

AMERICA'S QUEST FOR A PROPER CONCEPT OF "INSURABLE INTEREST": THE PERILS OF IGNORING THE IMPLICATIONS

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I. TRACING THE REQUIREMENT TO ITS ROOTS

A. The Influence of the English Doctrine

American law makes clear that an applicant for insurance on the life of another must have an "insurable interest" in such life and that mere "wager policies" (viz., policies in respect of which the applicant has no interest whatever in the continued life of the insured but only in the termination thereof) are void as against public policy. The United States Supreme Court has traced the American requirement for an insurable interest to the common law of England enforced prior to the Revolution of 1688 and to the Statute of 14 Geo. III.c.48 also known as the Life Assurance Act of 1774 (the "1774 Act"), commenting that:

"In this country, statutes to the same effect have been passed in some of the States; but where they have not been, in most cases either the English statutes have been considered as operative, or the older common law has been followed.

Connecticut Mutual Life Insurance Company v. Schaefer, 94 U.S. 457, 460 (1876). The Act of 1774 provides that an applicant for a policy of insurance on the life of another has an insurable interest if he has a "pecuniary interest" in the continued life of the person whose life is insured.

Massachusetts and Connecticut, states in the vanguard of the American Revolution, rejected the 1774 Act., and considered the requirement of an insurable interest to be solely a question of common law. See *Loomis v. Eagle Life Insurance Co.*, 72 Mass. 396, 6 Gray 396, 1856 WL 5690 (1856) (the Massachusetts Chief Justice compared the circumstances of Massachusetts to those of Ireland to which he asserted the 1774 Act did not extend and cited *Scott v. Roose, Longfield & Townsend*, 54; and *British Ins. Co. v. Magee, Cook & Alcock*, 182). The 1774 Act having been rejected by Massachusetts, what is required there to avoid objection of a policy's being a wager policy is (per Chief Justice Shaw in the *Loomis* case) that the policy applicant have some interest in the life of the *cestui que vie*; that his temporal affairs, his just hopes

and well grounded expectations of support, of patronage, and advantage in life will be impaired, so that the real purpose is not a wager, but to secure such advantages, supposed to depend on the life of another. . . “ Even today Massachusetts has resisted codification of the insurable interest rule as evidenced by a case involving a widow’s negligence claim against a carrier for having failed to spot a forged assignment of benefit in respect of a policy of insurance on her late husband’s life, the forgery having been effected by a business partner who had subsequently poisoned the husband. See, *Bacon v. Federal Kemper Life Assurance Company*, 400 Mass. 850, 512 N.E. 2d 941 (1987) [“ . . . even though Kemper required a beneficiary to have an insurable interest in an insured’s life, there is no such requirement under our law. *Strachan v. Prudential Ins. Co.*, 321 Mass. 507, 509, 73 N.E. 2d 840 (1947).”]

B. Pecuniary Interest or Interest Engendered by Love and Affection

Most states (unlike Massachusetts) have codified insurable interest rules, but unlike the English rule which (save in the case of a husband and wife) looks exclusively to pecuniary interest for the purpose of determining the existence of an insurable interest, all states except for California, in addition to equating insurable interest with pecuniary interest, also recognize an insurable interest without regard to the existence a pecuniary interest in the cases of persons “closely related by blood or by law” where there is in consequence a “substantial interest engendered by love and affection”. See, e.g., NY Ins. Law § 3205(a)(1)(A) (McKinney’s 2002); ND Cent. Code § 26.1-29-09.1(3)(a)(2001) and see generally Best, *Defining Insurable Interests In Lives*, 22 Tort & Ins. L.J. 104 (1986).

American courts have not been uniformly generous in finding an insurable interest premised upon love or affection. See, e.g., *Life Ins. Clearing Co. v. O’Neill*, 106 F. 800 (3d Cir. 1901) (holding that an adult son had no insurable interest in his father, rejecting the Massachusetts rule described in *Loomis* and citing with approval English case law). The Federal Appellate Court decision in *O’Neill* was, however, out of step with emerging law in the United States as presaged by the U.S. Supreme Court’s decision in dicta in *Warnock v. Davis*, 104 U.S. 775 (1881) [“It is not easy to define with precision what will in all cases constitute an insurable interest. . . it may be stated generally however, to be such an interest, arising from the relations of the party obtaining the insurance, either as creditor of or surety for the assured, or from the ties of blood or marriage to him, as will justify a reasonable expectation of advantage or benefit from the continuance of his life (emphasis supplied).”]

In 1908, the Kentucky high court declared the American doctrine of “insurable interest” to be free of the constraints of the English law pecuniary rule in a well reasoned decision citing to the laws of numerous other American jurisdictions. After making reference to the “English doctrine” attributable to the 1774 Act it stated

“Although having no similar statute [to 14 Geo. III, c.48], the courts of several states have adopted the English doctrine. With all due deference to the courts thus holding, we are of the opinion that the rule announced

by them does not accord with the weight of authority and is not based upon sound reasoning.

Woodsy. Woods'Administrator, 130 Ky. 162, 113 S.W. 79,81(1908).

C. Lack of Symmetry in the American Definition

Although the majority of American states have codified the insurable interest rule in a form which reaches beyond the confining English law definition which equates insurable interest with pecuniary interest, there is a distressing lack of uniformity among the laws of the fifty American states. Some, for example take the view that a grandparent has an insurable interest in a grandchild and vice-a-versa, and others assert the contrary. Occasional pleas for a uniform law defining what constitutes an insurable interest in the United States appear to have fallen on deaf ears. See *Best, supra*, 22 Tort & Ins. L.J. 104, n.49 at 112. Even California which appears to follow the English doctrine by defining an insurable interest in such a manner as to preclude any party other than the insured or a person with a pecuniary interest in the insured from having an insurable interest arguably has a muddled view of the matter because its statute defining the insurance of minors clearly contemplates the possibility of close family relations of the minor having an insurable interest in the minor. Compare Cal. Ins. Code § 10110 (West's 2002) with Cal. Ins. Code § 10112 (West's 2002); and see *Best, supra*, 22 Tort & Ins. L.J. 104, 106.

D. Points of Inquiry for the International Insurance Market

(1) If American states existing at the time of the American Revolution either received the old English common law in respect of insurable interests or treated the 1774 Act as "operative" (per the U.S. Supreme Court at 94 U.S. 457, 460), other territories controlled by England at one time or another in their history subsequent to 1774 might have done the same; and if so what might this imply regarding the status of their current law?

(2) If an American resident is an insured life under the terms of a policy for the benefit of a bona fide "friend" and if such policy is governed by the law of an offshore jurisdiction of convenience, and if that jurisdiction's law defines an insurable interest by reference not only to pecuniary factors but also in the alternative by reference to persons having a substantial interest engendered by love and affection (without requirement for a blood or legal relationship). may one reasonably infer that (a) there would be no ground for the IRS to assert that the policy was a mere "wager" and not a "contract of insurance and (b) there would be no ground for the estate of the insured decedent to seek recover of proceeds otherwise payable to the policyholder?

II. CHANGE OF CIRCUMSTANCE OR POLICY ASSIGNMENT – MIGHT THIS TERMINATE THE INSURABLE INTEREST

A. Change of Circumstance

As a result of divorce, parties formerly having an insurable interest in each other might cease to have such following the dissolution of the marriage, although it should be noted that numerous special circumstances exist which have been held to support a continuing claim to an insurable interest by one former spouse in the life of the other former spouse. See, *3 Couch On Insurance* § 43:2 (3rd ed. 1995), footnotes 6-11. Absent special circumstance, is it the case that, where the dissolution of a marriage destroys all vestiges of insurable interest, a policy of life insurance procured by one spouse on the life of the other in advance of divorce becomes void for lack of a continuing insurable interest? American courts have responded to this question with a consistent “no”. See, *Connecticut Mutual Life Insurance Company v. Schaefer*, supra, 94 US 457, 461 [“We do not hesitate to say, however, that a policy taken out in good faith, and valid at its inception, is not avoided by the cessation of the insurable interest, unless such be the necessary effect of the provisions of the policy itself”] The Supreme Court in Schaefer paid particular close attention to the construction of the English doctrine citing with approval the holding of *Dalby v. India & London Life Assurance Co.*, 15 C.B. 365 (1854) which established the rule that there must be an insurable interest at the time the insurance is effected, but that it need not continue until death.

Is the rule otherwise where a former spouse has previously endeavored to murder her ex-husband and continues to have benefit of a policy of insurance on his life gifted to her in advance of the first attempt on the then husband’s life? Citing this as a “matter of first impression” an appellate court in Illinois declined to order, as requested by the former husband, that the policy on his life be cancelled citing as a basis for its decision the fact that a dissolution of marriage does not terminate the insurable interest of a spouse on the life of the former spouse as a matter of Illinois law and buttressing its decision with the observation that, if the ex-wife were to endeavor again to terminate her former husband’s life and succeed, she could not as a matter of Illinois law collect on the policy. See, *Meehan v. Transamerica Occidental Life Insurance Co.*, 148 Ill. App. 3d 477, 499 N.E. 2d 602 (1986). Although the Illinois Court in Meehan, might have gotten it right regarding the “insurable interest” principle, commentators have been critical of the decision and have observed that an insurance company which affects a “neutral” stance, as it did in the Meehan case, and fails itself to seek declaratory relief or take other protective steps”. . . may expose the company to a negligence claim if the insured is subsequently murdered by the beneficiary.” See, Rooney, *Tort Exposure and Policy Administration: Forgeries, Murders and Other Pitfalls*, 24 Tort & Ins. L.J. 702, 710 (1989).

B. Assignment Of A Policy: Bonafide Or Contrived And What Consequence

As a general matter of law in the United States, a policy of life insurance is assignable by the insured and enforceable by the assignee beneficiary against the insurer when the policy matures provided the policy has been taken out in good faith in the first instance with no idea of assigning it and afterwards in good faith the policy is assigned for valuable consideration to one who has no insurable interest in the life of

the insured. See, *Grigsby v. Russell*, 222 U.S. 149 (1913). The validity of such assignments even where all the formalities required by the carrier for effecting the assignment have not been observed is regularly recognized. See, e.g., *Luxton v. State Farm Life Insurance Co.*, 89 AFTR 2d 2002-866 (D. Minn. 2002) (Assignments of proceeds of three life insurance policies to the Internal Revenue Service to settle tax debts held effective).

American law will not permit an assignee to recover the proceeds of a policy on the life of an insured in respect of which he holds no insurable interest if evidence shows that assignment of the policy occurred contemporaneously with its issuance or later with a wagering intent. Such an assignment might either invalidate the policy or alter the identity of the party entitled to recover the proceeds on maturity. See, *Finnie v. Walker*, 257 F. 698 (2nd Cir. 1919) (holding that the contemporaneous assignment is a wagering contract, that the invalidity of the assignment does not void the policy, and that the assignee must account as trustee to the estate of the insured).

Long standing judicial policy requiring special scrutiny of contemporaneous issuances and assignments of insurance policies with a wagering intent have not deterred the aggressive growth in the United States of the "viatical settlement industry". The origins of this industry in the late 1980's were humane. It was intended to permit persons suffering from AIDS to sell at a discounted value policies on their own lives in order to facilitate their care and well-being while battling a terminal illness. This well-meaning business transmuted into a literal "lottery on lives" having nothing to do with the AIDS epidemic. In the typical scenario a healthy looking older client would be approached by an insurance agent with a promise of \$25,000 to 35,000 of cash per \$1 million dollars of coverage which the agent would place upon the agreeable insured with the intention that such policy be promptly assigned and sold to speculators. Often the applicant is in fact not healthy, but the policy (if it is small) avoids initial carrier scrutiny by reason of "clean sheeting". Because policies insured at the urging of a viatical settlement broker are typically assigned within weeks of issue, these transactions are known in the United States as "wet-ink" transactions. They have properly been labeled in commentary as "scams, lacking in validity as well as legality" and some commentators have projected that sooner or later regulators, insurance carriers or the estates of persons who lent their lives to such transactions will raise the obvious insurable interest issue. See, Baskies and Samuels, *Aggressive Viatical Settlement Transactions: Gambling On Human Lives*, 28 Estate Planning 76 (2001); www.crimes-of-persuasion.com ("Viatical Settlements Investment Fraud"); www.state.ct.us/CID/viafraud.htm.

C. Points Of Inquiry For The International Insurance Market

(1) Is there consistency of view in all jurisdictions with regard to the principle that an insurable interest existing at the time a policy is procured is sufficient notwithstanding a later change of circumstance which terminates the insurable interest?

(2) How might an off-shore carrier deal in its local jurisdiction with an

expression of concern by an insured regarding the murderous intent of an ex-spouse who owns a policy on his life?

(3) Are international insurers alert to the potential dangers of “wet-ink” transactions and the strong public policy concerns such policies engender in the jurisdictions where the insureds reside?

III. “LACK OF AN INSURABLE INTEREST”: THE INSURER’S SHIELD OR THE AGGRIEVED ESTATE’S SWORD?

A. Is A Policy Issued Upon Application Of A Person Lacking An Insurable Interest Void *Au Initio*

The English doctrine of insurable interest was judicially construed in 1904 not to mean that a policy issued in favor of one lacking an insurable interest is void *ab initio* but merely that it is vulnerable to an insurer’s later claim of lack of enforceability. See *Attorney-General v. Murray and Another* [1904] 1 K.B. 165. By contrast there can still be found in modern American case law some instances of policies being construed as *void ab initio* by reason of the failure of an applicant to obtain the formal consent of the insured before the policy has issued. See, e.g., *Time Insurance Co. v. Lamar*, 195 Ga. App. 452, 393 S.E. 2d 734 (Ct. App. 1990) [“The public policy of this state [Georgia] is clear regardless of the technical existence of an *insurable interest*. . . a life insurance contract issued insuring an adult. . . is void *ab initio*, *unless* the adult to be insured, being of competent legal capacity to contract, either applied for the insurance personally or consented to it in writing.”].

The greater weight of American authority clearly favors a finding that a policy issued without necessary consent or to one lacking an insurable interest is not void but merely voidable. See, *New England Mutual Life Insurance Co. v. Caruso*, 73 N.Y. 2d 74, 538 N.Y.S. 2d 217 (1989). Modern New York law gives a carrier a two-year period to contest enforceability whereafter the obligation of the insurer to pay is enforceable but entitlement to the proceeds may be contested by the insured or his representative if a payment has been made to a policyholder lacking an insurable interest. See also, *Jackson National Life Insurance Co. v. Receconi*, 113 N.M. 403, 827 P. 2d 118 (1992) [Jackson’s most strenuously asserted argument on this appeal -- although we do not attach nearly as much credence to it as does *Jackson* -- is that Fr. Receconi’s life insurance policy was void *ab initio* because he did not sign the application or consent to the policy in writing ...we think this issue is satisfactorily resolved by reference to New Mexico authority ...an insurance policy which violates a statute designed for the protection of the insured is nevertheless enforceable against the insurer.”].

B. May Only The Insurer Raise The Issue Of Lack Of Insurable Interest-- The Times, They Might Be Changing

Historically as a matter of English law and American law lack of

insurability has been considered a defense for the insurer and not one which may be raised by other parties. Commentary advises that the majority of courts which have considered the issue have held that only the insurance carrier itself may raise the objection of lack of an insurable interest. See, *3 Couch On Insurance* § 41:5 (3rd ed. 1995), footnote 37. Typical of cases holding that the insurer alone may assert that the beneficiary of a life policy does not have an insurable interest are *Secor v. Pioneer Foundry Company*, 20 Mich. App. 30, 173 N.W. 2d 780 (Ct. App. 1969) (widow denied standing to complain that her late husband's former employer had no continuing insurable interest after her husband had left its employ) and *Ryan v. Tickle*, 210 Neb. 630, 316 N.W. 2d 580 (1982) (widow of decedent had no standing to complain that her late husband's business partner lacked an insurable interest in her husband's life, accordingly she and other heirs of the insured could not proceed on such a cause of action against the designated beneficiary).

Insurance carriers and beneficiaries, who have applied for policies where an insurable interest has been lacking, should take note that both statutes in certain states (such as New York and North Dakota) and judicial construction in other states such as New Mexico and Texas today support the proposition that statutes requiring an insurable interest or requiring a consent by the insured are intended for the protection of the insured, not for the protection of the insurance carrier. Law in those states allows the estate of the deceased insured and his heirs to raise a claim against beneficiaries who lack an insurable interest and thereby to draw the carrier into the nexus of the dispute the end result of which may be severe finance loss for the beneficiary and significant legal cost for the insurer.

New York law in force since 1939 and cited with approval in *New England Mutual Life Ins. Co. v. Caruso*, 73 N.Y.2d 74, 80, 538 N.Y.S. 2d 217, 220-22 1 (1989), states:

"If the beneficiary, assignee or other payee under any contract made in violation of this subsection [insurable interest in the person] receives from the insurer any benefits thereunder accruing upon the death, disablement or injury of the person insured, the person insured or his executor or administrator may maintain an action to recover such benefits from the person receiving them." N.Y. Ins. Law § 3205(d)(4) (McKinney's 2002).

North Dakota statute law is now identical to that of New York. See ND Cent. Code § 26.1-29-01.1(2)(2001).

The Texas Court of Appeals, Houston District, in a recent landmark decision which should be of material concern both to large employers and to insurance carriers (See discussion, *infra*, regarding "dead peasant policies") has commented negatively on the Michigan Court of Appeals' decision in *Secor* and has held

"When issuing a policy, the insurer is aware the designated beneficiary differs from the insured and nonetheless agrees to pay a set amount

under certain circumstances. Once the policy has issued and the premiums have been paid, it would be inequitable for an insurer, at that late date, to attempt to escape its contract by claiming the beneficiary had no insurable interest. . . If the insurance company issues the policy, then regardless of whether there is an insurable interest, the insurer should have to pay the proceeds to the beneficiary. . . If the estate alleges the beneficiary receiving those proceeds had no insurable interest in the deceased, the estate should be able to challenge the beneficiary's right to retain those proceeds." *Tamez v. Certain Underwriters At Lloyd's London*, 999 S.W. 2d 12 (Tex. Ct. App. 1998).

What are the consequences of the estate of the deceased being granted standing to raise a claim of lack of insurable interest against the beneficiary of a life policy? In the *Tamez* case the face amount of the policy paid to National Convenience Stores, Inc. by Lloyd's following the accidental death of the employee insured was \$250,000. According to a footnote in a very recently published decision of the Texas Court of Appeals, Houston District, involving different parties but issues similar to those raised in the *Tamez* decision, National Convenience Stores". . . reportedly paid \$4.1 million to some of the *Tamez* family members" in order to settle the litigation. See *Certain Underwriters at Lloyd's London v. Smith*, -- S.W. 3d --, 2002 W.L. 730 463 (Tex. App. -Hous. (14 Dist.)), footnote 1.

C. Points of Inquiry for the International Insurance Market

(1) Should an off-shore insurance company caution an applicant who seeks to insure a life other than his own that, although it is not the intention of the carrier to contest his claim to an insurable interest, modern judicial construction in the jurisdiction in the applicant's residence might subject the applicant to a claim by the representative or heirs of the insured if he or it is found to lack an insurable interest under the law of the jurisdiction where he or it resides (i.e. how comfortable can either applicant or carrier be in this circumstance that the law of the jurisdiction where the policy issues will govern)?

(2) If an insurance company has loaned funds to a VUL policyholder secured by the separate account of such policy and if upon the decease of the insured the policyholder is deprived of entitlement to such funds by decision of a court in a jurisdiction such as New York or Texas that the policyholder lacks an insurable interest, what consequence for the carrier which has effected an offset against policy proceeds which have been held not to belong to the borrower beneficiary?

(3) Given Chief Justice Brister's observation in a concurring opinion that the *Tamez* panel "... may not have realized it was creating a mass tort" when it gave *Tamez* family members standing to challenge NCS's insurable interest, and given the reality that 'certain underwriters at Lloyd's London" have been defendants in the *Tamez* and other litigation along with policy beneficiary National Convenience Stores, Inc., how comfortable, can insurance carriers be that the transformation of their insurable interest

shield into a decedent estate's sword is a matter of concern only, or primarily, for the policyholder beneficiary?

IV. ACTIONABLE NEGLIGENCE FOR PROVIDING INDUCEMENT TO CRIMES

A. Saying "Sorry" Isn't Enough

Insurance carriers have been held liable in the United States for the consequences of negligent conduct where a policy has been issued to an applicant on the life of an insured in respect of whom the applicant obviously lacks an insurable interest and grievous harm thereafter befalls the insured at the hands of the applicant. See, e.g. *Liberty National Life Insurance Co. v. Weldon*, 267 Ala. 171, 100 So. 2d 696 (1957); *Ramey v. Carolina Insurance Co.*, 244 S.C. 16, 135 S.E. 2d 362 (1964). In *Weldon*, a vicious aunt (by marriage) of a young girl in whose life she had no insurable interest procured \$6,500 worth of life insurance with the connivance of an agent and thereafter poisoned the girl. The Alabama Supreme Court brushed aside the insurance carrier's argument that the insurable interest rule is meant only to protect insurance companies observing:

"The position of the defendant seems to be that if murder results, the insurance companies are, of course, sorry that the insured met with such a fate, but they have no liability if there is no insurable interest although they can treat such policies as completely void. . . The rule is designed to protect human life. Policies in violation of the insurable interest rule are not dangerous because they are illegal; they are illegal because they are dangerous. See, 267 Ala. 171, 186; 100 So. 2d 696, 708.

The Alabama Supreme Court affirmed a judgment for plaintiff in the amount of \$75,000, a verdict which the Alabama Court acknowledged was "perhaps the largest to come before this court [as of 1957] in a case brought under the so-called homicide statute."

B. Lack of Knowledge Constitutes a Defense

More is required for an insurance carrier to be held liable than evidence that the existence of a policy has motivated a policy holder to maim or kill the insured. A deeply divided Massachusetts Supreme Court exonerated an insurance carrier from liability (where a malevolent business partner forged an assignment of policy benefits from the wife and family of his partner to himself, openly named himself as witness to the forged assignment and thereafter murdered his partner) because the claimant widow could show no evidence proving that the insurer knew or should have known that its acceptance and approval of the change of beneficiary request exposed the insured to an unreasonable risk of harm. See, *Bacon v. Federal Kemper Life Insurance Co.*, 400 Mass. 840, 854, 512 N.E. 2d 941, 943 (1987). A commentator who has examined the *Bacon* case in detail has observed "regardless of the final outcome in *Bacon*, insurers would be well advised to recognize that their administrative activities may be closely

scrutinized if harm should befall an insured where life insurance is the motivation.” See, Rooney, *supra*, 24 Tort & Ins. L.J. 702, 709. In cases stemming from an airplane crash precipitated by a passenger to whom a large amount of life insurance had been sold and who thereafter allegedly caused the airplane to crash, courts have declined to agree that the sale of flight insurance presents a conspicuous hazard that a passenger might be induced to cause the airplane to crash. Distinguishing the circumstances from those found in the *Weldon* and *Ramey*’ cases a California Court held:

.the sale of flight insurance, unlike the sale of ordinary life insurance, must, by its very nature, be an expeditious process, thereby precluding the insurance companies from conducting an investigation into the financial condition and mental state of the passenger.

See, *Galanis v. Mercury International Insurance Underwriters*, 267 Cal.App.2d 690, 699 (Ct. App. 1st Dist. 1967).

C. Points of Inquiry for the International Insurance Market

(1) May an excessively liberal local law construction of insurable interest protect an insurer with international operations from liability in the jurisdiction of the residence of the insured or elsewhere if it has issued a policy on the life of the insured in manifest disregard of traditional notions of insurable interest and such action results in material harm to the insured?

(2) A commentator who analyzed the *Bacon* case in great detail conducted a survey of life insurance company practices in respect of witness checking on policy assignment forms and determined that “the few companies who did not compare signatures indicated that they had discontinued the practice as a cost cutting measure.” See, Rooney, *supra*, 24 Tort & Ins. L.J. 702, 709-7 10. To what extent has the offshore market considered the potential consequences of relaxing administrative safeguards in the interest of realizing modest economies?

V. “DEAD PEASANT POLICIES”: A CLEVER TAX SCHEME BEGETS AN INSURABLE INTEREST NIGHTMARE FOR BENEFICIARY AND CARRIER.

A. The Origins of Dead Peasant Policies

Company Owned Life Insurance (“COLT”) began innocuously enough approximately 60 years ago as “key man” insurance. No one questioned then, nor does anyone question today. the legitimate interest of a company in insuring the lives of its founder. its senior executives and its product development geniuses. A problem arose, however. when key man insurance evolved into “broad based leveraged COLI”, and companies began to insure not just founders and key executives but all manner of employees (*i.e.*, the “peasants”).

The motivation for insuring current and former employees from the janitorial ranks up is explained by the generous tax benefits which many large American corporations mistakenly thought they might obtain by investing in massive amounts of employee life insurance and then borrowing heavily against same. The specific impetus for dead peasant policies was likely 1986 tax legislation which expanded the IRC § 264 limitation on the deduction for interest paid in respect of amounts borrowed against a life insurance policy, subject to an exception for indebtedness not in excess of \$50,000 per employee. In 1996, the U.S. Congress put an end to the tax benefits associated with borrowing against the aggregate of broad based COLI by denying any interest deduction for loans directly related to life insurance regardless of loan size. Contemporaneous with the action of Congress, the IRS was busy litigating with marked success against the pre1996 schemes. A comprehensive treatment of the Internal Revenue Service position and citations to several tax cases involving broad based leveraged COLT may be found in IRS Technical Advice Memorandum 200213010 issued March 29, 2002.

B. The Connection Between Dead Peasant Policies and Insurable Interest

The promoters of broad based leveraged COLT understood from the outset the need for a relaxation of traditional insurable interest rules in order to justify a company's purchase and continued maintenance of policies on the lives of employees (and former employees) who fell outside the traditional definition of a "key man". Commentary points to Georgia as the pioneer in the development of facilitating legislation (something of an irony given the strict and very traditional construction of public policy in respect of insurable interest by the Georgia judiciary in other circumstances). See, Ga. Stat. §33-24-3(c): Leimberg & Gibbons, *COLI BOLI TOLI and "Insurable Interests"*, 28 Estate Planning 333 (2001) (citing to the Georgia law and commenting "where the new statutes have been enacted, the 'insurable interest' concept has moved far beyond the historical anti-wagering public policy").

Some states declined to follow the Georgia model, Texas being one of them. The *Tamez* case, discussed *supra*, involved accidental death policies, but the same attorneys of record in the *Tamez* case (viz., Michael D. Myers and Scott M. Clearman of McClanahan & Clearman) have commented publicly regarding their involvement in a case against Wal-Mart which took out approximately 350,000 life insurance policies on the lives of its employees payable to the company in respect of which Hartford Life Insurance Co. and AIG Life Insurance Co. are the insurers. A recent report reads:

"In each case, when the companies have sued the IRS to recover the money they had to pay in back taxes the courts have said the insurance was a tax dodge said Mike Myers, a lawyer with McClanahan & Clearman in Houston. He has sued Wal-Mart on behalf of Texas families seeking to collect the insurance proceeds that went to the giant retailer.

See, Sixel, *Executives Benefit From Workers' Demise*, San Francisco Chronicle (April 28, 2002) at G6.

C. Insurable Interest Becomes Politicized

The attorneys seeking to recover matured proceeds from the corporate beneficiaries of board based leveraged COLI have enlisted the assistance of the media and the assistance of Congress. The media have been pleased to oblige with catchy headlines referring to “dead peasant policies” which “pay out to bosses when employees die”. See, Sixel, *supra*, San Francisco Chronicle (April 28, 2002 at G3 and G6.) See also, Schultz and Francis, *Senator to Target Tax Boon to Firms Insuring Workers*, The Wall Street Journal, (May 3, 2002 at A2). The Honorable Gene Green (D-Tex.) introduced HR 4551 in the House of Representatives on April 23, 2002. a bill to deem the nondisclosure of employer-owned life insurance coverage of employees an unfair trade practice under the Federal Trade Commission Act and for other purposes. See, 2001 Cong. US HR 4551, 107th Cong., 2d Sess. In comments to the press, Congressman Green has said he is concerned that an employer engaged in the purchase of policies on workers (in whom it has no traditional insurable interest) might have a disincentive to provide a safe workplace because it would profit from an employee's death. In supporting remarks before Congress on April 23, 2002, Congressman Green linked COLI with the pejorative “dead peasant policy” moniker and characterized the scheme as secret life insurance purchased by American companies on the chance that one of their employees dies and they can collect the six-figure death benefit. Commenting that he was “... amazed that this all began as a simple tax dodge worth billions of dollars. . .” Congressman Green might unwittingly have been echoing similar comments being made senior executives of major corporations and insurance companies now ensnared in a public relations nightmare.

Ominously, Senator Bingham (D-N.Mex) has announced his intention to ask the Joint Committee on Taxation to bring renewed scrutiny to the use of COLI to reduce corporate taxes, a scrutiny which might cause Congress to revisit the question of formulaic reduction of corporate interest deductions where they benefit from tax free inside buildup in respect of policies carried on the lives of employees. Such legislation was proposed by the Clinton Administration in 1998 at which time representatives of the life insurance industry correctly observed that “this would impose an indirect tax on accumulating cash values — as unborrowed cash values increased, the business' interest disallowance would correspondingly increase.” See, February 25, 1998 Congressional Testimony, *John Jonas Written Statement for the Record of the Business Insurance Coalition to the Committee on Ways and Means*, 1998 WL 11516160.

D. Points of Inquiry for the International Insurance Market

(1) Overly aggressive schemes produce bad public relations, and bad public relations produce bad law — does the maxim have implications for the insurance industry beyond the immediate crisis caused by “dead peasant policies”?

(2) Will there be a legislative back lash to the relaxation in the insurable interest rule effected by many American states to accommodate broad based leveraged COLI?

VI. The Tax Definition of a “Life Insurance Contract”

The Internal Revenue Code requires that a life insurance contract qualify as such “under applicable law” and then proceeds to impose additional complex technical conditions designed to preclude life insurance from becoming a disguised investment contract. See, IRC § 7702 (a). The technical questions of whether a life insurance contract meets the requirement of either the “cash value accumulation test” or in the alternative, meets both the “guideline premium requirements” and falls within the “cash value corridor” are beyond the scope of this analysis of “insurable interest”.

The legislative history of the Tax Reform Act of 1984 which lead to the enactment of IRC § 7702 evidences that a life insurance contract is defined as any contract which is a life insurance contract under the applicable state or foreign law, provided the contract also meets the technical tests in respect of cash value accumulation or guideline premium and cash value corridor requirements. In order for an agreement to meet the basic definition of a “life insurance contract”, there must be a shifting and distributing of risk and there must be an insurable interest. The requirement for risk shifting is examined in *Barnes v. United States*, 801 F.2d 984 (7th Cir. 1986). The Seventh Circuit’s articulation of the risk shifting requirement is frequently cited by the IRS in administrative rulings. See, e.g., IRS Private Letter Ruling 200002030 (January 14, 2000). If there is risk shifting, but no insurable interest, the agreement may be construed as a wagering contract not eligible for the tax benefits conferred upon life insurance. See *Atlantic Oil Co. v. Patterson*, 331 F.2d 516 (5th Cir. 1964).

The failure of an agreement both (a) to qualify as a life insurance contract which is treated as such under state or foreign law and (b) meet one or the other of the technical tests of IRC § 7702 renders the policy holder liable to include in his or its current income as ordinary income “the income on the contract” for the taxable year. Income on the contract is equal to the sum of the increase in the net surrender value of the contract during the taxable year and the cost of life insurance protection provided under the contract during the taxable year over the premiums paid during the taxable year. See, generally, IRC § 7702(g).

Although Congress has evidenced a general willingness to accept that a contract constitutes life insurance if it meets the requirements of the applicable law of a foreign jurisdiction and also satisfies the technical tests designed to disqualify a disguised investment contract, it would seem unwise, particularly in light of the current public debate over “dead peasant policies”, for a foreign insurer creating US compliant policies for the American market to over emphasize the comparative liberality of its law regarding such matters as insurable interest or juvenile insurance. Cf 1 Mertens Law of Fed. Inc. Tax’n § 7.63 [Life Insurance Contracts -- Nonstatutory Requirements], fn. 83 [“Even after the enactment of IRC § 7702 it seems unlikely the Service or the Tax Court

would defer to a State's definition of insurance if it were out of the ordinary.”]

One commentator who has encouraged practitioners to investigate the impact of offshore insurance laws in the areas of insurable interest and juvenile insurance has also correctly observed:

...although Congress repeatedly has had the opportunity to narrow the scope of “applicable law” (in the IRC § 7702 context) to that of a purely domestic nature, it has declined to do so in each case through the use of language referencing “foreign law”.

See, Hampton, *International Life Insurance Presents Unique Planning Opportunities*, 24 *Tax Management Estates Gifts and Trusts Journal*, 175, 177 and 179 (1999).

Recognizing the potential that Congress could narrow the scope of applicable law, or that the IRS and a court could recharacterize a life insurance agreement as a wagering contract even without such a sweeping change as a refusal treat foreign law as applicable law, it would seem prudent for an offshore jurisdictions aiming at the US market not to move out of line with American public policy perceptions regarding insurable interest and juvenile insurance.

This article should not be construed as legal advice or opinion, since legal opinions are only given to clients in response to inquiries involving specific facts.