an interest. . . .”⁵³ In an unusual admonition, the court in *Dall* stated that it cannot easily be discerned why the underwriters of such an insurance policy should question its validity “after a loss has taken place, when it does not appear that any doubts existed when the contract was made; although the same subject was then in their contemplation.”⁵⁴

Thus, as early on as the first cases that formulated the insurable interest doctrine in the U.S., some interesting quirks in the doctrine are apparent. First, American judges seem to base their decisions not on any statute, but on some sense that insurable interest is integral to the public policy structure of the states. It is important to note the deep similarities between England’s basis in statute and the United States’ basis in public policy, as they establish the insurable interest doctrine with the same principles, but with two different methods of reasoning. Second, the determination of what qualifies for an affective stake triggering an insurable interest is unclear, and this lack of clarity existed even at the time of the doctrine’s inception. Third, insurance companies have consistently asserted the insurable interest defense well after the formation of an insurance policy, even though they are entitled to examine issues concerning the insurable interest at the outset of the policy—while the consumer is not allowed to create an insurable interest after-the-fact to save the policy.

Over the ensuing decades, the insurable interest doctrine developed on highly fact-based grounds, and the issue wound itself into the Supreme Court. The seminal quote upon which most scholars attribute modern insurable interest doctrines in the several states is found in *Warnock v. Davis*.⁵⁵ In *Warnock*, the Supreme Court based the validity of an insurance policy on the following: “[I]n all [life insurance] 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.”⁵⁶ The Court went on to resuscitate the wagering concerns from the British system as the reason un-

⁵¹ *Id.* at 118.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.* at 119.

⁵⁵ 104 U.S. 775 (1881).

⁵⁶ *Id.* at 779.

derpinning insurable interest law in America by stating that without an insurable interest, “[a] contract is a mere wager, by which the party taking the policy is directly interested in the early death of the assured.”⁵⁷ Finally, the court extended insurable interest doctrine one step further by stating that, “[t]he assignment of a policy to a party not having an insurable interest is as objectionable as the taking out of a policy in his name . . . [That person] stands in the position of one holding a[n invalid] wager policy.”⁵⁸ Implicitly, then, the court in *Warnock* placed the cost of an insurable interest wager on the consumer of the insurance policy—the insurance companies have the right, but not the obligation, to assert the insurable interest defense and invalidate a policy.

Around the time of the *Warnock* decision, there appears to have been some indecision in the American courts about whether a life insurance contract was one of indemnity or non-indemnity.⁵⁹ The Supreme Court seems to settle this question in *Phoenix Mutual Life Insurance Co. v. Bailey* by stating:

Life insurances have sometimes been construed in the same way [as indemnity insurance policies], but the better opinion is that the decided cases which proceed upon the ground that the insured must necessarily have some pecuniary interest in the life of the *cestui qui vie*⁶⁰ . . . [indicate] that the contract of life insurance is not necessarily one merely of indemnity for a pecuniary loss⁶¹

For the historical purposes of this paper, it is important to note that while the insurable interest doctrine originated in a muddy fashion, there exists a clear difference between indemnity and non-indemnity contract types.⁶²

Bailey, combined with the decision in *Grigsby v. Russell*,⁶³ brings both the American and the English systems in line with each other on the motives for insurable interest.⁶⁴ In *Grigsby*, the Supreme Court sanctioned the transfer of a life insurance policy to someone without an insurable interest

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ See Patterson, *supra* note 3, at 381.

⁶⁰ This term refers to the life that is the subject of the life insurance policy.

⁶¹ 80 U.S. 616, 619 (1871).

⁶² See RUSS & SEGALLA, *supra* note 2, § 103:4 (stating, for example, that: “The major substantive distinction between a liability policy and an indemnity contract is that payment of a claim by the insured is a condition precedent to the insured’s right to recover under the indemnity contract, but not under the liability contract. This distinction also means that liability insurance covers injuries sustained by third parties, while indemnity contracts cover first party losses.”).

⁶³ 222 U.S. 149 (1911).

⁶⁴ *Id.* at 155.

in the insured.⁶⁵ In that case, Justice Holmes stated, “the ground of the objection to life insurance without interest in the earlier English cases was not the temptation to murder, but the fact that such wagers came to be regarded as a mischievous kind of gaming.”⁶⁶ Thus, at the turn of the century, the Supreme Court painted the full picture of what it believed to be insurable interest policy: (1) an insurable interest—either pecuniary or blood—must exist prior to the execution of a life insurance policy; (2) if not, then the insurance policy is void and does not need to pay out; and (3) this must be the case, otherwise people will engage in “wagering” on each other’s lives that can be tied to the risk of murdering (in the case of humans) or destroying (in the case of property) the subject of the insurance. American law as it currently stands is elucidated in the next section.

C. Current U.S. Law Governing the Insurable Interest

While the insurable interest doctrine began as judge-made law, with no legislative basis in the United States, it was later codified by many of the states.⁶⁷ Such codification, across fifty jurisdictions, leaves the legal landscape uncertain for both insurance companies and consumers with respect to the insurable interest doctrine, as considerable variation among the fifty states’ laws exists. Essentially, states seek to regulate what is called the “secondary life insurance” market through the lens of the insurable interest doctrine. In its simplest form, the secondary market for life insurance policies originates because the surrender price of a life insurance policy is much less than the price the same policy would fetch if it were sold to investors on the open market.⁶⁸ An individual can sell his or her life insurance policy for a value below the face value of the policy, but above its cash-surrender

⁶⁵ *Id.* at 156.

⁶⁶ *Id.*

⁶⁷ *See, e.g.*, IOWA CODE § 502.102(31A) (2009); ME. REV. STAT. tit. 32, § 16102(32) (2009); NEB. REV. STAT. § 8-1101(17) (2010); N.J. STAT. ANN. § 49:3-49(w) (2010); N.C. GEN. STAT. § 78A-2(13) (2009); N.D. CENT. CODE § 10-04-02(21) (2009); OHIO REV. CODE ANN. § 1707.01 (LexisNexis 2010); UTAH CODE ANN. § 61-1-13(1)(v) (LexisNexis 2009); WIS. STAT. § 551.102(32) (2009).

⁶⁸ *See* Jared Heady, *Regulating the Secondary Market for Life Insurance: Promoting Consistency to Maximize Utility*, 62 RUTGERS L. REV. 849, 851 (2010).

Since life insurance companies had universally decided to refuse buying back issued policies, policyholders who could not afford to continue paying premiums were left with the option to either default, and subsequently let their policy lapse, or seek liquidation at an auction. Seeing injustice in these limited options, Elizur Wright, known to many as ‘the father of life insurance,’ endeavored to attach a cash-surrender value to life insurance policies, an amount reflective of the market value for the policy that the issuing life insurance company would be required to pay if policyholders default or seek to liquidate their policy.

Id.

value, to an investor or a group of investors on the open market. Thus, instead of settling for the cash-surrender value, individuals seek to maximize the value of their life insurance policies by going to the open market.⁶⁹

From the paltry sum arising out of the cash-surrender practice, the secondary life insurance industry exists because investors make an arbitrage bet between a cash-surrender value and a policy's face value. Indeed, the bet is a gruesome one that the individual will die either as actuarially scheduled or before, and that the payment from the face value of the policy will exceed premiums paid in by a certain percentage.⁷⁰ The insured gains because she gets much-needed immediate cash flow from an insurance policy. Meanwhile, investors enter the market as an investment for an opportunity to reap double-digit returns on their capital in an alternative product. The policy ramifications of this market and the effect of insurable interest regulation on it will be discussed below.⁷¹ However, this section will seek to lay out the current legal landscape in the United States for the insurable interest doctrine as is expressed in laws governing the secondary market for life insurance settlements in three fields: (1) viatical settlements;⁷² (2) life settlements;⁷³ and (3) stranger-originated life insurance (STOLI) policies.⁷⁴

To date, states fall into a few distinct categories of insurable interest legislation. Very few locales attempt to prohibit the "secondary market" in insurance by creating strict insurable interest regimes that invalidate insurance policies if the beneficiary at the time that the death benefit pays out does not have an insurable interest. The more common tact in states like Virginia and North Carolina is to structure insurable interest laws around the Viatical Settlements Model Act (the NAIC Model Act)⁷⁵ developed by the National Association of Insurance Commissioners (the NAIC) and the

⁶⁹ Richard J. Fidel & Elizabeth M. Fohl, *2010 in Review: Ten Key Insurance Regulatory Topics That Shaped the Year*, 2010 EMERGING ISSUES 5465 (2011) (LEXIS); see also Scism, *supra* note 1.

⁷⁰ Mark Maremont & Leslie Scism, *SEC Probes Company over Life-Span Data*, WALL ST. J., Jan. 20, 2011, at C1.

⁷¹ See *infra* Part III.

⁷² A viatical settlement is a policy that is sold on the open market where the insured has less than 24 months to live. See *Life Partners, Inc. v. Morrison*, 484 F.3d 284, 287 (4th Cir. 2007).

⁷³ A life settlement is a policy that is sold on the open market where the insured has more than 24 months to live. See LIFE SETTLEMENTS MODEL ACT § (2)(L) (Nat'l Conf. of Ins. Legislators 2007), available at <http://www.ncoil.org/Private/2007/annual/AdoptedLifeSettlementsModel.pdf>.

⁷⁴ Stranger-originated life insurance policies are policies that are taken out by an insured, but are in fact paid for by an investor or other individual and sold immediately after the contestability period in a state expires. See *id.* § (2)(Y).

⁷⁵ VIATICAL SETTLEMENTS MODEL ACT (Nat'l Ass'n of Ins. Comm'rs 2009), available at http://www.naic.org/committees_index_model_description_r_z.htm#viatical_act.

Life Settlements Model Act (the NCOIL Model Act)⁷⁶ adopted by the National Conference of Insurance Legislators (the NCOIL). These states alter the insurable interest doctrine by creating extended contestability periods⁷⁷ for policies, or preserving insurable interest as a contestable point notwithstanding the running of a contestability period, or utilizing other alterations to the doctrine.⁷⁸ The most liberal state regime allows for the immediate transfer of insurance policies to a beneficiary without an insurable interest.⁷⁹

1. Federal Regimes on Insurable Interest

Before the particulars of state regulation are elucidated, it is of some note that there is already federal legislation on insurable interest in the Internal Revenue Code (the Tax Code).⁸⁰ The Tax Code explicitly deals with income from viatical settlements, and what qualifies as an “amount paid,” but does not seem to deal with standard life settlements.⁸¹ In some sense, the Tax Code does away with the insurable interest requirement itself when it states:

If any portion of the death benefit under a life insurance contract on the life of an insured . . . is sold or assigned to a viatical settlement provider, the amount paid for the sale or assignment of such portion shall be treated as an amount paid under the life insurance contract by reason of the death of such insured.⁸²

Thus, in a few words, the Tax Code—for purposes of deciding payment—places the assignee of a life insurance policy in the shoes of the insured. For any amounts received under an insurance policy, the assignee is taxed as though they were the insured—whether or not they exhibit an insurable interest—for federal purposes. Furthermore, the law sets out explicit definitions for what persons qualify as “terminally ill”⁸³ or “chronically ill,”⁸⁴

⁷⁶ LIFE SETTLEMENTS MODEL ACT (Nat’l Conf. of Ins. Legislators 2007).

⁷⁷ Contestability periods are discussed in more detail *infra* Part II.C.3.

⁷⁸ See, e.g., PHL Variable Ins. Co. v. Price Dawe 2006 Ins. Trust, 28 A.3d 1059, 1066 (Del. Sept. 20, 2011).

⁷⁹ See *Kramer v. Phoenix Life Ins. Co.*, 940 N.E.2d 535, 542 (N.Y. 2010).

⁸⁰ I.R.C. § 1 (2010).

⁸¹ See *id.* § 101(g) (This section is explicitly titled “Treatment of certain accelerated death benefits.”).

⁸² See *id.* § 101(g)(2)(A).

⁸³ See *id.* § 101(g)(4)(A) (“The term ‘terminally ill individual’ means an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification.”).

⁸⁴ See *id.* (“The term ‘chronically ill individual’ has the meaning given such term by section 7702B(c)(2); except that such term shall not include a terminally ill individual.” A “chronically ill individual” is defined in I.R.C. § 7702B(c)(2) as a person who is “unable to perform (without substantial assistance from another individual) at least 2 activities of daily

and carves out special circumstances for the individual brokering the sale of a viatical settlement and for a person receiving proceeds from such a settlement.⁸⁵

2. *The Model Codes and the States*

Despite the efforts of insurance law reformers to create a model code, a vast array of disparate state legislation exists in the insurable interest area. Due to the need to protect sick individuals and to create a transparent and fair viatical settlements market, the National Association of Insurance Commissioners developed the NAIC Model Act⁸⁶ and the Viatical Settlements Regulations⁸⁷ to guide states in their regulation of the viatical settlements industry. On the life settlements front, the National Conference of Insurance Legislators adopted the NCOIL Model Act. The model acts have grown over time to contain licensing requirements, contract statement requirements, reporting requirements and privacy, examinations and investigations, disclosure, general rules, prohibited practices, advertising requirements, fraud prevention and control, penalties for failure to comply, and unfair trade practices.⁸⁸ Various portions of these model acts have been adopted by the adherent states. One important difference between the model acts is the level to which they prohibit stranger-originated life insurance transactions—speaking most directly to the most vexing area of insurable interest jurisprudence. The NAIC Model Act imposes a five-year waiting period between the time of issuance of a life insurance policy and the time of entering into a life settlement contract.⁸⁹ That is, the NAIC Model Act would increase what is called a state’s “contestability period” beyond the currently standard two-year period.⁹⁰ These contestability periods act as the primary enforcement time when an insurable interest can be controverted by an insurance company. Thus, if a policy is taken out, and an insurable interest is found *not* to exist or some other defect is found in a policy during the contestability period, the policy can be retracted. After a contestability period runs, however, retracting the policy becomes much more difficult, and transferability by the consumer becomes much easier. For example, after the contestability period runs, any transaction—even if that transaction is to or from a stranger—is not able to be controverted by an insurance firm. The NCOIL Model Act, on the other hand, provides a definition of STOLI,

living for a period of at least 90 days due to a loss of functional capacity . . .”).

⁸⁵ See *id.* § 101(g)(2)–(3).

⁸⁶ VIATICAL SETTLEMENTS MODEL ACT (Nat’l Ass’n of Ins. Comm’rs 2009), available at http://www.naic.org/committees_index_model_description_r_z.htm#viatical_regulation.

⁸⁷ VIATICAL SETTLEMENTS MODEL REGULATION ACT (Nat’l Ass’n of Ins. Comm’rs 2009),

⁸⁸ See, e.g., LIFE SETTLEMENTS MODEL ACT (Nat’l Conf. of Ins. Legislators 2007).

⁸⁹ VIATICAL SETTLEMENTS MODEL ACT § 11(A) (Nat’l Ass’n of Ins. Comm’rs 2009).

⁹⁰ Heady, *supra* note 68, at 865 n.115.

which indicates that it is prohibited as a “fraudulent life settlement,” and subjects a provider, broker, or other person involved in a STOLI transaction to criminal penalties or sanctions.⁹¹ However, the NCOIL Model Act imposes only a two-year waiting period—subject to certain exceptions for terminally ill or chronically ill policy owners—prior to entering into a life settlement contract.⁹² That is, the NCOIL Model Act leaves room for individuals to quickly transfer their life policies and does not extend the waiting period beyond a customary two-year period.

Of particular import, the Tax Code adopts Sections 8 and 9 of the NAIC Model Act,⁹³ which outline disclosure requirements to both the vitiator and insurance company by the successor in interest to a policy, respectively.⁹⁴ Thus, in order to get the proper tax-free treatment for a death benefit paid out from an assigned viatical policy, one is pointed to the model law requirement—a rarity in the law—but also a clear indication of a public policy favoring disclosure in financial transactions, even ones dealing in personal life insurance. On the life settlements front, the Internal Revenue Service (the IRS) released Revenue Ruling 2009-13, to attempt to clarify the issue of what is taxable at the regular income rate and what is taxable as capital gains.⁹⁵ However, the guidance is unclear and the Life Insurance Settlement Association has asked for a clarification of the issues from the IRS.⁹⁶

Jared Heady conducted a very helpful survey of insurable interest regulations in early 2010;⁹⁷ however, given the relative rapidity of change in this market, even that survey is slightly out of date. The most recent surveys by the NAIC come to the following findings:

Five states have adopted the NAIC Model Act in a uniform and substantially similar manner Thirteen states [have] adopted [at least] some portions of the NAIC Model Act. [Other] states have undertaken “related state activity” in the area of life settlements. In all, 44 states are identified as having adopted legislation relating to life settlements under state insurance law. Among states that have recently enacted life-settlement related legislation, the majority have followed the NCOIL model act or have combined elements of the NAIC and NCOIL model acts. The NAIC identifies approximately

⁹¹ LIFE SETTLEMENTS MODEL ACT § 2(H)(1)(a)(x) (Nat’l Conf. of Ins. Legislators 2007).

⁹² LIFE SETTLEMENTS MODEL ACT § 11(N) (Nat’l Conf. of Ins. Legislators 2007).

⁹³ See 26 U.S.C. § 101(g)(2)(B)(ii)(I) (2010).

⁹⁴ VIATICAL SETTLEMENTS MODEL ACT §§ 8–9 (Nat’l Ass’n of Ins. Comm’rs 2009).

⁹⁵ Rev. Rul. 2009-13, 2009-21 I.R.B. 1029.

⁹⁶ See *Tax Implications of Life Settlement Transactions*, LIFE INS. SETTLEMENT ASS’N, <http://www.thevoiceoftheindustry.com/content/42/Tax-Implications-of-Life-Settlement-Transactions.aspx> (last visited Oct. 3, 2011).

⁹⁷ See Heady, *supra* note 68, at 866–74.

30 states where life settlement legislation, including anti-STOLI legislation, has been enacted since spring of 2008. Of these, [fourteen] tracked the NCOIL model act provisions, and 12 states enacted hybrid legislation, combining elements of the NAIC and NCOIL model acts.⁹⁸

What is somewhat odd about these new restrictions enacted by the Model Act makers is that they appear to be similar to those enacted by the Marine Insurance (Gambling Policies) Act of 1909⁹⁹—in that they are piecemeal legislation that does not address the whole market, with heavy, possibly criminal, sanctions attached—yet none seem to cite to the 1909 Act. It should also be noted that the criminal provisions in the 1909 Act went relatively unused; it is yet to be seen whether the NCOIL Model Act’s criminal provisions will suffer the same fate.¹⁰⁰

3. *New York vs. Delaware and the Quagmire of Disagreement*

The most recent developments in the U.S. insurable interest arena come not from statute, but rather from divergent state supreme court rulings in New York¹⁰¹ and Delaware,¹⁰² decided roughly one year apart. The New York court dealt a fatal blow to the insurable interest doctrine in that jurisdiction.¹⁰³ In contrast, the insurable interest doctrine not only endures in Delaware,¹⁰⁴ but also is firmly declared to be a valid defense even after the

⁹⁸ SECS. & EXCH. COMM’N, LIFE SETTLEMENTS TASKFORCE REPORT 35 (July 22, 2010) [hereinafter SEC REPORT] (citation omitted), available at <http://www.sec.gov/news/studies/2010/lifsettlements-report.pdf> (citing two documents prepared by the NAIC: (i) an April 2010 NAIC Model Act state adoption table and (ii) a June 2010 viatical settlements/STOLI legislation survey). The five states that had adopted the NAIC Model Act in a uniform and substantially similar manner were Nebraska, North Dakota, Oregon, Vermont, and West Virginia. *Id.* at 35 n.163. The thirteen states that had adopted at least some portions of the NAIC Model Act were Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Minnesota, Nevada, Ohio, Oklahoma, Rhode Island, Tennessee, and Washington. *Id.* at 35 n.164. The states that had undertaken “related state activity” had adopted an older version of the NAIC Model Act, legislation or regulation derived from other sources, bulletins, and administrative rulings. *Id.* at 35 n.165. The SEC noted that of the 44 states identified by the NAIC as having adopted legislation relating to life settlements under state insurance law, a few “regulate only viaticals (sale of a life insurance policy by a person who is terminally or chronically ill) and not all life settlements.” *Id.* at 35 n.166. Additionally, as of July 22, 2010, the date of the SEC’s report, 45 states had adopted legislation relating to life settlements, as New Hampshire had just recently enacted life settlement legislation. *Id.*

⁹⁹ 1909, 9 Edw. 7, c. 12 (Eng.).

¹⁰⁰ See SUTTON, *supra* note 11, at 531.

¹⁰¹ See *Kramer*, 940 N.E.2d 535.

¹⁰² See *Dawe*, 28 A.3d 1059; *Lincoln Nat’l Life Ins. Co. v. Joseph Schlanger 2006 Ins. Trust*, 28 A.3d 436 (Del. Sept. 20, 2011).

¹⁰³ See *Kramer*, 940 N.E.2d at 542.

¹⁰⁴ See *Dawe*, 28 A.3d at 1073–74 (“Although the statute has been periodically updated,

expiration of a two-year contestability period for an insurance policy,¹⁰⁵ as the Delaware Supreme Court describes in twin cases decided on the same day. This rift among arguably the two most important states for the investment and creation of life and casualty insurance will likely create dramatic uncertainty in the market for insurance products, and offer insurers and insureds an opportunity to structure even more complex insurance products to subvert the rulings.

a. New York & The Case of Arthur Kramer

Notwithstanding many states' adoptions according to the Model Acts, one important state stands apart from the rest: New York. In the case of *Kramer v. Phoenix Life Insurance Co.*, the New York Court of Appeals determined that New York law permits a person to procure an insurance policy on her own life and immediately transfer it to one without an insurable interest in that life, even where the policy was obtained for the purpose of such an immediate transfer.¹⁰⁶ In *Kramer*, Arthur Kramer—a prominent New York lawyer and founder of Kramer, Levin, Naftalis & Frankel LLP—was approached by an insurance broker offering to turn life insurance policies into cash without any obligation on Kramer's part.¹⁰⁷ Kramer assented to the creation of two trusts that would later be funded with insurance policies issued on his life upon death.¹⁰⁸ Two trusts were formed, with the interest in those trusts initially issued in the names of Kramer's children, for the purposes of procuring the life insurance that would fund the trust.¹⁰⁹ Immediately following the insurance purchases, the interests in those trusts were assigned, so as to reduce Kramer's potential premium liability.¹¹⁰ Policy arguments in that court were three-fold, and similar to those we have seen throughout the history of the insurable interest requirement, as discussed above: (i) a policy obtained with the intent to assign to a party lacking insurable interest violates statutory language; (ii) in accordance with the common law rule, an insured can only assign a policy if obtained in "good

the substance of Delaware law on insurable interest has remained the same. An insured is permitted to take out an insurance policy on his own life, but the law prohibits persons other than the insured from procuring or causing to be procured insurance, unless the benefits are payable to one holding an insurable interest in the insured's life.”).

¹⁰⁵ See *Schlanger*, 28 A.3d at 441 (“[I]f a life insurance policy lacks an insurable interest at inception, it is void *ab initio* because it violates Delaware’s clear public policy against wagering. . . . As a result, the incontestability provision does not bar an insurer from asserting a claim on the basis of a lack of insurable interest after the []contestability period expires.”).

¹⁰⁶ *Kramer*, 940 N.E.2d at 542.

¹⁰⁷ *Id.* at 537.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 538.

¹¹⁰ *Id.* at 537–39.

faith” as a real insurance policy first; and (iii) a person does not act of their own initiative if he or she obtains an insurance policy only at the suggestion of another.¹¹¹

The New York Court of Appeals strongly put these arguments to rest by stating, “[t]here is simply no support in . . . [New York’s] statute [(N.Y. Ins. Law § 3205)] for . . . [the] . . . argument that a policy obtained by the insured with the intent of immediate assignment to a stranger is invalid.”¹¹² The New York court interpreted language in §3205(b) of New York’s Insurance Law, which explicitly allows for “immediate transfer or assignment”¹¹³ of a life insurance policy, as “evidently anticipat[ing] that an insured might obtain a policy with the intent of assigning it, since one who ‘immediately’ assigns a policy likely intends to assign it at the time of procurement.”¹¹⁴ With such sweeping language, the “good faith” common law argument was also swept away—as the court read any “good faith” requirement out of the statutory language, which so manifestly allowed for immediate assignment.¹¹⁵ Finally, the court does not allow for the argument that the insured must make the policy of his or her own initiative by stating, “[t]he initiative requirement, without more, does not prohibit an insured from obtaining a policy pursuant to a non-coercive arrangement with an investor.”¹¹⁶

The dissent, on the other hand, asserts standard public policy concerns against wagering.¹¹⁷ These concerns, however, seem to have lost favor with the court, as evidenced by the majority opinion in *Kramer*, and, by extension, the New York State Legislature. In fact, the dissent admits, “[i]n a sense, of course, all insurance is a bet, but for most of us who buy life in-

¹¹¹ *Id.* at 540.

¹¹² *Kramer*, 940 N.E.2d at 541.

¹¹³ N.Y. Ins. Law § 3205 (McKinney 2007).

¹¹⁴ *Kramer*, 940 N.E.2d at 541.

¹¹⁵ *Id.* at 542.

In light of the overwhelming textual and historical evidence that the Legislature intended to allow the immediate assignment of a policy by an insured to one lacking an insurable interest, we are not persuaded by plaintiff and the insurers’ argument that section 3205(b) is limited by the common law requirement that an insured cannot obtain a life insurance policy with the intent of circumventing the insurable interest rule by immediately assigning it to a third party. To the extent that there is any conflict, the common law has been modified by un-ambiguous statutory language.

Id. (citations omitted).

¹¹⁶ *Id.* at 541. (addressing the following language in the dissenting opinion: “My view of New York law is that where, as in this case, an insured purchases a policy on his own life for no other purpose than to facilitate a wager by someone with no insurable interest, the transaction is unlawful.” (Smith, J., dissenting)).

¹¹⁷ *Id.* at 543–44 (Smith, J., dissenting).

surance it is a bet we are happy to lose.”¹¹⁸ The dissent goes on to lay out the logic behind immediate transfer transactions as driven by “a belief that the insured’s life expectancy is less than what the insurance company thinks it is.”¹¹⁹ The dissent also makes clear that this is a point about risk, and that the risk of knowledge about health is the issue.¹²⁰ The dissent states that “we may be . . . confident that the purchasers in this case thought, probably with good reason, that they knew something about Arthur Kramer’s health that the insurance companies did not know.”¹²¹ Thus, the dissent adopts the position that insurance policies should be freely assignable with *one* exception: “where the insured, at the moment he acquires the policy, is in substance acting for a third party who wants to bet on the insured’s death,”¹²² as a “cloak for a wager.”¹²³ Thus, in New York, where even the *dissent* accepts most treatments of life insurance as a piece of property, the weakness of the insurable interest doctrine is evident. Presciently, the dissent ends with, “insurable interest rules, as our opinions in this case surely demonstrate, are tricky to handle.”¹²⁴

To be clear, the NCOIL Model Act was drafted to *penalize* just this type of transaction.¹²⁵ The NCOIL recommended, in 2007, that “states should consider adopting an amendment to their insurable interest laws, if necessary, to provide additional protection against trust-initiated STOLI and other schemes involving a cloak . . .”¹²⁶ The National Conference of Commissioners on Uniform State Laws (the NCCUSL) seems to be in a bit of a tension with the NCOIL over this point, as the former seeks to explicitly amend the Uniform Trade Code (the UTC) to allow not only for the use of such trust instruments, but also for the additional protection afforded by these trusts being linked to an individual who *would have* (as opposed to an individual who *has*) an insurable interest according to common law consanguinity.¹²⁷ This amendment came about because the definition of insurable interest became a matter of widespread concern among trust and estate planners after *Chawla v. Transamerica Occidental Life Insurance Co.*,¹²⁸

¹¹⁸ *Id.* at 544.

¹¹⁹ *Id.*

¹²⁰ *Kramer*, 940 N.E.2d at 544.

¹²¹ *Id.*

¹²² *Id.* at 543.

¹²³ *Id.* at 559.

¹²⁴ *Id.* at 546.

¹²⁵ See LIFE SETTLEMENTS MODEL ACT, first drafting note (Nat’l Conf. of Ins. Legislators 2007).

¹²⁶ *Id.*

¹²⁷ See INSURABLE INTEREST AMENDMENTS TO THE UNIFORM TRUST CODE §113(b) (Nat’l Conf. of Comm’rs on Unif. State Laws 2010), available at <http://www.law.upenn.edu/bll/archives/ulc/iirta/2010final.pdf>.

¹²⁸ No. CIV.A. 03-CV-1215, 2005 WL 405405 (E.D. Va. Feb. 3, 2005), *aff’d in part, va-*

where a Virginia federal district court applying Maryland law held that a trust did not have an insurable interest in the life of the insured who was the settlor and creator of the trust.¹²⁹ This *Chawla* problem permeates various areas of insurance law and presents several legal and moral problems for policy makers.

The NCCUSL appears to be engaging in a standard interpretive maneuver—as to insurable interest, at least—of expanding the definition of an insurable interest to fix a common law determination that puts certain persons outside that definition. The NCCUSL states, “if on the date the policy is issued the trustee has an insurable interest in the individual whose life is insured, the policy is not subject to being declared void for lack of such an interest.”¹³⁰ However, the UTC revision attempts to establish, “the requirement that the proceeds of a life insurance policy used to fund the trust be payable primarily to certain types of trust beneficiaries.”¹³¹ Thus, as currently drafted, the UTC allows an insurable interest to vest in a trust at the time of inception, while the UTC amendment provides only that the “proceeds” from a life insurance policy be payable to certain types of beneficiaries. An issue with the amendment’s limitation is that it is unclear whether the limitation applies at the time of the formation of the trust and insurance policy or thereafter. Indeed, regardless of when the limitation applies, the proceeds always have the likelihood of being paid out to any designated or assigned individual, regardless of his or her insurable interest, after the time that a state contestability period has run.

Kramer and the UTC Amendments together appear to merely be continuing the gradual evisceration of the insurable interest doctrine in the United States. Indeed, in New York, the doctrine seems to be completely eviscerated—however, a series of complex procedures (like those in *Kramer*) are still required to work around the insurable interest doctrine. Such gradual evisceration in “an ever-broadening approach to insurable interests,” merely creates massive transaction costs and uncertainty for individuals seeking to alienate their life insurance as property.¹³²

b. Delaware & A Strong Comeback for Insurable Interest

In 2011, the Delaware Supreme Court was presented in the case of *PHL Variable Insurance Co. v. Price Dawe 2006 Insurance Trust* with

cated in part, 440 F.3d 639 (4th Cir. 2006).

¹²⁹ *Id.* at *6.

¹³⁰ INSURABLE INTEREST AMENDMENTS TO THE UNIFORM TRUST CODE §113, cmt., ll. 13–15 (Nat’l Conf. of Comm’rs on Unif. State Laws 2010).

¹³¹ *Id.* at ll. 40–41.

¹³² *Mayo v. Hartford Life Ins. Co.*, 354 F.3d 400, 408 (5th Cir. 2004) (indicating that a federal court sitting in diversity ought not to disturb a complex and wide-ranging state statute).

three questions of law certified by the U.S. District of Delaware.¹³³ First, whether Delaware law permitted an insurer to challenge the validity of a life insurance policy based on a lack of insurable interest after the expiration of a two-year contestability period required by Delaware statute.¹³⁴ Second, whether Delaware law permits an insured from procuring a policy on his or her own life with the intent to immediately transfer that policy, or a beneficial interest in a trust that owns and is the beneficiary of the policy, to a person without an insurable interest in the insured's life.¹³⁵ Third, whether Delaware law confers upon the trustee of a Delaware trust established by an individual insured an insurable interest in the life of that individual when, at the time of the application for life insurance, the insured intends that beneficial interest in the Delaware trust to be transferred to a third-party investor with no insurable interest in the individual's life following the issuance of the life insurance policy.¹³⁶ On each of these questions, the Delaware court came out strongly on the side of solidifying the insurable interest doctrine's survival in Delaware.

On the first question, the Delaware court explained, “[a]n incontestability clause is a contractual provision wherein the insurer agrees that, after a policy has been in force for a given period of time, that it will not contest the policy based on misrepresentations in the insurance application.”¹³⁷ Historically, such clauses were introduced because “insureds sometimes paid premiums for a long period of time only to have the insurer declare the contract void because of [innocent and minor] misrepresentations in the application.”¹³⁸ Counteracting such negative consequences, incontestability clauses function as a sort of statute of limitation and repose, “provid[ing] security in financial planning for the insured, while also providing an insurer a reasonable opportunity to investigate any misrepresentations in the application.”¹³⁹ Today, forty-three states have adopted mandatory incontestability clauses relating to life insurance policies, while four states have also adopted incontestability clauses relating to other types of insurance.¹⁴⁰ Thus, incontestability clauses have become an industry standard.¹⁴¹

In answering the first question, the Delaware Supreme Court employed a fraud in the factum theory,¹⁴² and essentially granted a permanent option

¹³³ 28 A.3d 1059, 1064 (Del. 2011).

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.* at 1065.

¹³⁸ *Id.*

¹³⁹ 28 A.3d at 1065.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.* at 1067 (“As with all contracts, fraud in the inducement renders a life insurance

to insurance companies, allowing insurers to check the validity of an insurable interest in an insurance policy at any time, by stating:

Under Delaware common law, if a life insurance policy lacks an insurable interest at inception, it is void *ab initio* because it violates Delaware's clear public policy against wagering. It follows, therefore, that if no insurance policy ever legally came into effect, then neither did any of its provisions, including the statutorily required incontestability clause.¹⁴³

This statement of policy, while seemingly meager on its face, creates a clear advantage for insurance companies over insureds or consumers. Under this standard, if an insurance company feels that its investment in an insured is not meeting the actuarial standards the company determined at the outset of a policy, then the insurance company can challenge the validity of that policy *at any time* for any misrepresentation relating to possible flaws in the statement of an insurable interest at inception. Thus, a clear message has been sent out to investors in the life insurance market—stay out, or face the near certainty of a protracted legal battle that will invalidate your investment vehicle. The permanency of this option creates an invaluable advantage for insurers, as insurers are more likely to challenge a policy the more unprofitable the policy looks. Indeed, a perverse incentive is created to see how low the price of a policy can go, before an insurance company essentially “shorts” the policy and moves for invalidation in the court system to save money in precise congruence to the losses it is experiencing between the actuarial value of the policy at its outset and the value of the policy at the time of challenge.

In answering the second question presented to it, the Delaware Supreme Court attempted to blunt the impact of its answer to the first question by allowing an insured the right to take out a policy with the intent to immediately transfer the policy, but the court also limited such right to “bona fide sales of [a] policy taken out in good faith.”¹⁴⁴ The court explained that:

policy voidable at the election of the innocent party. Certain agreements, however, are so egregiously flawed that they are void at the outset. These arrangements are often referred to as void *ab initio* Fraud in the factum occurs when a party makes a misrepresentation that is regarded as going to the very character of the proposed contract itself, as when one party induces the other to sign a document by falsely stating that it has no legal effect. If the misrepresentation is of this type, then there is no contract at all, or what is sometimes anomalously described as void, as opposed to voidable, contract.”)

¹⁴³ *Id.* at 1067–68. The *Schlanger* case uses identical reasoning to the *Dawe* case. See *Lincoln Nat'l Life Ins. Co. v. Joseph Schlanger 2006 Ins. Trust*, 28 A.3d 436, 441 (Del. Sept. 20, 2011) (“Under Delaware common law, if a life insurance policy lacks an insurable interest at inception, it is void *ab initio* because it violates Delaware's clear public policy against wagering.” (internal citation omitted)).

¹⁴⁴ *Dawe*, 28 A.3d at 1076.

[I]f a third party financially induces the insured to procure a life insurance contract with the intent to immediately transfer the policy to a third party, the contract lacks an insurable interest. . . . The relevant inquiry is who procured the policy and whether or not that person meets the insurable interest requirements.¹⁴⁵

Thus, the court created a rather difficult-to-enforce standard which said, “if a third party funds the premium payments by providing the insured the financial means to purchase the policy then the insured does not procure or affect the policy.”¹⁴⁶ The Delaware Supreme Court also distinguished the *Kramer* case as being “decided on a narrow set of issues applying unique New York insurance statutes.”¹⁴⁷ However, the statutory distinction made by the Delaware court is somewhat inapposite to the broad policy statement made by the *Kramer* court that individuals are considered to take life policies out of their own initiative, even if assisted by an investor.¹⁴⁸ The Delaware court rightly noted that “after *Kramer* the New York legislature revised the state’s insurance laws”¹⁴⁹ to prohibit persons from “directly or indirectly engag[ing] in any act, practice or arrangement that constitutes stranger-originated life insurance.”¹⁵⁰ However, this notation does not vitiate the New York court’s reasoning in the absence of such a knee-jerk ban on transactions. It should also be of some note that the Delaware court’s broad statement that the New York statutory change in effect “limit[s] the precedential value of *Kramer*,”¹⁵¹ is inapposite inasmuch as prohibiting STOLI transactions may be related to but is fundamentally different from allowing immediate assignment of policies.

This standard the Delaware Supreme Court laid down is rife with problems. First, it is difficult to enforce. Second, in light of an insurance company’s ability to inspect issues dealing with insurable interest at any time, financial transactions that were sound enough to create an insurable interest at the inception of a contract, may be viewed as illogical by a court five, ten, or fifty years after the inception of a policy. When an insured is long dead, it becomes particularly difficult to glean his or her intent, or to discern how certain cash flows that may *seem* to lack an insurable interest in fact do so. For example, if an individual procures a loan from a friend (or a bank) that funds the individual’s purchase of a life insurance policy in 2011, but

¹⁴⁵ *Id.* (“Stated differently, if an insured procures a policy as a mere cover for a wager, then the insurable interest requirement is not satisfied.”).

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* at 1075.

¹⁴⁸ *See Kramer*, 940 N.E.2d at 541.

¹⁴⁹ *Dawe*, 28 A.3d at 1075.

¹⁵⁰ N.Y. INS. LAW § 7815 (McKinney 2007).

¹⁵¹ *Dawe*, 28 A.3d at 1075.

the individual later sells that policy because he cannot pay the loan back to the same friend (or bank) that gave him or her the loan, then the policy *looks* like it lacked an insurable interest at its inception. However, suppose that those are the only facts that a court has after the individual is deceased in 2051; then, it *looks* like the friend (or bank) funded the initial premiums of the policy. In essence, the Delaware court was left with the same structuring issues it had before it decided question number two. Once more, the assertion of an insurable interest doctrine creates litigation uncertainty that favors insurance companies over an insured or an investor in an insurance policy. Allowing an individual to later transfer the policy, as the Delaware court did, is a half-measure that has all the same problems of a very strictly-enforced insurable interest policy.

As to the third question, relating to trusts, the Delaware Supreme Court takes a further half-measure to protect the insurable interest doctrine. The court stated:

Where the individual insured creates a trust to hold a life insurance policy on his life and funds the trust with that policy or with money to pay its premiums then the trustee¹⁵² has the same insurable interest that the settlor¹⁵³ has in his own life. Thus we only inquire whether the owner (either the insured or the trust) has an insurable interest in the insured's life at the policy's inception and not whether the beneficiaries of the policy have an insurable interest. If the individual insured creates and initially funds the trust, then the trustee has an insurable interest without regard to how the trust beneficiaries obtained their interest.¹⁵⁴

This statement of law does not necessarily solve the problem that the Delaware court sought to solve in its answers to the first two questions asserting the strength of the insurable interest doctrine. Rather, this third response will serve to alter the way the market is structured for investment in life insurance. Individuals seeking to create a marketable financial product with their life insurance policies will now need simply to create a trust, create the appearance of an insurable interest in an insured's life at the inception of a policy, then fund the trust with that policy, followed by allowing individuals—regardless of their affiliation with the insured—to procure beneficial interests in the trust. The trust mechanism ruling only serves to allow the market for “cloaks” to flourish by allowing stranger investors in life insurance through the door of trust law and not insurance law. This rul-

¹⁵² A trustee is an individual who represents a fiduciary legal interest for the trust and its execution.

¹⁵³ A settlor is the creator of a trust who funds the initial trust corpus.

¹⁵⁴ *Dawe*, 28 A.3d at 1075.

ing, however, does avoid the *Chawla* problem¹⁵⁵ of a trust not having an insurable interest in the life of the insured, even when the insured was the settlor and creator of the trust.¹⁵⁶ Here, a trust *can* have an insurable interest.

The enforcement mechanism that the Delaware Supreme Court created is similar to that in its response to the second certified question presented: “In cases where a third party either directly or indirectly funds the premium payments as part of a pre-negotiated arrangement with the insured to immediately transfer ownership, the policy fails at its inception for a lack of insurable interest.”¹⁵⁷ Not only is this enforcement mechanism difficult to discern through decades-old financial statements, but it also creates a current problem. Since individuals now are disallowed from procuring insurance policies funded by a third party, either directly or indirectly, persons seeking to invest in the life insurance market will engage in a black market for investment in such policies. That black market will be created by unspoken agreements to fund the inception of life insurance policies, thus artificially creating the appearance of an insurable interest. Therefore, what is allowed to be express and written down under New York law—that is, that an insurance policy is intended for immediate transfer—must remain unspoken under Delaware law.¹⁵⁸

Furthermore, even if the Delaware ruling is completely enforceable, it limits investment in life insurance policies to the wealthy, or to those individuals who can *bona fide* purchase expensive life insurance policies for later sale. Suppose a person of lower financial means desired to enter the market for life insurance because he or she is of current good health and needs an investment that will yield cash quickly. If the Delaware ruling were taken to its logical conclusion, this person would have to take out an insurance policy and pay all of its premiums up front in the hopes that an investor would purchase the policy at a later date. Taken one step further, if this individual did not have the money to purchase the policy now, and sought a loan for the payment of the proceeds, so that he can later cash it out, such a loan would *look* like an attempt by a third party to induce the purchase of an insurance policy, which may lead to its invalidation at a later date. Thus, derivatively, the market for loans to help low-income individuals procure life insurance will dry up due to the legal uncertainty now asso-

¹⁵⁵ See *supra* Part II.C.3.a.

¹⁵⁶ *Chawla*, 2005 WL 405405.

¹⁵⁷ *Dawe*, 28 A.3d at 1078.

¹⁵⁸ It should be noted that this scenario in life-policy loan industry has recently come under scrutiny in Florida. See Leslie Scism, *Life-Policy Loans Under Scrutiny*, Wall St. J., Oct. 4, 2011, at C1 (“Federal and state courts long have upheld consumers’ rights to sell their policies to outside investors. What insurers say sets . . . [life-policy loans] apart from these longstanding policy sales is the role of agents and other commission-based middlemen in allegedly inducing older people to take out policies with the intent to sell them.”).

ciated with an unlimited ability by insurance companies to challenge the insurable interest underlying an insurance policy. Logically, then, if individuals of lower financial means learn of the legal uncertainty associated with such a market, they will either be driven out, or they will be exploited by persons who induce them to use whatever means they have to pay for the premiums of a policy now, on unwritten promises that these persons will purchase the policy after the applicable contestability period has run.

It should be clear from the above analysis that while the Delaware Supreme Court had good intentions in strengthening the insurable interest doctrine to prevent wagers, its decision merely created a market where what can be in writing in New York—due to *Kramer*—has been relegated to the status of a *sub rosa* black market. Not only does the *Dawe* ruling create an internal investment problem for the life insurance market *within* Delaware, but it also creates interstate uncertainty, as a severe conflict of law is created between Delaware and New York's standards for the insurance market. With its ruling in *Dawe*, Delaware also falls behind its peer capital markets in England and Australia, which have engaged in the modernization of their insurance markets by eliminating the insurable interest doctrine and, thus, streamlining regulation of the markets.

III. A DOCTRINE CREATES A MARKET: INSURABLE INTEREST AND THE LIFE SETTLEMENT INDUSTRY

A. The Secondary Life Insurance General Market Structure and Size

The legal structure described in Part II lays the groundwork for the modern market for secondary life insurance, where most interesting questions about insurable interest dwell. This part will seek to explain how legal tools are used to create the life settlement market, the structure of which is driven primarily by the insurable interest doctrine. This part will also seek to show that the insurable interest doctrine causes market contortions that create unnecessary transaction costs without any payoff.

The need for cash flow by insurance policy holders has created the three different types of life settlement products discussed above: viatical settlements,¹⁵⁹ life settlements, and pure stranger-originated life insurance.

¹⁵⁹ This interesting nomenclature of “viatical settlement” was traced by the Fourth Circuit fairly recently in *Life Partners, Inc. v. Morrison*:

A “viaticum” in ancient Rome was a purse containing money and provisions for a journey. A viatical settlement, by which a dying person is able to acquire provisions for the remainder of his life’s journey by selling his life insurance policy, is thus thought to provide a viaticum. In the language of the industry, the insured is the “viator,” who sells his policy at a discount to a “provider” of the viaticum. 484 F.3d 284, 287 (4th Cir. 2007).

A more recent iteration on the life settlement market is stranger-originated annuity transactions, which function in essentially the same way as the other three products, with the exception that the underlying insurance product is an annuity.¹⁶⁰ Viatical settlements are important because they are viewed as the beginning of the modern market for secondary life insurance policies.¹⁶¹ As the AIDS epidemic raged on in the 1980s, medical care became increasingly expensive, while individuals with AIDS had predictably short life spans.¹⁶² Thus, many individuals with AIDS who had life insurance policies sought to cash out the policies and avoid paying their premiums by alienating their estate's rights to collect the death benefit of the policies.¹⁶³ In essentially the same manner as previously described,¹⁶⁴ an investor (or group of investors) would pay the insured a sum discounted from the face value of the policy, but more than the cash-surrender value. In return for an up-front cash value, as well as a guarantee that the premiums for the insurance policy will be paid, the insured (or the insured's beneficiaries) transfer the right to collect the death benefit to the investors. Viatical settlements qualify as a distinct category because they are generally regarded to be properly issued to individuals with (a) an illness; and (b) 24 months or less left on their life expectancy.¹⁶⁵ Life Settlements, on the other hand, are issued to individuals with greater than 24 months to live.¹⁶⁶ Generally, these settlement transactions are engaged in with a growing group of elderly individuals and retiring baby boomers who already have high net worth but are seeking cash. The legal structure of life settlements does not differ in any material respect from viatical settlements.

Stranger-originated life insurance policies engage with trust law in an interesting way. These policies engage in various ways to thwart the insurable interest doctrine. They are generally structured as follows: (1) an investor induces a person, typically falling into the viatical or life settlement category, to purchase a life insurance policy that the person likely would not have otherwise purchased; (2) the person applies for the policy (becoming the insured) with the prior understanding that he or she will cede control of the policy to the investor; (3) the investor and the insured agree that at the end of a state's contestability period for an insurance policy, ownership of the policy will be transferred to the investor, or some third party, who

¹⁶⁰ INSURABLE INTEREST AMENDMENTS TO THE UNIFORM TRUST CODE §113(b) (Nat'l Conf. of Comm'rs on Unif. State Laws 2010).

¹⁶¹ See *Life Partners, Inc. v.*, 484 F.3d at 287.

¹⁶² See *id.*

¹⁶³ See *id.*

¹⁶⁴ See *supra* notes 68–69 and accompanying text.

¹⁶⁵ SEC REPORT, *supra* note 98, at n.2.

¹⁶⁶ *Id.*

expects to receive the death benefit when the insured dies.¹⁶⁷ The two parties must wait the duration of the contestability period provided for insurance policies by a state—typically two years—before transferring the policy, because during that time insurance companies may seek to have the policies judicially invalidated for want of an insurable interest.¹⁶⁸ Generally, after the contestability period of a life insurance policy runs, the insurer is prohibited from contesting the policy based on misrepresentations by the insured.¹⁶⁹

Conning Research and Consulting, Inc., an insurance industry observer, reports on the life settlements industry and produces an annual study. In 2007, Conning Research estimated that the market, then estimated at \$12 billion in face amount of life insurance settled,¹⁷⁰ would grow to \$90–\$140 billion in face amount settled by 2016.¹⁷¹ Conning Research later estimated that \$11.7 billion of face amount in life insurance was settled in 2008,¹⁷² putting growth in the market from 2007 to 2008 at slightly below zero. BusinessWeek estimated the market for unwanted life insurance policies at \$15 billion in face amount during 2008.¹⁷³ More recently, the amount settled has declined due to the economic recession of 2008. Conning Research estimated that \$8 billion of life insurance face value settled in 2009,¹⁷⁴ while annual volume dropped to \$3.8 billion face in 2010, reflecting sustained buyer's market conditions.¹⁷⁵ Even if these estimates are off by several magnitudes, it is clear that there is massive market demand for such products, even despite the massive drop in the face value of such products in 2010.

¹⁶⁷ See SEC REPORT, *supra* note 98, at 11.

¹⁶⁸ RUSS & SEGALLA, *supra* note 2, § 240:1.

¹⁶⁹ *Id.*

¹⁷⁰ Press Release, Conning Research and Consulting, Life Settlements—New Challenges to Growth (Oct. 8, 2008), *available at* <http://www.conning.com/pressreleasedetail.aspx?id=154>.

¹⁷¹ See Sam Rosenfeld, *Life Settlements: Signposts to a Principal Asset Class 3* (Wharton Financial Institutions Center, Working Paper No. 09-20), *available at* <http://fic.wharton.upenn.edu/fic/papers/09/0920.pdf> (citing Conning Research and Consulting's 2007 publication LIFE SETTLEMENT MARKET: INCREASING INVESTOR AND CAPITAL DEMAND).

¹⁷² Press Release, Conning Research and Consulting, Life Settlements: A Buyers' Market for Now (Oct. 8, 2009), *available at* www.conning.com/pressrelease-detail.aspx?id=3447.

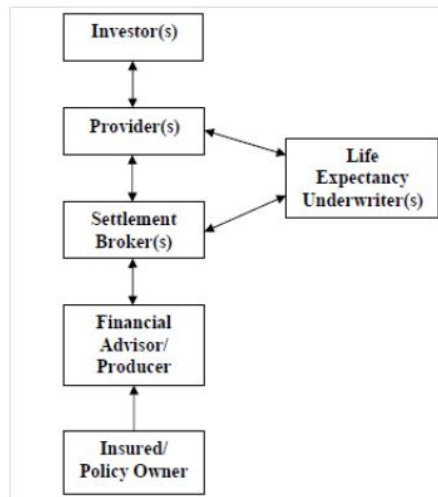
¹⁷³ Matthew Goldstein, *Why Death Bonds Look so Frail*, BUS. WK. (Feb. 25, 2008, 5:00 PM), http://www.businessweek.com/magazine/content/08_08/b4072040348943.htm.

¹⁷⁴ Press Release, Conning Research and Consulting, U.S. Life Settlements Annual Volume Dropped 36% in 2009 (Oct. 28, 2010), *available at* www.conning.com/pressrelease-detail.aspx?id=4818.

¹⁷⁵ Press Release, Conning Research and Consulting, Life Settlements: An Asset Class Resets (Oct. 5, 2011), *available at* <http://www.conning.com/pressrelease-detail.aspx?id=5971>.

B. Actors Effectuating the Mechanics of Subverting the Insurable Interest Law

In order to get around insurable interest laws effectively, a number of market intermediaries become necessary to effectuate the secondary life insurance market. Although life settlement transactions may be termed in the above three different ways (viatical settlements, life settlements, and STOLI), they typically involve an insured individual, or the owner of the policy, a producer who may be a financial advisor or an insurance agent, one or more settlement brokers who may also be insurance agents, one or more life expectancy underwriters, one or more providers who typically represent the party acquiring the policy, and one or more investors.¹⁷⁶ A 2010 Securities and Exchange (“SEC”) Report on this subject provides a compelling graphical representation of all of the players in the market:¹⁷⁷



As the SEC image illustrates, the number of actors involved in the creation of just one single life insurance transaction make transaction costs in this area high, as parties to the investment must go through several intermediaries in order to transact in the sphere. But, the SEC characterization does not capture all of the relevant actors in the life settlement, viatical settlement, and stranger-originated life insurance markets,¹⁷⁸ which include: the insured,¹⁷⁹ owner,¹⁸⁰ broker,¹⁸¹ provider,¹⁸² investment agent,¹⁸³ purchas-

¹⁷⁶ See SEC REPORT, *supra* note 98, at 6.

¹⁷⁷ *Id.*

¹⁷⁸ See generally Heady, *supra* note 68.

¹⁷⁹ “[T]he person covered under the policy being considered for sale in [the secondary market for life insurance],” is generally referred to as the ‘insured.’ LIFE SETTLEMENTS

er,¹⁸⁴ financing entity,¹⁸⁵ special purpose entity,¹⁸⁶ and life insurance pro-

MODEL ACT § 2I (Nat'l Conf. of Ins. Legislators 2007).

¹⁸⁰ “[T]he owner of a life insurance policy or a certificate holder under a group policy, with or without terminal illness, who enters or seeks to enter into [a settlement on the secondary market for the benefits of their life insurance policy]” is the ‘owner.’ *Id.* § 2N; *see also* VIATICAL SETTLEMENTS MODEL ACT § 2T (Nat'l Ass'n of Ins. Comm'rs 2009).

¹⁸¹ The broker is “a Person who, on behalf of an Owner [or viator] and for a fee, commission or other valuable consideration, offers or attempts to negotiate [the settlement] between an Owner [or viator] and [settlement] Providers.” LIFE SETTLEMENTS MODEL ACT § 2B (Nat'l Conf. of Ins. Legislators 2007); *see also* VIATICAL SETTLEMENTS MODEL ACT § 2M (Nat'l Ass'n of Ins. Comm'rs 2009).

¹⁸² The provider is “a person, other than an Owner [or viator], who enters into or effectuates a [settlement on the secondary market for life insurance] with an Owner [or viator].” LIFE SETTLEMENTS MODEL ACT § 2S (Nat'l Conf. of Ins. Legislators 2007); *see also* VIATICAL SETTLEMENTS MODEL ACT § 2P (Nat'l Ass'n of Ins. Comm'rs 2009).

¹⁸³ The investment agent is “a person who is an appointed or contracted agent of a licensed . . . provider who solicits or arranges the funding for the purchase of a viatical settlement [or life settlement] by a viatical settlement [or life settlement] purchaser and who is acting on behalf of a viatical settlement [or life settlement] provider.” VIATICAL SETTLEMENTS MODEL ACT § 2O (Nat'l Ass'n of Ins. Comm'rs 2009).

¹⁸⁴ As the Life Settlements Model Act explains:

A Person who pays compensation or anything of value as consideration for a beneficial interest in a trust which is vested with, or for the assignment, transfer or sale of, an ownership or other interest in a life insurance policy or a certificate issued pursuant to a group life insurance policy which has been the subject of a [settlement on the secondary market for life insurance],

is known as the “purchaser.” LIFE SETTLEMENTS MODEL ACT § 2U (Nat'l Conf. of Ins. Legislators 2007); *see also* VIATICAL SETTLEMENTS MODEL ACT § 2R(1) (Nat'l Ass'n of Ins. Comm'rs 2009).

¹⁸⁵ As the Life Settlements Model Act explains:

[A]n underwriter, placement agent, lender, purchaser of securities, purchaser of a policy or certificate from a Provider, credit enhancer, or any entity that has a direct ownership in a policy or certificate that is the subject of a [settlement on the secondary market for life insurance] . . . whose principal activity related to the transaction is providing funds to effect the [settlement] or purchase one or more of the policies; and . . . who has an agreement in writing with one or more Providers to finance the acquisition of [settlements for life insurance on the secondary market],

is deemed the “financing entity.” LIFE SETTLEMENTS MODEL ACT § 2F (Nat'l Conf. of Ins. Legislators 2007); *see also* VIATICAL SETTLEMENTS MODEL ACT § 2E(1) (Nat'l Ass'n of Ins. Comm'rs 2009). Investors or purchasers who are non-accredited are not considered financing entities. VIATICAL SETTLEMENTS MODEL ACT § 2E(2) (Nat'l Ass'n of Ins. Comm'rs 2009); LIFE SETTLEMENTS MODEL ACT § 2F (Nat'l Conf. of Ins. Legislators 2007).

¹⁸⁶

A corporation, partnership, trust, limited liability company, or other legal entity formed solely to provide either directly or indirectly access to institutional capital markets . . . for a financing entity or provider; or . . . in connection with a transaction in which the securities in the special purpose entity are acquired by the owner or by a “qualified institutional buyer;”

ducer.¹⁸⁷

In an effort to get around insurable interest laws, these actors coalesce typically around individual insured persons as the locus of activity. Arthur Kramer's case illustrates how these actors function with each other in a highly complex dance with trust law to shield the insurance policies from the insurable interest hurdle:¹⁸⁸ (1) Steven Lockwood (acting as the broker), the principal of Lockwood Pension Services, approached Mr. Kramer to solicit his participation in a stranger-owned life insurance arrangement; (2) two trusts were created (acting as the special purpose entities) to hold insurance policies issued by the three insurance companies; (3) an employee of the insurance broker was named trustee of the trust; (4) several children of Kramer (the insured), or other persons with an insurable interest, were named as beneficiaries of the trusts; (5) the trusts were then funded with insurance policies (from a provider), with death benefits in the millions of dollars; (6) after the trusts were formed and funded, the beneficiaries of the trusts then assigned their beneficial interests to a stranger investor (the purchaser), relatively immediately.¹⁸⁹ Typically, financing is arranged so that the premiums for the insurance policy are paid first by the insured—through loans provided by financing entity, and solicited by an investment agent—then paid by investors after the transfer is effectuated.

As the above explanation elucidates, in order for consumers to effectively seek cash-out of an insurance policy, or the market potential for such a policy, they must go through a series of legal slights of hand to get at those monies. Even for an investor to capitalize on the earning potential of an investment in life insurance policies, it must put an individual on the hook (with the consonant ramifications of default) for premium payments in the interim, if not long-term. Thus, in contrast to investment in other product types, where the equity in the product stands alone, investment in an in-

or “the securities pay a fixed rate of return commensurate with established asset-backed institutional capital markets,” is defined a “special purpose entity.” LIFE SETTLEMENTS MODEL ACT § 2X (Nat'l Conf. of Ins. Legislators 2007).

¹⁸⁷ “Any person licensed . . . as a resident or nonresident insurance producer who has received qualification or authority for life insurance coverage or a life line of coverage pursuant” to the applicable statutes in each state in which they operate is considered a “life insurance producer.” LIFE SETTLEMENTS MODEL ACT § 2K (Nat'l Conf. of Ins. Legislators 2007); *see also* VIATICAL SETTLEMENTS MODEL ACT § 2G (Nat'l Ass'n of Ins. Comm'rs 2009).

¹⁸⁸ *See Kramer*, 940 N.E.2d at 536–37.

¹⁸⁹ There is a question here in many states about “good faith,” and whether an insurable interest policy should be upheld if it was not taken out in good faith by the insured. However, STOLI structurings typically wait for the completion of a contestability period to transfer. As reflected in *Kramer*, the New York system does not consider good faith and allows policies to be immediately transferred. *See id.* at 541–42. *But see* N.Y. INS LAW § 7815 (McKinney 2007) (“No person shall directly or indirectly engage in any act, practice or arrangement that constitutes stranger-originated life insurance.”).

insurance product requires that you have some legal interest in the continuance of the product. Indeed, if the insurable interest doctrine existed in other spheres, the idea of “shorting” a stock might seem morally abhorrent as a bet against a product creating a negative interest in the particular item.

C. How Insurable Interest Functions in Indemnity Policies

The indemnity principle differentiates life insurance policies as non-indemnity policies from those that are strictly indemnity policies to remunerate for the value of lost property.¹⁹⁰ The indemnity line of insurance is the sister strand to life insurance, and it was the one first regulated by English statute, as discussed above.¹⁹¹ “The notion that the purpose of insurance is to protect the insured against suffering a loss, not to create the opportunity for gain,” forms the basis for why an insurable interest doctrine exists for insurance policies relating to property.¹⁹² In contrast to contestability periods for life insurance, indemnity policies have stricter constructions in the courts than those for life insurance.¹⁹³ Most courts hold that an indemnifying insurer cannot be estopped to assert that there was no insurable interest at all and cannot be held to have waived the requirement¹⁹⁴—a stark contrast to the life insurance industry’s statutorily mandated contestability period.¹⁹⁵ Indeed, courts permit an indemnifying insurer to question the extent of an insurable interest after a loss has occurred in order to guard against over-insuring.¹⁹⁶

There are four different tests for insurable interest in a piece of property.¹⁹⁷ First, a legal or equitable interest in property will always suffice, subject sometimes to the condition that the interest have at least some value.¹⁹⁸ However, while the legal interest doctrine prevailed historically, a second “factual expectations” test has emerged over time to allow an insurable interest to vest if the beneficiary expects to derive actual economic gain from the property’s continued existence.¹⁹⁹ Third, a contract right that depends

¹⁹⁰ KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION* 201 (4th ed. 2005).

¹⁹¹ See *supra* Part II.

¹⁹² ABRAHAM, *supra* note 190 (citing the twin English acts of 1746 and 1774 in establishing this notion).

¹⁹³ *Id.* at 202.

¹⁹⁴ *Id.*

¹⁹⁵ Statutorily mandated contestability periods are usually two years in length. See, e.g., DEL. CODE ANN. tit. 18, § 2908 (2011) (“There shall be a provision that the policy shall be incontestable after it has been in force during the lifetime of the insured for a period of not more than 2 years after its date of issue . . .”).

¹⁹⁶ ABRAHAM, *supra* note 190, at 202.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ See Jacob Loshin, *Insurance Law’s Hapless Busybody: A Case Against the Insurable*

on the continued existence of property also supports an insurable interest in that property.²⁰⁰ Finally, the potential for suffering legal liability for the destruction of property will support an insurable interest in that property.²⁰¹ One can notice that these tests bear a very close resemblance to those in the English system.²⁰²

While one might assume that the insurable interest tests in the indemnity area would be clearer than any for life insurance, as contracts for property involve measurable losses, they are not actually so. The four tests for insurable interest in indemnity are muddy fact-based determinations akin to the “blood or affinity” tests or “pecuniary interest” tests developed in the non-indemnity arena. Indeed, it can be said that it is even more difficult to determine who has an insurable interest in a piece of property insured, than in the life of an individual insured.²⁰³ The space between the “factual expectation” and “legal interest” tests creates an opportunity for individuals to exploit the insurable interest doctrine as it is applied in the different states.

D. Litigation Costs due to the Insurable Interest Doctrine

Yet another transaction cost created by the insurable interest doctrine is long, drawn-out litigation and its attendant substantial uncertainty as to the result. Insurable interest generally gets litigated only if the following three things happen: (i) the insurance company has issued the policy and the insured represented at the time of issuance to having an insurable interest; (ii) the contestability period has run on those representations by the insured; and (iii) the insured event has happened, or is very close to happening.²⁰⁴ If the policy does not pay out, and it is surrendered for its cash value, or it lapses altogether, an insurance company will likely not litigate the insurable interest issue. Currently, the majority of states have no requirement that an insurance company disclose to an insured that there is a life settlement option prior to permitting the lapse or surrender of a life insurance policy.²⁰⁵ Six states require insurance companies to inform senior citizens or the chronically ill who are about to surrender life insurance policies for cash value, or let the policies lapse entirely, about the option of privately selling that asset to a third party in a life settlement transaction.²⁰⁶

Interest Requirement, 117 YALE L. J. 474, 486 (2007).

²⁰⁰ See ABRAHAM, *supra* note 190, at 202 (noting that secured creditors fall into this category).

²⁰¹ *Id.* (citing *Vill. of Constantine v. Home Ins. Co.*, 427 F.2d 1338 (6th Cir. 1970)).

²⁰² See *supra* Part II.A and Part II.B.

²⁰³ JOHN F. DOBBYN, *INSURANCE LAW IN A NUTSHELL* 82 (3d Ed. 1996).

²⁰⁴ *Id.*

²⁰⁵ SEC REPORT, *supra* note 98, at 7.

²⁰⁶ The six states are California, Kentucky, Maine, Oregon, Washington and Wisconsin. *Id.* at 7 n.29.

Insurance companies will often assert the insurable interest doctrine as a defense to being compelled to pay out an insurance policy that has vested.²⁰⁷ Thus, insurance companies have a very high incentive to maintain the doctrine, and its concomitant transaction costs, instead of writing insurable interest considerations into their underwriting policies up-front. The insurable interest defense essentially acts as an embedded option built into insurance policies.²⁰⁸ If an insured event never happens, the option is useless, but the insurer does not need to pay out on the policy anyway. If the insured event happens, the insurer can assert the defense—after the contestability period has run—and, in effect, get a second chance at invalidating the policy after more information has been gained and premiums have been paid into the insurers coffers. If the insurable interest doctrine defense is successful, the insurer need only pay back premiums, but retains the value of the death benefit—creating massive cost savings. Thus, the option value increases as the probability of invalidation increases,²⁰⁹ with the caveat that there is some uncertainty about whether or not the insurer will be able to convince a court that no insurable interest exists—this determination will be made according to murky fact-based tests.²¹⁰ But, even that litigation uncertainty works in favor of the insurable interest doctrine as a defense because, even in the most strained scenarios, factually uncertain tests are still worthwhile for an insurance company to submit to, as they create some probability of invalidation. Thus, most of the benefit of the insurable interest doctrine accretes to the insurance company—with very little in terms of social welfare going to the initial insured or investor in a policy.

For example, the insurance company in *Chawla v. Transamerica Occidental Life Insurance Co.*²¹¹ likely saw an opportunity to have an insurance policy invalidated for want of an insurable interest when the insured used a life insurance trust as a transaction vehicle, since Maryland law (the applicable law) had never addressed the question of whether a life insurance trust can have an insurable interest in the life of the insured. As previously discussed, the court deciding the case held that the trust did not have an insurable interest in the life of the insured, even though the insured was the settlor and the creator of the trust.²¹² Significant costs must have been incurred in litigating this case. In the end, the insurance company reaped all

²⁰⁷ See, e.g., *Chawla v. Transamerica Occidental Life Ins. Co.*, No. CIV.A. 03-CV-1215, 2005 WL 405405 (E.D. Va. Feb. 3, 2005), *aff'd in part, vacated in part*, 440 F.3d 639 (4th Cir. 2006).

²⁰⁸ See Loshin, *supra* note 199, at 495.

²⁰⁹ *Id.*

²¹⁰ See *supra* Parts II.B (for life insurance) & III.C (for property insurance).

²¹¹ 2005 WL 405405 (E.D. Va. 2005), *aff'd in part, vacated in part*, 440 F.3d 639 (4th Cir. 2006).

²¹² *Id.* at *6.

the benefit of the risk taken on the insurance policy by invoking the insurable interest doctrine, leaving the insured and his successors in interest with no value for years of premiums paid. In addition, as a direct result of the *Chawla* decision, the NCCUSL drafted yet another patch to the insurable interest law.²¹³ That patch attempts to create an insurable interest for trustees,²¹⁴ as part of the definition of what type of relationship qualifies for an insurable interest in an insurance policy that funds a trust.²¹⁵ In an attempt to expand or contract what is within the ken of the insurable interest doctrine, many states and Model Act drafters have adopted varying solutions, creating an uneven landscape of regulation.²¹⁶ The information inequality created by an uneven regulatory landscape, of course, can really only mean additional cost and burden being placed on the uninformed or misinformed insured—the precise individuals the insurable interest doctrine was meant to protect.

E. Additional Policy Problems Arising From Market Structure

Since its English beginnings, the insurable interest doctrine has been held up as an area where individuals are protected against being used as an object of wager.²¹⁷ A slightly more modern interpretation implies that moral hazard is the real reason to keep the insurable interest doctrine around. That is, the insurable interest doctrine protects individuals against the risk of being killed for their insurance monies. Taking these justifications as given, the doctrine still exhibits both internal definitional problems and external effects problems with its existence. Thus, the insurable interest doctrine should be abolished.

1. Definitional Problems

If the main purpose of the insurable interest doctrine is to protect the dignity of the individual and the individual's right not to be used as a wager or a hedge without consent, the insurable interest doctrine has been a non-starter from the beginning. Many employers purchase insurance policies insuring the lives of their employees. These policies, generally referred to as “corporate-owned life insurance” (COLI) or “employer-owned life insurance” (EOLI), are used to fund employee benefit plans and buy-sell agreements, and to protect employers against the financial consequences of the

²¹³ See INSURABLE INTEREST AMENDMENTS TO THE UNIFORM TRUST CODE §113(b) (Nat'l Conf. of Comm'rs on Unif. State Laws 2010).

²¹⁴ *Id.* §112(b).

²¹⁵ *Id.* §112(b)(2).

²¹⁶ See *supra* Part II.

²¹⁷ See *supra* Part II.B.

death of a key employee.²¹⁸ The insurable interest doctrine has always allowed employers to take out insurance policies on the lives of their employees without the consent of the insureds, because a company has a pecuniary interest in a key employee or officer of its firm.²¹⁹ Second, the insurable interest doctrine has always allowed an interest in the life of an insured by his or her spouse.²²⁰ This doctrine says nothing, though, of when an insurable interest ends if a spouse has become estranged. It likewise says nothing of co-domiciled couples or same sex civil unions. Third, issues involved with how an insurable interest arises as to a contract of indemnity are complex and unnecessary.²²¹ The existence of four tests as to how an interest is created²²² engenders substantial market uncertainty that harms consumers of such products writ large. So, if one heeds dignity concerns, one should eliminate the need for an insurable interest doctrine for the holding of, but not for the inception of, a policy. At the very least, insureds remain as a clearinghouse for insurance policy transferability. This allows for cashing out of a policy, but does not eliminate the massive transaction costs associated with life settlements or the definitional problems described above. Thus, this half-measure would likely be insufficient to allow for a market to operate without a plethora of unnecessary actors and would also keep the insured on the hook for his or her policy and premiums.

2. Systemic Concerns

A healthy secondary insurance market enhances liquidity for policyholders.²²³ By extension, a market unhampered by the insurable interest doctrine will further increase the liquidity of these policies, as policies will be unhampered by the legal uncertainty introduced by litigation at the time the settlement pays out. A result of this increased liquidity, though, as insurance companies argue, is that the price of life insurance will rise, because “lapse rates” for insurance policies will drop in the absence of a robust insurable interest doctrine.²²⁴ As explained by the SEC:

Currently, insurers may experience economic gains associated with

²¹⁸ Craig E. Behrenfeld & Erica Good Pless, *Employer-Owned Life Insurance After the Pension Protection Act of 2006*, 83 FLA. B. J. 47, 47 (2009).

²¹⁹ See, e.g., *Mayo*, 354 F.3d 400.

²²⁰ As exhibited by both English and Australian statutes, and the statutes of the several states.

²²¹ See *supra* Part III.D.

²²² See *supra* Part III.C.

²²³ See Neil A. Doherty & Hal J. Singer, *The Benefits of a Secondary Market for Life Insurance Policies*, 38 REAL PROP. PROB. & TR. J. 449, 469 (2003).

²²⁴ Hanming Fang & Edward Kung, *How Does Life Settlement Affect the Primary Life Insurance Market? 2* (Nat'l Bureau of Econ. Res., Working Paper No. 15761, 2010), available at <http://www.nber.org/papers/w15761.pdf>.

lapsed policies because insurers will have received premiums for these policies but will not be liable for payment of death claims associated with these policies. These economic gains may be used to subsidize remaining policy owners. Since life settlements provide policy owners with an alternative to allowing their policies to lapse, they may cause lapse rates to decline and reduce the subsidies available to the remaining policy owners.²²⁵

Thus, because they are denied the return on lapsing or surrendered policies, life insurance companies claim that “the life settlement market . . . increases the costs of providing policies in the primary market,” and further allege that “these costs will have to be passed on to consumers, which would ultimately make the consumers worse off.”²²⁶

Life insurance lapse rates are based upon experience, so it is difficult to predict when lapse rates will rise or fall.²²⁷ However, the industry already prices insurance policies with very conservative predictions of lapse.²²⁸ Therefore, an open and free transferability market, or insurance procurement market, will likely have a very small effect on both pricing and profitability of insurance companies.²²⁹ Indeed, according to one analysis, “a life settlements transaction generally has minimal or no impact on the anticipated profitability of a life insurance contract because the persistency of an unhealthy policyholder is precisely what is assumed at the time of original pricing.”²³⁰ Thus, because the risk of an unhealthy policyholder is already priced into the market, and low lapse rates are assumed, the maximum amount prices in the insurance market would rise would be by the value of the option in favor of the insurance company created by judicial invalidation of a policy.²³¹ In addition, current lapse rates have come under fire from state insurance regulators as it has become known that insurers abuse notice requirements in insurance policies to increase lapse rates and avoid the payment of the death benefit.²³² The elimination of the insurable

²²⁵ SEC REPORT, *supra* note 98, at 19.

²²⁶ *Id.* at 19 n. 82.

²²⁷ *Id.*

²²⁸ See Christian Kendrick, *Special Report: Return of Premium Products*, SCOR (Jul. 13, 2007, 12:00 AM), http://www.scorgloballifeamericas.com/Media/media_associateArticle.aspx?id=295.

²²⁹ SEC REPORT, *supra* note 98, at 20.

²³⁰ DELOITTE CONSULTING LLP & UNIV. OF CONNECTICUT, *THE LIFE SETTLEMENT MARKET: AN ACTUARIAL PERSPECTIVE ON CONSUMER ECONOMIC VALUE 12* (2005), available at http://www.quatloos.com/uconn_deloitte_life_settlements.pdf.

²³¹ See Loshin, *supra* note 199.

²³² Leslie Scism, *MetLife Defends Itself On Death-Policy Tack*, WALL ST. J., May 20, 2011, at C1 (explaining that MetLife “used a database that tracked deaths when doing so proved beneficial for one side of the company, but for years didn’t use the same database when doing so could have meant more payouts to families of its life insurance clients who

interest doctrine would create greater efficiency by creating more vigilant policyholders and preventing lapse from occurring.

There is an additional concern that the free transferability of life insurance policies will lead to securitization of these policies. If the insurable interest doctrine is eliminated, the argument goes, life policies will be treated akin to any other security, and an unhealthy number of unsophisticated market participants will enter the market for life insurance, akin to the collateralized debt obligation or credit default swap markets.

In 2010, the SEC examined state securities laws, and concluded that almost all states treat life settlements as securities under state law,²³³ although the actual sources of that law are in great disarray. The SEC found that the definition of life settlements as a security falls into four (yes, four!) different tranches. First, “[a] majority of states include life settlements in their statutory definition of ‘security,’ either directly in that definition, or as part of the definition of ‘investment contract.’”²³⁴ Second, “[i]n a number of other states that do not include life settlements in their statutory definition of security or investment contract, courts or state regulators found life settlements to be a security under an investment contract analysis.”²³⁵ Third, “[a] few other states have concluded that life settlements are securities pursuant to a statement of policy issued by state securities regulators.”²³⁶ Finally, “[o]nly two states have not made a determination as to whether life settlements are securities under state law.”²³⁷ As of July 2010, no public securitizations of life insurance products have ever been done, but some privately offered life settlement securitizations have occurred.²³⁸ A market for “mortality swaps” does exist, and such swaps are rated by the Fitch rating agency.²³⁹ As it stands, mortality swaps are only available to

died.”).

²³³ See SEC REPORT, *supra* note 98, at 36. “Some states, however, exclude from the definition of security the original sale from the insured or policy owner to the provider.” *Id.* These states include Kentucky, Iowa, Maine, Nebraska, New Jersey, North Carolina, North Dakota, Ohio, Utah, and Wisconsin. *Id.* at 36 n.173.

²³⁴ *Id.* at 36. These states are Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, South Carolina, South Dakota, Tennessee, Utah, Vermont, West Virginia, and Wisconsin. *Id.* at 36 n.174.

²³⁵ *Id.* at 36. These states are Delaware, Louisiana, Maryland, Massachusetts, New Hampshire, New York, Oregon, Virginia, and Washington. *Id.* at 36 n.175.

²³⁶ *Id.* at 36. These states are Alabama, Pennsylvania, Rhode Island, and Texas. *Id.* at 36 nn.175–76.

²³⁷ *Id.* at 36. These states are Connecticut and Wyoming. *Id.* at 36 n. 177.

²³⁸ *Id.* at 5.

²³⁹ Katy Burne, ‘Mortality Swaps’ Coming Alive: Fitch Issues Rating on Insurer’s Death-Risk Transaction, WALL ST. J., Nov. 12, 2010, at C1 (explaining that a “transaction in question helped an unidentified U.S. life insurer transfer the risk that several policyholders might

insurance companies.²⁴⁰ However, the ability to hedge against such risk should not be available only to one side of the ledger (insurance companies) and not the other (consumers). This evidence of disparate types of securities, ranging from mortality swaps to the actual securitization of life policies, shows both that the market for securities based upon an individual life as the relevant equity is widely accepted, but also that a great deal of legal uncertainty exists due to non-uniformity among the products in this field.

States are the primary regulators of the life insurance settlement market because Section 3(a)(8) of the Securities Act of 1933²⁴¹ exempts from federal regulation by the SEC any “insurance . . . policy” or “annuity contract” issued by a corporation that is subject to the supervision of a state insurance commissioner, state bank commissioner, or similar state regulatory authority.²⁴² However, this exemption does not apply to “variable life insurance policies,” or policies where the cash value and/or death benefit vary based on the performance of the assets in which the premium payments are invested.²⁴³ In contrast to a variable life insurance policy, a standard insurance policy merely allocates a set death benefit, and the premiums go to the general account of the insurer.²⁴⁴ This divergence shows that the nature of the insurance market has always been vexing even for securities regulators. Further reflecting this point, the D.C. Circuit²⁴⁵ and the Eleventh Circuit²⁴⁶ are split regarding the status of fractional interests in life settlements as securities under the federal securities laws. The SEC recently recommended that standard life settlement contracts be pulled into the definition of a security under the Securities Act of 1933 and the Securities Exchange Act of 1934.²⁴⁷ Uniform regulation, coupled with the elimination of the insurable interest doctrine, would allow alienated life insurance contracts to be securitized, to be sure, but it would force sunlight onto pre-existing securitization under state schemes and (most importantly) would allow for consistent treatment of and standards for investors and consumers.

If litigation under the current regime is any indication, the life settlement market is extremely flawed for insured individuals because the insurable interest doctrine pushes the market *sub rosa*. For example, at the height of the secondary market for life insurance in the last decade, “tens of

die sooner than expected to institutional investors.”).

²⁴⁰ *Id.*

²⁴¹ 15 U.S.C. § 77a (2010).

²⁴² *Id.* § 77c(a)(8); *see also* SEC REPORT, *supra* note 98, at 21.

²⁴³ SEC REPORT, *supra* note 98, at 21 n.89.

²⁴⁴ *Id.* at 21 n.89.

²⁴⁵ *See* SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996), *reh’g denied*, 102 F.3d 587 (D.C. Cir. 1996).

²⁴⁶ *See* SEC v. Mut. Benefits Corp., 408 F.3d 737 (11th Cir. 2005).

²⁴⁷ SEC REPORT, *supra* note 98, at 39.

thousands of older people sought to make fast cash by taking out multimillion-dollar policies to sell to investors.”²⁴⁸ However, as explained above, the insurable interest doctrine forces insured individuals to pay premiums on policies in the time between the origination of the policies and their sale to investors.²⁴⁹ Thus, once the market weakened at the end of the decade, “older people who took out life policies on assurances that could flip them to investors are suing agents, lenders, and insurers, claiming they were misled into shelling out premiums on policies that ultimately found no buyers.”²⁵⁰ Thus, when no buyers are found for a life insurance policy, the insured loses past premiums paid and receives no cash remuneration for the policy. The insured is then forced to stop paying premiums on the policy, the policy lapses, and the insurance company gets to retain the insurance premiums without the obligation to pay out on the policy. All of this is because the insurable interest doctrine requires that a “cloak” be used, as explained above, in order to effectuate the cash out of these STOLI policies.²⁵¹ The elimination of the doctrine would allow investors to invest in the life insurance market without forcing an insured individual to be on the hook for premium payments. The great advantages of this approach are certainty and the streamlining of the number of persons involved in an insurance policy’s formation.

Because the insurable interest doctrine forces several third parties²⁵² into a transaction that is essentially an arrangement to take out a futures contract on a person’s life, it creates massive informational problems for investors. This problem arises in the actuarial component of the current life settlements market. For example, Life Partners Holdings Inc., in Waco, Texas, arranged for investors to buy several billion dollars of life insurance policies from their original owners.²⁵³ However, Life Partners had to engage in the procedure of analyzing the life expectancies of the insured individuals because it is a crucial part of the investment equation.²⁵⁴ Generally, the shorter an insured person’s expected life span, the more Life Partners could charge for the policy, because investors could expect a faster payout.²⁵⁵ Life Partners marketed to investors that they should expect a ten to

²⁴⁸ Leslie Scism, *New Life-Policy Fallout: Suits From Insured*, WALL ST. J., Feb. 2, 2011, at C1–2.

²⁴⁹ See *Dawe*, 28 A.3d at 1065 (explaining that the whole purpose of incontestability clauses was to reduce the uncertainty of paying premiums into a policy that would be rendered ineffective at a later date via litigation by an insurance company).

²⁵⁰ Scism, *supra* note 248.

²⁵¹ See *supra* Part II.C.3.a.

²⁵² See *supra* Part III.B.

²⁵³ *Maremont & Scism*, *supra* note 70, at C1.

²⁵⁴ *Id.*

²⁵⁵ *Id.*

fifteen percent payout if they invested in a pool of life insurance policies tagged to individuals with a certain lifespan.²⁵⁶ However, these life expectancies were calculated by a Reno, Nevada physician who testified that he sometimes did dozens of these life expectancy estimates a day and didn't review his prior predictions for accuracy.²⁵⁷ Therefore, because of the flaw in these life expectancy estimates, returns on these policies began to miss their ten to fifteen year mortality targets, and investors alleged that they were misled by Life Partners' marketing schemes.²⁵⁸ In the meantime, as the arranger of deals between insureds and investors, Life Partners had extracted "often-hefty fees in the deals."²⁵⁹ Essentially, a firm like Life Partners exists at the behest of the insurable interest doctrine by creating the necessary cloak to bring together investors and insureds. The elimination of the doctrine would force these transactions out from under the cloak and allow for greater informational clarity. Investors will demand that insurance companies make actuarially accurate guesses about the life span of an individual insured, and insurance companies will be on notice about to whom and where the policy will pay out at its inception.

One final traditional concern in this area is that if insurance policies are able to be taken out by "strangers" to an insured, then moral hazard will either dictate that the subject of the policy (a person in life insurance scenarios, or an object in indemnity policy scenarios) will be destroyed by the person taking out the policy and/or there will be an incentive to take less good care of a person who is the subject of the insurance. The first concern, about moral hazard leading to the untimely demise of an individual, is obviated by laws in other areas, notably trust and estate law, called "slayer" laws.²⁶⁰ Codified statutorily in many states, but generally stemming from common law, slayer laws prohibiting inheritance by a person who murders someone from whom she stands to inherit.²⁶¹ Some states' case law even goes so far as to limit the right of the killer's descendants to take property under a will or the relevant intestacy statutes.²⁶² Since insurance payments from the death benefit pay into a trust under the most common policies, or are reviewed by the insurance company prior to payment, slayer laws would likely prevent murderers from collecting on these policies. The second issue of taking less good care of an individual from whom an insurance policy is supposed to pay out is already an issue that exists under the current

²⁵⁶ *Id.*

²⁵⁷ Mark Maremont & Leslie Scism, *Life Partners will Change Sales Method.* WALL ST. J., Jan. 27, 2011, at C1.

²⁵⁸ Maremont & Scism, *supra* note 70, at C1.

²⁵⁹ *Id.*

²⁶⁰ JESSE DUKEMINIER ET AL., *WILLS, TRUSTS AND ESTATES* 149 (8th ed. 2009).

²⁶¹ *Id.*

²⁶² *Id.* (citing *In re Estate of Mueller*, 655 N.E.2d 1040 (Ill. App. 1995)).

life settlement regime, and the risk of such lower care of that may not necessarily be any different under a regime which is merely less cumbersome because of the elimination of the insurable interest doctrine.

IV. A NATURAL EXPERIMENT: THE DEATH OF INSURABLE INTEREST IN AUSTRALIA

The argument that the insurable interest doctrine should be eliminated is further bolstered by the Australian experience. The insurable interest doctrine is effectively dead in Australia.²⁶³ In 1982, the Australian Law Reform Commission recommended the insurable interest doctrine be eliminated for property.²⁶⁴ The Commission also intimated that the policy should be eliminated for life insurance:

The need to allow policyholders to use policies as a form of property, together with the uncertainty that would be introduced into insurance practice if the policyholder were required to have an interest at the date of death of the life insured, constitute[s] an adequate justification for not restricting the existing freedom of assignment.²⁶⁵

The road to the modern day status of insurable interest in Australia is instructive for the American system, as the two systems share the same roots in two English statutes²⁶⁶ and similar trajectories in the creation of a complex market for secondary life insurance products.

In Australia, the requirement of an insurable interest was said to serve three main policies: (i) to discourage wagering on lives in the form of insurance; (ii) to minimize the risk of destruction of the object of the insurance; and (iii) (in the case of property) to restrict the insured to no more than a full recovery for its actual loss.²⁶⁷ Given Australia's English provenance, the English Marine Insurance Act of 1745 and Life Insurance Act of 1774 remained in effect to govern the insurance world until they were altered by the Australian Marine Insurance Act of 1909²⁶⁸ and Insurance Contracts Act of 1984.²⁶⁹ Australia's Marine Insurance Act of 1909 stated that marine insurance that amounted to a wager was void; but, if a contract of marine insurance were entered into with the intention of obtaining an insurable inter-

²⁶³ See SUTTON, *supra* note 11, at 531.

²⁶⁴ AUSTL. LAW REFORM COMM'N, INSURANCE CONTRACTS 87–88 (1982).

²⁶⁵ *Id.*

²⁶⁶ Marine Insurance Act, 1745, 19 Geo. 2, c. 37 (Eng.); Life Assurance Act, 1774, 14 Geo. 3, c. 48, § I (Eng.).

²⁶⁷ See Kosmopoulos v. Constitution Ins. Co., [1987] 1 S.C.R. 2, 25 (Can.) (citing Bertram Hartnett & David V. Thornton, *Insurable Interest in Property: A Socio-Economic Reevaluation of a Legal Concept*, 48 COLUM. L. REV. 1162, 1178–83 (1948)).

²⁶⁸ *Marine Insurance Act 1909* (Cth) ss 5–6 (Austl.).

²⁶⁹ *Insurance Contracts Act 1984* (Cth) ss 5–7 (Austl.).

est, it was held valid.²⁷⁰ That legal stance, while statutorily applying to only marine contracts from the 1909 law, is said to have applied more broadly to non-marine risks in property until 1984.²⁷¹ The Life Insurance Act of 1945 altered the landscape for insurable interest for life insurance by delineating five categories where an insurable interest would arise.²⁷² An insurable interest was given to: (i) the parent of a child under 21; (ii) a wife to a husband and vice versa; (iii) any person who depended upon the support of the insured in whole or in part; (iv) a corporation or other person in the life of an officer or employee; and (v) a person who had a pecuniary interest in the duration of the life of another person.²⁷³ Thus, until 1984, essentially the same legislation and case law as the English system governed the Australian system, with a few differences in how far an insurable interest would extend. At least one scholar and court indicate that there was a presumption during this time in favor of finding an insurable interest because it was often a technical objection—made by insurance companies—after premiums had been paid to an insurer by an insured.²⁷⁴

In 1984, Australia made a sharp break with its American and English contemporaries by eliminating the insurable interest requirement for indemnity contracts and other property insurance contracts.²⁷⁵ Section 16 of the Insurance Contracts Act of 1984 provides that a contract of “general insurance” is not void if the insured did not have an insurable interest in the subject of the insurance at the time that the contract is formed.²⁷⁶ The 1984 Act effectively abandons the “legal interest” test outlined in *Macaura* in favor of a test based in economic loss for indemnity contracts.²⁷⁷ Therefore, since an insured normally has to show that “he or she has suffered loss as a result of an event insured against before he or she can recover under the policy . . . proof of loss is equivalent to proof of interest.”²⁷⁸ Thus, somewhat elegantly, “[f]lexibility to both insurer and [insured] is achieved without in any way promoting gaming and wagering in the form of insurance or adding to the risk of the destruction of the property insured.”²⁷⁹ However, the 1984 Act stops short of eliminating an insurable interest for life insur-

²⁷⁰ See SUTTON *supra* note 11, at 506.

²⁷¹ *Id.* at 515.

²⁷² *Life Insurance Act 1945* (Cth) s 86(1) (Austl.).

²⁷³ *Id.* s 86(1)(a)–(f).

²⁷⁴ See SUTTON, *supra* note 11, at 524 (citing *Stock v. Inglis*, [1884] 12 Q.B.D. 564, 571 (Eng.)).

²⁷⁵ *Insurance Contracts Act 1984* (Cth) s 11(1) (Austl.).

²⁷⁶ *Id.* s 16(1).

²⁷⁷ See SUTTON, *supra* note 11, at 528.

²⁷⁸ *Id.* at 527.

²⁷⁹ *Id.* at 528.

ance contracts.²⁸⁰ By delineating life insurance contracts broadly as a separate category of insurance still requiring traditional insurable interest requirements at the time of contract formation,²⁸¹ the insurable interest doctrine was only partially abrogated.

In 1995, Australia took yet another break from the common law and its contemporaries by abolishing the insurable interest requirement for life insurance altogether.²⁸² According to one scholar, “[t]he rationale behind the previous insistence on [the] requirement—the reduction of the temptation to murder the life insured in the hope of obtaining the proceeds from the life insurance, and the discouragement of wagering and gaming—apparently no longer holds sway.”²⁸³ Since the common law does not require an interest in the life of the insured at the time of death,²⁸⁴ and the 1995 Life Insurance Act no longer requires such an interest at the time of formation,²⁸⁵ the insurable interest doctrine is gone in Australia. Up until 1995, the market for the assignment of life insurance policies had grown in Australia to the point where the law recognized the assignments of life policies, subject only to compliance with the necessary convoluted procedure involving cloaks similar to the U.S. system described above.²⁸⁶ In exactly the same fashion, many American jurisdictions recognize the assignment of life policies, subject to procedures that satisfy the insurable interest doctrine.²⁸⁷

The 1995 Act allows the transfer of life insurance policies by simple assent of the transferor and the transferee, subject to disclosure requirements.²⁸⁸ The process was simplified because the Australian Law Reform Commission thought that life insurance ought to be treated as property; thus:

[T]he need to allow policy holders to use policies as a form of property, together with the uncertainty that would be introduced into insurance practice if the policy holder were required to have an interest at the date of death of the life insured, constitute an adequate justification for not restricting the . . . freedom of assignment.²⁸⁹

²⁸⁰ *Insurance Contracts Act 1984* (Cth) s. 16(1) (Austl.).

²⁸¹ *Id.* s. 18.

²⁸² *Life Insurance Act 1995* (Cth) s 200 (Austl.).

²⁸³ See SUTTON, *supra* note 11, at 531.

²⁸⁴ *Id.*

²⁸⁵ *Life Insurance Act 1995* (Cth) s 200 (Austl.) (deleting s 16(2) from the Insurance Contracts Act of 1984 and repealing s 18 of the same act, eliminating the necessity for an insurable interest in either property contracts or life insurance contracts).

²⁸⁶ See SUTTON *supra* note 11, at 531; see also *supra* Part II.C.

²⁸⁷ See *supra* Part III.

²⁸⁸ See *Life Insurance Act 1995* (Cth) ss 200(2)(a)–(f) (Austl.).

²⁸⁹ AUSTL. LAW REFORM COMM’N, *supra* note 264, at 87.

Moreover, the law, as written, eliminates the requirement for the insured to have an insurable interest at any point of an insurance transaction.²⁹⁰ Thus, the Australian legislature seems to have made a balanced decision on the elimination of the insurable interest doctrine completely. On the one hand, the legislature was prepared to accept the risk that the risk of wagering or gaming on the lives of others will increase. On the other hand, in exchange for eliminating the insurable interest doctrine, it created a comprehensive regulatory scheme intended to streamline the market; and, it eliminated the need to draft detailed provisions as to whether an insurable interest could exist in certain relationships and as to whether and what type of loss was necessary to occur to effectuate an insurance policy *ex post*.

To be sure, the Australian authorities did not enact the 1995 Act without any regard for regulation. The elimination of the insurable interest doctrine came with the creation of a comprehensive regulatory scheme in two major divisions of the Australian government. In 1998, the Australian Prudential Regulation Authority was created to administer the Life Insurance Act of 1995.²⁹¹ Furthermore, the Australian Securities and Investments Commission is charged with administering the Insurance Contracts Act of 1984.²⁹² These two regulatory bodies maintain the difference between indemnity contracts dealing with property and life insurance policies dealing with life insurance regulation that began in the eighteenth century and continues to press against law today.

After the introduction of the 1995 Act, the Australian securitization market developed rapidly into one of the most active outside the U.S.²⁹³ The Australian insurance industry is not suffering either, according to statistics released as recently as June 2010.²⁹⁴ Net profit after tax was \$2.765 billion Australian dollars (\$2.229 billion USD), up from \$1.985 billion Australian dollars in the previous year. Industry revenue totaled \$29.896 billion Australian dollars (\$3.155 billion USD), up from \$24.448 billion in the previous year. In what is likely to have been a remarkable year, the return on net assets for the life insurance industry alone was 17.3%. As is clear from these statistics, a robust, profitable insurance market can (and does) exist in the absence of the insurable interest doctrine as a “safety valve.”

²⁹⁰ See *Life Insurance Act 1995* (Cth) ss 200–29 (Austl.).

²⁹¹ See *About APRA*, AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY (APRA), <http://www.apra.gov.au/aboutAPRA/> (last visited Oct. 5, 2011).

²⁹² See *Our Role*, ASIC, <http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Our%20role> (last visited Mar. 5, 2012).

²⁹³ Alvin Liaw & Guy Eastwood, *The Australian Securitisation Market* (Australian Prudential Regulation Authority, Working Paper 6, Oct. 2000).

²⁹⁴ Australian Prudential Regulation Authority, *Statistics: Half Yearly Life Insurance Bulletin* (Jan. 5, 2011), available at <http://www.apra.gov.au/Statistics/upload/HYLIB-Jun-10-20110105-4.pdf>.

V. CONCLUSION

The insurable interest doctrine has outlived its effectiveness. American regulators can learn much from the successes of their peer insurance regulators in England and Australia. The lessons from those nations' elimination of the doctrine are easily transferable to the U.S. The American insurance markets are not ostensibly different as to life and indemnity insurance law from their English and Australian counterparts. The elimination of the doctrine would be a boon to both insurance companies and consumers seeking greater clarity in the rules governing the rights and responsibilities within insurance contracts. Many states are currently reviewing their insurance law regulations to attract insurers; the insurable interest doctrine should be eliminated in an effort to make doing business in those states more efficient for both consumers and insurers.²⁹⁵

²⁹⁵ Louise Story & Mary Williams Walsh, *Seeking Business, States Loosen Insurance Rules*, N.Y. TIMES, May 8, 2011, at A1, available at http://www.nytimes.com/2011/05/09/business/economy/09insure.html?_r=1&pagewanted=all.