

CATALYSTS FOR CLARIFICATION: MODERN TWISTS ON THE INSURABLE INTEREST REQUIREMENT FOR LIFE INSURANCE

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The long dormant insurable interest doctrine is being revisited as banks and other funds purchase life insurance policies in increasing numbers. Some industry commentators have raised objections, accusing Wall Street of perpetrating schemes that amount to impermissible gambling on the lives, and deaths, of others. In response, Wall Street financiers have insisted that they are committed to complying with state insurable interest statutes and that their efforts at building a secondary market for life insurance policies is expanding consumer options and eliminating the long-standing monopsony of the insurance companies. A workable compromise between the insurance industry and Wall Street positions that will modernize the insurable interest doctrine must simultaneously protect the free-assignability of life insurance policies and avoid a rekindling of the long-despised practice of gambling on lives. Development of such a proposal requires comprehensive examinations of the history of the insurable interest doctrine, the modern context within which it is being applied, and the primary proposals to modernize the doctrine that have been offered to date.

I. AN INTRODUCTION TO THE CURRENT INSURABLE INTEREST DEBATE

The long dormant insurable interest doctrine is now being revisited as an outgrowth of the last decade's halcyon financial markets.¹ As banks

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¹ See generally Bryan D. Bolton & Michael P. Cunningham, *An Ancient Doctrine Confronts Modern Problems*, FOR THE DEFENSE (Sep. 2008); Robert B. Barnett, Jr. et al., *Amended Substitute House Bill 404: Ohio's Definition of "Insurable Interest" Unfortunately Remains Largely Uncodified*, 19 OHIO PROB. L.J. 4 (2008); James C. Magner, *Whose Life (Insurance) is it, anyway?*, STEVE LEIMBERG'S EST. PLAN. EMAIL NEWSL. (Oct. 30, 2007); Jacob Loshin, *Insurance Law's Hapless Busybody: A Case Against the Insurable Interest Requirement*, 117 YALE L.J. 474 (2007); Robert B. Barnett, Jr. & Jessica B. Kling, *The Insurable Interest Rule: Who Kicked the Slumbering Bear-and Did it Wake Him Up?*, 16

and other funds purchase life insurance policies in increasing numbers, insurance industry commentators have raised objections, accusing Wall Street of perpetrating schemes that amount to impermissible gambling on the lives, and deaths, of others. Describing Wall Street's foray into the mortality markets as "death pools" designed to profit on the arrival of the Grim Reaper, commentators have characterized this practice as violating the spirit, if not the letter, of state insurable interest laws.²

In objection to such characterizations, Wall Street financiers assure the industry that they are committed to complying with state insurable interest statutes. They further suggest that their efforts at building a secondary market for life insurance policies is expanding consumer options and eliminating the insurance companies' long-standing monopoly.³ Just as the viatical markets were created in an effort to help AIDS patients deal with end-of-life expenses, they argue, a robust secondary market will increase the liquidity and value of consumers' unwanted insurance policies.⁴

The enormous demand created by Wall Street's desire to make the life insurance market yet another sub-asset class in the greater asset-backed securities paradigm has served as the germ seed of some expansive interpretations of the insurable interest requirements, thus prompting many of the industry commentators' complaints.⁵

As regulators and legislators attempt to refine the insurable interest doctrine, this article examines the pitfalls and possibilities presented by their efforts to improve upon the policy objectives underlying the insurable interest requirement. Specifically, this article examines the insurable

OHIO PROB. L.J. 171 (2006); Peter Nash Swisher, *The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 DRAKE L. REV. 477 (2005).

² See Jenny Anderson, *Wall Street Pursues Profit in Bundles of Life Insurance*, N.Y. TIMES, Sep. 5, 2009, <http://www.nytimes.com/2009/09/06/business/06insurance.html?emc=eta1>; <http://www.nytimes.com/2009/09/06/business/06insurance.html?emc=eta1>; M. Corey Goldman, *'Til Death Do us Part*, HFM WEEK, Jan. 18-24, 2007, at 23; Magner, *supra* note 1.

³ See, e.g., Natalie Rosenfelt, *The Verdict on Monopsony*, 20 LOY. CONSUMER L. REV. 402, 404 (2008).

⁴ Vishaal Bhuyan, LIFE MARKETS: TRADING MORTALITY AND LONGEVITY RISK WITH LIFE SETTLEMENTS AND LINKED SECURITIES 14 (John Wiley & Sons eds., 2009); Kelly J. Bozanic, *An Investment to Die for: From Life Insurance to Death Bonds, the Evolution and Legality of the Life Settlement Industry*, 113 PENN ST. L. REV. 229 (2008).

⁵ See e.g. Bolton, *supra* note 1.

interest doctrine and its place in the mixture of separate but interrelated issues implicated by STOLI transactions, including: (1) material misrepresentations made on the policy application; (2) placement of the burden of establishing an insurable interest; and (3) the doctrine's wider interrelationship with the bundle of intangible property rights inherent in a modern life insurance contract. By means of a thorough examination of the insurable interest doctrine in the context of these related and intertwined issues, this discussion serves as a call for measured restraint as policy makers attempt to address market abuses with changes to the long-standing insurable interest doctrine.

Recent commentary decrying STOLI and similar practices has, in many cases, focused on violations of the insurable interest doctrine. Largely unaltered in British and American law over 230 years, the insurable interest doctrine is a natural candidate for upgrade in the morass of insurance regulations and common law doctrines implicated by STOLI. Destabilization of the doctrine will introduce uncertainty as to the value of many life insurance policies. If potential purchasers can no longer be certain of whether a policy will be valid or void for lack of an insurable interest, the resulting questions about the enforceability of the contract creates a potential shadow looming large over the foundation of consumer confidence in life insurance generally. Rather than impinging on the insured's property interest in a life insurance policy by introducing uncertainty into the insurable interest requirement, the tangle of socially undesirable activities inherent in most STOLI transactions must be unwound and individually scrutinized. Violations of the insurable interest requirement are an essential element of STOLI, but other elements of the transaction are equally offensive. For instance, if the insurer does adequate due diligence, asking questions sufficient to ferret out offending policies, parties conspiring to purchase a policy as part of a STOLI scheme must, by necessity, make misrepresentations on the policy application. These misrepresentations are ripe for STOLI enforcement, as they often void the contract and also may violate criminal law. Focusing solely on revising the insurable interest doctrine is too narrow an approach to deal with modern problems like STOLI. Wholesale revision of the insurable interest doctrine is unnecessary, when other less drastic tools for combating STOLI and other undesirable practices are available.

Viewed in its historical context, the insurable interest requirement emerges as a relevant, powerful tool to combat unsavory life-insurance practices. The continuing relevance of the insurable interest doctrine, and the importance of policing misrepresentations on life insurance policies, will be explored as follows: Section II maps the development of the

insurable interest doctrine, placing it, and the contemporary discussion surrounding it, into historical context. Section III examines the effect that lack of an insurable interest has on the validity of policy, drawing out one of the disincentives the doctrine presents to STOLI participants. Further exploring the bar the insurable interest requirement presents to those who would purchase a life insurance policy for an improper purpose, section IV probes the allocation of the economic and legal burdens of the insurable interest requirement between parties to the insurance contract. Section V examines the history of life insurance as personal property, encouraging circumspect deliberation for those who would restrict the transferability of life insurance contracts. Concluding the examination of the transferability of life insurance contracts, Section VI surveys the history of the secondary market for life insurance. Section VII moves the discussion to recent cases illustrating the modern problems taxing the flexibility of the insurable interest doctrine. In addition to enunciating the courts' use of the insurable interest requirement, that section also draws out the second facet of the courts' analysis of STOLI, the misrepresentations necessarily made on most applications for STOLI policies. Finally, section VIII discusses NAIC and NCOIL and their affect on the insurable interest requirement.

II. HISTORY OF THE INSURABLE INTEREST REQUIREMENT

A. DEFINITION OF THE INSURABLE INTEREST REQUIREMENT FOR LIFE INSURANCE

In general, anyone purchasing a life insurance policy must have an insurable interest in the life of the insured. The definition of "insurable interest" has changed very little from its inception in English life insurance law in 1774⁶ to its present manifestation in US statutory and case law.⁷

⁶ See LIFE ASSURANCE ACT, 1774, 14 GEO. 3, c. 48, §§ 1-3 (Eng.). The Act, which is still in force, provides as follows:

1. From and after the passing of this Act no insurance shall be made by any person or persons, bodies politick or corporate, on the life or lives of any person, or persons, or on any other event or events whatsoever, wherein the person or persons for whose use, benefit, or on whose account such policy or policies shall be made, shall have no interest, or by way of gaming or wagering; and every assurance made contrary to the true intent and meaning hereof shall be null and void to all intents and purposes whatsoever.

In most versions of the insurable interest requirement, a person has an insurable interest in the life of an individual based on either (1) “love and affection” or (2) a substantial economic interest in the continued life of that individual.⁸ Additionally, an insured generally has an unlimited insurable interest in his or her life.⁹

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

3. And in all cases where the insured hath interest in such life or lives, event or events, no greater sum shall be recovered or received from the insurer or insurers than the amount of value of the interest of the insured in such life or lives, or other event or events.

⁷ Compare ARIZ. REV. STAT. ANN. § 20-1104(c)(1)-(2) (2010)(defining “insurable interest” as “a substantial interest engendered by love and affection... or a lawful and substantial economic interest in having the life, health or bodily safety of the individual insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the individual insured.”) with *Warnock v. Davis*, 104 U.S. 775, 779 (1881) (stating that an insurable interest arises “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.”).

⁸ See, e.g., ARIZ. REV. STAT. ANN. § 20-1104(c) (2009/2010); N.D. CENT. CODE § 26.1-29-09.1 (2010); ALA. CODE 1975 § 27-14-3(a) (SUPP. I 2009); GA. CODE ANN. § 33-24-3(a) (SUPP. I 2009); CAL. INS. CODE § 10110.1(a) (2005); ARK. CODE ANN. § 23-79-103 (c)(1) (2004); MISS. CODE ANN. § 83-5-251(3) (2009/1972); *But see* *Halford v. Kymer*, 10 B. & C. 724 (1830) (holding that a father does not have an insurable interest in the life of his son because, under the Life Assurance Act of 1774, a pecuniary interest is essential to find an insurable interest.) *contra* *Loomis v. Eagle Life & Health Ins. Co.*, 6 Gray 396 (Mass. 1856) (stating that, under Massachusetts law, a father has an insurable interest in the life of his son); *see also* *Barnes v. London, Edinburgh & Glasgow L. Ins. Co.*, 1 Q.B. 864 (1892).; *Erskine Hazard Dickson, Insurable Interest in Life, III*, 44 AM. L. REG. 161 (1896).

⁹ See, e.g., GA. CODE ANN. § 33-24-3(b) (SUPP. I 2009); CAL. INS. CODE § 10110.1(b); (2005); *Equitable Life Ins. Co. v. Cummings*, 4 F.2d 794 (3d Cir. 1925); *Davis v. Gulf States Ins. Co.*, 151 So. 167, 168 (Miss. 1933); *Hill v. United Life Ins. Ass'n*, 25 A. 771 (Pa. 1893); *Gray v. Nash*, 259 S.W.3d 286 (Tex. App. 2008);).

The “love and affection” brand of insurable interest is typically manifest as a close familial relationship.¹⁰ An economic interest in the continued life of the insured often exists as a creditor-debtor relationship¹¹, but has also been found to exist between partners in a company with respect to its employees.¹²

The relationships encapsulated by both the “love and affection” and “economic interest” types of insurable interest are viewed as giving a policy-owner an interest in the insured’s life that exceeds the pecuniary benefit the beneficiary will reap from the policy on the insured’s death.¹³

Though the foregoing definition of “insurable interest” has remained relatively static since its inception, its effectiveness in the face of modern variations on life insurance is still the subject of substantial disagreement.¹⁴ Of particular importance to understanding its application to novel, contemporary life insurance arrangements are the policy considerations motivating the insurable interest requirement.

B. POLICY CONSIDERATIONS MOTIVATING THE INSURABLE INTEREST REQUIREMENT

The insurable interest requirement is motivated by two primary policy considerations: (1) the immorality inherent in gambling on the life of another human being and (2) the moral hazard created when a beneficiary

¹⁰ See, e.g., CAL. INS. CODE § 10110.1(a) (2005); ARK. CODE ANN. § 23-79-103(c)(1)(A); (2004).

¹¹ See, e.g., *Crotty v. Union Mut. Life Ins. Co. of Maine*, 144 U.S. 621 (1892); *Connecticut Mut. Life Ins. Co. v. Luchs*, 108 U.S. 498 (1883); *Warnock v. Davis*, 104 U.S. at 775.

¹² See, e.g., *Connecticut Mut. Life Ins. Co.*, 108 U.S. at 505-06; *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 901 A.2d 106 (Del. 2006); *Prime Mortg. USA, Inc. v. Nichols*, 885 N.E.2d 628, 669-70 (Ind. Ct. App. 2008) (holding that a statute giving an employer an insurable interest in its employees applies whether the employer provides the policy to the employee or purchases a policy on its employee’s life.).

¹³ See, e.g., *Waldman v. Maini*, 195 P.3d 850 (Nev. 2008).

¹⁴ Compare *Loshin*, *supra* note 1 (arguing that elimination of the insurable interest requirement will free economic forces to police the insurance industry and the secondary markets and protect against the abuses the insurable interest requirement is intended to assuage) with *BOLTON & CUNNINGHAM*, *supra* note 1 (analyzing the traditional insurable interested requirement as applied to the modern phenomenon of stranger-originated life insurance).

has a motivation to bring about the death of an insured to accelerate a policy's payout.¹⁵

Gambling on lives was a relatively common practice in 18th century England, where the institution resembled modern day sports betting. While this wagering sometimes took place in social settings, the preferred method for wagering was the purchase of life insurance contracts, most often on the lives of public figures. The value of these speculative contracts floated depending on factors affecting the perceived life expectancy of an insured, like the turning of tide in war and the progress of capital trials. Though public condemnation of the practice in England lagged far behind the rest of Europe, by the late-18th century, public sentiment had turned. Gambling on lives came to be viewed as blunting human empathy and encouraging acts by beneficiaries that would hasten collection of a policy's death benefit.¹⁶

A notorious example often cited as illustrating the moral hazard inherent in a life insurance policy issued to one without an insurable interest in the insured's life¹⁷ is the case of Thomas Griffiths Wainwright (1774-1847).¹⁸ Wainwright was an author and dandy with extravagant tastes that led him to commit increasingly risky and horrific crimes to satisfy his appetites and the debts they accumulated. When forgery and the acceleration of an inheritance by his uncle's suspicious death were insufficient to sustain Wainwright's lavish lifestyle, he turned to life insurance as an "investment." Wainwright insured the life of his sister-in-law, though he did not have an insurable interest in her life, and soon increased the coverage on her life six-fold. She died of poisoning shortly thereafter. Wainwright never successfully collected the life insurance proceeds, and he as he spent the remainder of his years in jail on a charge of forgery.¹⁹ Though not as romanticized as the Wainwright case, another often cited example of moral hazard is the Weldon case, where a woman

¹⁵ See *Grigsby v. Russell*, 222 U.S. 149 (1911); *Warnock v. Davis*, 104 U.S. at 778-79; *Trinity College v. Travelers' Ins. Co.*, 18 S.E. 175 (N.C. 1893); *Aetna Life Ins. Co. v. France*, 94 U.S. 561 (1876); *Connecticut Mutual Mut. Life Insurance Company Ins. Co. v. Schaefer*, 94 U.S. 457 (1876); *Aetna Life Ins. Co. v. France*, 94 U.S. 561 (1876); William Reynolds Vance, *HANDBOOK OF THE LAW OF LIFE INSURANCE* 125-26 (1904); Robert W. Buechner, *Stranger-Owned Life Insurance: The Good, the Bad, and the Ugly*, 19 OHIO PROB. L.J. 7 (2008).

¹⁶ GEOFFREY WILSON CLARK, *BETTING ON LIVES: THE CULTURE OF LIFE INSURANCE IN ENGLAND, 1695-1775* 49-60 (1999).

¹⁷ See, e.g., *Grigsby*, 222 U.S. at 154-155.

¹⁸ Wainwright wrote under the pseudonym Janus Weathercock.

¹⁹ ALEXANDER COLIN CAMPBELL, *INSURANCE AND CRIME* 223-38 (1902).

purchased a life insurance policy on the life of her two-and-one-half-year-old niece and then poisoned the child in an effort to accelerate payment of the policy's death benefit.²⁰

It is worthwhile to note that in both the Wainwright and Weldon cases, at the time each crime occurred, both jurisdictions had an insurable interest requirement that voided the policies.²¹ While these examples are proof that in at least some cases the insurable interest requirement is insufficient to eliminate the motivation of an individual with a criminal disposition to use life insurance as part of a nefarious scheme, the requirement is likely to have at least some deterrent effect by exponentially increasing the difficulty of securing a death benefit payout in the absence of an insurable interest.²²

C. SNAPSHOT OR CONTINUUM

1. In general

Generally, an insurable interest is required only at the time a life insurance policy is issued, unless the policy specifies otherwise.²³ This stands in contrast to most other types of insurance policies, which require beneficial owners of a policy to have an insurable interest in the subject matter of the policy both when the policy is issued and when the policy pays on a loss.²⁴

²⁰ *Liberty National Life Insurance Co. v. Weldon*, 100 So.2d 696 (Ala. 1957.); *See also Mutual Mut. Life Ins. Co. v. Armstrong*, 117 U.S. 591 (1886) (considering whether the assignee of a life insurance policy is permitted to recover the policy's death benefit. Unsurprisingly, the Court decided against the murderer.); *Ben Kingree & Louise Tanner, Life Insurance as Motive for Murder*, 29 TORT & INS. L.J. 761 (1994).

²¹ *See LIFE ASSURANCE ACT*, 1774, 14 Geo., 3, c. 48 (Eng.); *Liberty National Nat'l Life Insurance Ins. Co. v. Weldon*, 100 So.2d 696 at 704; *Campbell*, *supra* note 19, at 225.

²² *See Kingree & Tanner, supra* note 20, at 772.

²³ *See, e.g., MO. REV. STAT. § 5862*; *Connecticut Mutual Mut. Life Insurance Company Ins. Co. v. Schaefer*, 94 U.S. 457, 461 (1876); *Mutual Wellhouse v. United Paper Co.*, 29 F.2d 886 (5th Cir. 1929); *Mut. Life Insurance Ins. Co. v. Allen*, 138 Mass. 24 (1884); *Olmsted v. Keyes*, 85 N.Y. 593 (1881); *Bowers v. Missouri Mut. Ass'n*, 62 S.W.2d 1058 (Mo., 1933); *First-Columbus Nat. Bank v. D. S. Pate Lumber Co.*, 141 So. 767 (Miss. 1932); *Appeal of Corson*, 6 A. 213 (Pa. 1886); *Hilliard v. Jacobs*, 874 N.E.2d 1060 (Ind. Ct. App. 2007); *Rawls v. American Life Ins. Co.*, 36 Barb. 357 (N.Y. Sup. Ct. 1862);

²⁴ *See generally* 44 C.J.S. *Insurance* § 322 (2009/2010).

From the advent of the insurable interest requirement, most jurisdictions have followed the modern rule, only requiring an insurable interest in the insured's life at the time the policy is issued and not at any time thereafter.²⁵ For example, when a life insurance policy purchased on a spouse's life during marriage names the other spouse as a beneficiary, in most jurisdictions, divorce will not terminate an ex-spouse's right to collect policy proceeds even though the ex-spouse's insurable interest likely died with the divorce.²⁶

2. Application of the Insurable Interest Requirement to Policy Assignments

While the insurable interest requirement has generally only applied at a policy's issuance, courts have struggled with the issue of whether an insurable interest is also required of an assignee on assignment of the policy. While the present rule permitting assignment to a person without an insurable interest is fairly uniform across jurisdictions, prior to the 20th century, there was a split of authority. In some jurisdictions, an assignment of a life insurance policy to a person without an insurable interest in the insured's life was void as a matter of law.²⁷ In other jurisdictions, such an assignment was permissible, though not so to the extent it violated the prohibition on wager policies.²⁸

Courts requiring an assignee to have an insurable interest in the life of the insured typically reasoned that the public policy rationale for

²⁵ See, e.g., *Steinback v. Diepenbrock*, 158 N.Y. at 30 (1899); *Appeal of Corson*, 6 A. at 213.

²⁶ *Connecticut Mutual Mut. Life Ins. Co.*, 94 U.S. at 457; *Land v. West Coast Life Ins. Co.*, 270 P.2d 154, 156 (Or. 1954); *Begley v. Miller*, 137 Ill. App. 278 (1907).

²⁷ See, e.g., *Warnock v. Davis*, 104 U.S. 775, 781 (1881); *Stevens v. Warren*, 101 Mass. 564 (1869); *Franklin Life Ins. Co. v. Hazzard*, 41 Ind. 116, 121 (1872) (refusing to permit assignment of a policy to one without an insurable interest on the grounds that “[a]ll the objections that exist against the issuing of a policy to one upon the life of another in whose life the former has no insurable interest, seem to us to exist against his holding such policy by mere purchase and assignment from another. In either case, the holder of such policy is interested in the death, rather than the life, of the party assured..”).

²⁸ See e.g. *Steinback v. Diepenbrock*,²⁸ See, e.g., *Midland Nat'l Bank of Minneapolis v. Dakota Life Ins. Co.*, 277 U.S. 346 (1928); *Grigsby*, 222 U.S. 149 (1911); *Mut. Life Ins. Co. v. Armstrong*, 117 U.S. 591 (1886); *Aetna Life Ins Co v. France*, 94 U.S. 561, 563-64 (1876); *Steinback v. Diepenbrock*, 52 N.E. at 662.

requiring an insurable interest at a policy's inception apply equally on assignment of the policy. They reasoned that the assignee gambles that the insured will die sooner rather than later, thus benefitting from the insured's early passing. They also viewed the assignee as motivated to hasten the insured's death to the same extent as a person without an insurable interest who purchases a policy on the insured's life from an insurance company.²⁹

In jurisdictions requiring assignees to have an insurable interest in the insured's life, an assignee who purchased a policy from the insured was treated as the insured's creditor to the extent of amounts expended by the assignee. The assignee was only permitted to recover an amount of the death benefit equal to the sum of consideration paid for the assignment and any premiums and fees paid by the assignee.³⁰

By the early 20th century, a majority of jurisdictions generally upheld assignment of a life insurance policy to an assignee without insurable interest in the insured's life.³¹ However, some assignments are still impermissible.

3. Prohibited Assignments

Schemes designed to circumvent the insurable interest requirement by effectuating an initial purchase of a life insurance policy by a person with an insurable interest in the insured's life and subsequently transferring the policy to a party without an insurable interest are not a new phenomenon.³² In the late 19th century, jurisdictions requiring an insurable interest only at a policy's inception were aware that permitting assignment of life insurance policies made circumventing the insurable interest requirement possible but believed that other policy considerations outweighed the danger of permitting free-assignment (see *infra* section V).³³

²⁹ *Id.*

³⁰ See, e.g., *Culver v. Guyer*, 29 So. 779 (Ala. 1901); *Missouri Valley Life Ins. Co. v. Sturgis*, 18 Kan. 93 (1877);).

³¹ *Steinback*, 52 N.E. at 663 (considering whether assignment of a policy to an assignee without an insurable interest in the insured's life was permissible, and concluding that: "The result of our further examination persuades us that what has been understood to be the rule in this state is not only in line with the authorities in most jurisdictions upon that subject, but is sound as a matter of public policy.") (emphasis added).

³² *Warnock*, 104 US 775 (1881).

³³ *Steinback*, 158 N. Y. 24 at 31.

Even where an insurable interest appears to have existed at a policy's issuance, courts often dig deeper to determine whether the party with an insurable interest in the insured's life purchased the policy with the intent to circumvent the prohibition on wager policies.³⁴ The intent of the parties to a transaction involving the purchase and assignment of a policy controls treatment of the transactions. Regardless of the form of the transaction, if the intent of the parties is to effectuate a wager policy, courts ignored the intermediate step of the insured purchasing the policy and read the transaction as a direct purchase of the policy by the assignee. If the assignee did not have an insurable interest in the insured's life, the policy was void for lack of an insurable interest.³⁵

The modern approach to assignments developed through two U.S. Supreme Court cases, *Warnock* and *Grigsby*.

4. Warnock

Warnock was an early U.S. Supreme Court case holding that the assignment of a life insurance policy to someone without an insurable interest was impermissible. In *Warnock*, the insured purchased a life insurance policy and assigned the policy to investors who would pay all premiums on the policy, retaining nine-tenths of the policy's death benefit and remitting the remaining ten-percent to the insured's family.³⁶

The Supreme Court held that an assignment of a policy to a person without an insurable interest in the insured's life was impermissible because it was just as objectionable as purchase of the policy outright by that same party. The assignee has, after all, a pecuniary interest in the insured's death.³⁷

Rather than void the assignment, the Court permitted the assignee to recover an amount equal to the assignee's outlay in the transaction. The assignment, and the subsequent payout of the death benefit, was partitioned into two components. The first part was an amount equal to sums actually advanced by the assignee, with interest.³⁸ This amount was essentially

³⁴ *Conn. Mut. Life. Ins. Co. v. Schaefer*, 94 U.S. 457, 460-63 (1876); *Loomis v. Eagle Life & Health Ins. Co.*, 6 Gray 396, 398-99 (Mass. 1856). *Steinback*, 158 N. Y. at 31; *See generally* Application of the insurable interest requirement to assignments is discussed *infra*.

³⁵ *Steinback*, 158 N. Y. 31-32.

³⁶ *Warnock*, 104 U.S. at 775-76; *See also* *Franklin Life Insurance Company v. Hazzard*, 41 Ind. 116, 117-18 (1872).

³⁷ *See Warnock*, 104 U.S. at 779-80.

³⁸ *Id.* at 781.

deemed to be a loan from the assignee to the insured. As such, the assignee has an insurable interest in the insured's life to the extent of this amount, and the assignment is valid to that extent. The second part of the assignment, which includes any amount of the payout in addition to the first amount, was a payout on an illegal wager policy.³⁹

Cases decided subsequent to *Warnock* often focused on the fact that the policy at issue in *Warnock* was taken out under an agreement to immediately assign the policy; the policy was purchased to benefit parties without an insurable interest in the insured's life and was clearly a wager policy.⁴⁰

5. Grigsby

The second case, *Grigsby*, took a more nuanced approach than *Warnock*, holding that assignments factually akin to those in *Warnock* were invalid, but that a blanket prohibition on assignment to a person without an insurable interest was too restrictive. While cases decided by the U.S. Supreme Court prior to *Warnock* had hinted at the free assignability of life insurance policies without an insurable interest requirement,⁴¹ it was not until the Court's decision in *Grigsby* that the doctrine took its final, modern form.⁴²

In *Grigsby*, the insured assigned a policy to someone without an insurable interest after the policy was purchased and after the insured made two premium payments. When the insured was unable to make the third

³⁹ See *id.* at 782-83; *Cammack*, 82 U.S. 643, 647-48 (1872); See also *Steinback*, 158 N.Y. at 32-33.

⁴⁰ See *Steinback*. 158 N. Y. at 32. Without addressing *Warnock*'s arguments against assignability, the court in *Steinback v. Diepenbrock* (1899) held that assignment of a validly issued life insurance policy to a person without an insurable interest in the insured's life is permissible. In discussing *Warnock*, the court emphasized that the transaction at issue in *Warnock* would be illegal because it involved the purchase of a policy with the intent to sell it. They believed it unfair to restrict policy holders from selling their policies to attend to their financial needs, especially when the insured suffers from an illness that has dramatically reduced his or her lifespan.

⁴¹ See *e.g.* *Aetna Life Ins. Co. v. Fr.*, 94 U.S. 561, 563-64 (1876) (holding that an assignment by the insured to a family member is presumed not to be made as "cover for a wager policy," regardless of the arrangement between the parties for payment of premiums.); See also *N. Y. Mut. Life Ins. Co. v. Armstrong*, 117 U.S. 591, 597 (1886) (holding that a validly issued policy is freely assignable.).

⁴² *Grigsby v Russell*, 222 U.S. 149 (1911).

payment, he sold the policy to a Dr. Grigsby to pay for needed surgery. There was no allegation that the insured purchased the policy with the intent to assign it to a third party.

Agreeing with *Warnock*, the U.S. Court of Appeals held that Grigsby was only permitted to take the policy's death benefit to the extent of his advances, including the amount he paid for the policy and premium payments he made prior to the insured's death.⁴³

The U.S. Supreme Court, however, overruled the appellate court and extended the permissibility of assignments of life insurance policies to assignees without an insurable interest in the insured's life, "where an honest contract is sold in good faith."⁴⁴

The Court recognized that in early English cases, the primary purpose of the insurable interest requirement was to prohibit wager policies. Citing the permissibility of remainders after life estates, the Court made the case that the law does not inherently disfavor "pecuniary benefit accruing upon a death."⁴⁵ The Court recognized that after a policy is validly issued, the insured will have the best frame of reference for deciding whether to trust a potential assignee.⁴⁶

III. IMPACT OF THE INSURABLE INTEREST REQUIREMENT ON A POLICY'S ENFORCEABILITY

The insurable interest requirement is fundamental to the existence of a life insurance contract. Because of the important public policy considerations motivating the requirement, an insurance contract issued without an insurable interest is in most cases void and cannot be resurrected by agreement of the parties or because of inaction on the part of the insurer.⁴⁷ The taint infecting a policy issued without an insurable interest thus follows a policy from its issuance to the insured's death.

⁴³ *Russell v. Grigsby*, 168 F. 577 (6th Cir. 1909).

⁴⁴ *Grigsby v. Russell*, 222 U.S. at 156.

⁴⁵ *Id.* at 155-56.

⁴⁶ *Id.* at 155.

⁴⁷ *See Beard v. Am. Agency Life Ins. Co.*, 550 A.2d 677, 686-88 (Md. 1988); *Woods v. Washington Fidelity Nat. Ins. Co.*, 113 S.W.2d 121 (Mo. Ct. App. 1938). *But see Van Zandt v. Morris*, 17 So. 2d 435, 436 (Miss. 1944); *Rogers v. Atlantic Life Ins. Co.*, 135 S.C. 89 133 S.E. 215, 218 (S.C. 1926). *See generally* 44 C.J.S. *Ins.* § 378 (2009); RESTATEMENT (SECOND) OF CONTRACTS § 7, cmt. a (2009) (stating that a "'void contract' is not a contract at all; it is the 'promise' or 'agreement' that is void of legal effect").

A. VOID AND VOIDABLE LIFE INSURANCE CONTRACTS

A life insurance policy purchased by a person without an insurable interest in insured's life is void *ab initio*.⁴⁸ An agreement that is void *ab initio* is unenforceable by either party to the agreement, because either the law does not provide a remedy for breach of the agreement or does not "recognize a duty of performance."⁴⁹ Generally, contracts that are void *ab initio* are missing an element essential for contract formation or are so violative of the law or public policy that it would be improper to enforce them in the courts.⁵⁰

Though often referred to as a "void contract," an agreement that is void *ab initio* is not a contract and is unenforceable from its inception.⁵¹ As a result, in most jurisdictions an insurer cannot be required to pay the death benefit on a life insurance policy that is void *ab initio*.⁵²

In contrast to a void contract, a voidable contract is enforceable, but the legal obligations created by the contract may be rescinded at the option of one (or, alternatively, all) of the parties to the contract.⁵³ For instance, a life insurance contract is voidable by the company who issued the policy based on material misrepresentations made by the applicant that the insurer relied on when issuing the policy; for instance, when the insured fails to disclose serious health problems material to the company's decision whether to issue the policy.⁵⁴

⁴⁸ See e.g. ARIZ. REV. STAT. ANN. § 20-1104 (2002); CAL INS. CODE § 10110(e) (1997); Warnock v. Davis, 104 U.S. 775, 779 (1881); Conn. Mut. Life Ins. Co. v. Schaefer, 94 U.S. 457, 460, 24 L.Ed. 251 (1876); First Penn-Pacific Life Ins. Co. v. Evans, 313 Fed.Appx. 633, 636 (4th Cir. 2009); Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 796-97 (6th Cir. 2009); Paul Revere Life Ins. Co. v. Fima, 105 F.3d 490, 492 (9th Cir. 1997); AXA Equitable Life Ins. Co. v. Infinity Financial Group, LLC, 608 F.Supp.2d 1349 (S.D.Fla. 2009); Ky. Cen. Life Ins. Co. v. McNabb, 825 F.Supp. 269, 272 (D. Kan. 1993); Gristy v. Hudgens, 203 P. 569, 572 (Ariz. 1922); Beard v. Am. Agency Life Ins. Co., 550 A.2d 677, 688 (Md. 1988).

⁴⁹ RESTATEMENT (SECOND) OF CONTRACTS § 7, cmt. a.

⁵⁰ See e.g., Bassett v. Nat'l Collegiate Athletic Ass'n, 528 F.3d 426 (6th Cir. 2008).

⁵¹ RESTATEMENT (SECOND) OF CONTRACTS § 7, cmt. a.

⁵² See generally 44 C.J.S. Ins. § 352 (2009).

⁵³ BLACK'S LAW DICTIONARY *void contract* (8th Ed. 2004).

⁵⁴ 3 AM. JUR. PROOF OF FACTS 3d 367. See e.g. Gay v. United Benefit Life Ins. Co., 96 So.2d 497, 489-99 (La. 1957).

B. EXCEPTIONS TO THE NONENFORCEABILITY OF A POLICY
ISSUED WITHOUT AN INSURABLE INTEREST

In a small minority of jurisdictions, including Texas, an insurer who issues a policy to a party without an insurable interest in the insured's life may nevertheless be required by the court to pay out policy proceeds. In such a case, the policy may be void or voidable with respect to the party purchasing the policy but can still be given effect by the court. When required to pay out on such a policy, the proceeds will generally be distributed under equitable principles. In most cases, this rule results in payment of policy proceeds to the decedent insured's estate.⁵⁵

The justification for requiring a company to pay on an otherwise illegal policy is that the insurer should not be permitted to take shelter in failure of the insurable interest requirement when the insurer was in the best position to determine whether the requirement was satisfied. The insurer is not harmed by being required to pay the set amount it contracted to pay under the policy, even though the estate was not a named beneficiary.⁵⁶

C. THE INSURABLE INTEREST REQUIREMENT AND CONTESTABILITY
PERIOD

In a small minority of jurisdictions there are limited circumstances under which an insurance company will not be permitted to rescind a policy issued without an insurable interest. Most jurisdictions provide for a contestability period, after which a life insurance company is not permitted to challenge the policy's enforceability based on the applicant's fraud or misrepresentation. Most states have a two-year contestability period.⁵⁷

Generally, an incontestability clause is based on the presumption that a valid contract exists. In the case of voidable contracts—such as those entered into based on misrepresentations by the applicant—a valid contract exists, and the contestability period applies to permit the insurance company to challenge payout on the policy.⁵⁸

⁵⁵ See e.g., *Steinback v. Diepenbroc*, 52 N.E. 662 (N.Y. 1899).

⁵⁶ *Tamez v. Certain Underwriters at Lloyd's, London, Int'l Accident Facilities Inc.*, 999 S.W.2d 12, 14-16 (Tex.Ct. App. 1998).

⁵⁷ See e.g., CAL. INS. CODE § 10113.5(a) (2005); COLO. REV. STAT. § 10-7-102(b) (2010); D.C. CODE § 31-4703 (3)(A)(i) (2005); FLA. STAT. § 627.455 (2005).

⁵⁸ Bryan D. Bolton & Michael P. Cunningham, *An Ancient Doctrine Confronts Modern Problems*, FOR THE DEFENSE 57, 61 (Sept. 2008).

Because a contract purchased by a party without an insurable interest in the insured's life is void, and not simply voidable, most states permit a life insurance company to challenge the enforceability of a life insurance contract on insurable interest grounds even after the close of the contestability period,⁵⁹ on the basis that to disallow a challenge to the legality of a contract purchased without an insurable interest would allow private parties to subvert public policy by agreement.⁶⁰

Only two jurisdictions—Michigan and New York—have barred an insurance company from rescinding a policy issued without an insurable interest after the contestability period has passed.⁶¹

IV. BURDEN OF ESTABLISHING INSURABLE INTEREST

Though the duty to determine whether an insurable interest exists when a policy is issued rests at least nominally on the insurer's shoulders,⁶²

⁵⁹ See, e.g., *Paul Revere Life Ins. Co. v. Fima*, 105 F.3d 490 (9th. Cir. 1997); *Carter v. Cont'l Life Ins. Co.*, 115 F. 2d 947 (D.C. Cir. 1940); *Aetna Life Ins. Co. v. Hooker*, 62 F.2d 805 (6th Cir. 1933) *First Penn Pacific Life Ins. Co. v. Evans*, No. 05-444, 2007 WL 1810707 (D.Md. 2007); *Ky. Cent. v. McNabb*, 825 F. Supp. 269 (D.C. Kan. 1969); *Commonwealth Life Ins. Co. v. George*, 28 So.2d 910 (Ala. 1947); *Home Life v. Masterson*, 21 S.W.2d 414 (Ark. 1929); *Foreman v. Great United Mut. Benefit Ass'n*, 23 N.E. 2d 813 (Ill. App. Ct. 1939); *Bromley's Adm'r v. Wash. Life Ins. Co.*, 92 S.W. 17 (Ky. 1906); *Stevens v. Woodmen of the World*, 71 P.2d 898 (Mont. 1937); *Wharton v. Home Sec. Life Ins. Co.*, 173 S.E. 338 (N.C. 1934); *Brady v Prudential Life Ins. Co.*, 5 Kulp 505 (1890); *Henderson v. Life Ins. Co. of Va.*, 179 S.E. 680 (S.C. 1935). See generally Franklin L. Best Jr., *Securitization of Life Insurance Policies*, 44 TORT TRIAL & INS. PRAC. L.J. 911 (2009).

⁶⁰ Additionally, most jurisdictions will not allow the use of waiver and estoppel to force a life insurance company to pay out on a policy issued without an insurable interest or bar an insurer from raising lack of an insurable interest as a defense to payment of policy proceeds. See *Kentucky Cent. Life Ins. Co. v. McNabb*, 825 F.Supp. 269 (D.Kan. 1993); *Beard v. American Agency Life Ins. Co.*, 550 A.2d 677 (Md. 1988); *Woods v. Washington Fidelity Nat. Ins. Co.*, 113 S.W.2d 121 (Mo. Ct. App. 1938). See generally C.J.S. *Ins.* § 378 (2007).

⁶¹ See e.g. *Bogacki v. Great-West Life Assur. Co.*, 253 Mich. 253 (Mi. 1931); *New England Mut. Life Ins. Co. v. Caruso*, 523 N.Y.S.2d 928 (N.Y. App. Div. 1988), order *aff'd*, 73 N.Y.2d 74 (1989). Note that in Michigan, the decision to bar rescission of a contract issued without an insurable interest was based on the fact that the state did not have an insurable interest statute. The public policy considerations driving the contestability statute were held to prevail over the common law insurable interest requirement. *Bogacki*, 234 N.W. at 866.

in effect, the financial burden resulting from failure of the insurable interest requirement falls decisively on the policy's owner and beneficiaries.⁶³ As established above, a policy issued in violation of the insurable interest requirement is generally void and unenforceable and, regardless of any inequity, the insurer will not be required to pay out on the policy to the policy's beneficiaries, the decedent's family members, or any other party.⁶⁴ The purchaser of the policy issued without an insurable interest will, in most cases, hold a valueless policy, and beneficiaries will not receive the policy's death benefit if the policy is found to have been issued without an insurable interest. Thus, for practical purposes, it is a policy's owner and beneficiaries who bear the economic burden of the insurable interest requirement.

In addition to bearing the financial burden associated with a failure of the insurable interest requirement, beneficiaries also have the burden of proving the existence of an insurable interest in a lawsuit on a life insurance policy.⁶⁵ The burden is the beneficiary's regardless of whether the beneficiary brings suit to compel the insurance company to pay the death benefit to the beneficiary, or if the insurer seeks a declaratory judgment stating that the beneficiary has no right to the policy proceeds.⁶⁶

⁶² An insurer who does not conduct due diligence when issuing or paying out on a policy may inadvertently pay on a void policy or face the expense of challenging a beneficiary's right to a policy payout. In general, only the insurer has the power to raise lack of an insurable interest as a defense to payment on a policy. *See e.g.*, *National Life Ins. Co. v. Tower*, 251 F.Supp. 215 (D. Md. 1966); *In re Marriage of Day*, 74 P.3d 46 (Kan. Ct. App. 2003); *Ryan v. Tickle*, 316 N.W.2d 580 (Neb.1982); *Moran v. Moran*, 346 N.Y.S.2d 424 (N.Y. Sup. Ct. 1973).

⁶³ Beneficiaries have the burden of proving the existence of an insurable interest. *See Kentucky Cent. Life Ins. Co. v. McNabb*, 825 F.Supp. 269 (D. Kan. 1993); *Rubenstein v. Mutual Life Ins. Co. of New York*, 584 F.Supp. 272 (D.C. La. 1984); *American Nat. Ins. Co. v. Moore*, 70 So. 190 (Ala. Ct. App. 1915); *Interstate Life & Acc. Co. v. Houseworth*, 25 S.E.2d 233 (Ga. Ct. App. 1943). The burden is the beneficiary's regardless of whether the beneficiary brings suit to compel the insurance company to pay the death benefit to the beneficiary, or if the insurer seeks a declaratory judgment stating that the beneficiary has no right to the policy proceeds. *See e.g.*, *Kentucky Cent. Life Ins. Co.* 825 F.Supp. at 273.

⁶⁴ *See supra* Part III.

⁶⁵ *Kentucky Cent. Life Ins. Co.* 825 F.Supp. at 269; *Rubenstein v. Mutual Life Ins. Co. of New York*, 584 F.Supp. 272 (D. La.,1984); *American Nat. Ins. Co. v. Moore*, 70 So. 190 (Ala. Ct. App. 1915); *Interstate Life & Acc. Co.*, 25 S.E.2d at 233.

⁶⁶ *See e.g.* *Kentucky Cent. Life Ins. Co. v. McNabb*, 825 F.Supp. at 269. Insurers have also been held liable for failing to inform the insured that a policy

Up to this point, the discussion has been limited to claims sounding in contract. Though an insurer who carelessly or even intentionally issues a policy to a party without an insurable interest in the insured's life cannot usually be compelled to pay the policy's death benefit, an insurer may be held liable in tort for the failure. Insurers have a duty to use reasonable care in determining whether the purchaser of a policy has an insurable interest in the insured's life, and can be held liable in a wrongful death suit for failing to investigate whether the party purchasing the policy has an insurable interest, where the insured is murdered so the policy owner can collect on the policy.⁶⁷

Regardless of who bears the burden—financial or otherwise—of determining whether an insurable interest exists at policy issuance ultimately falls upon, in practice, such determination is best made at policy issuance based on responses to the policy application. The questions and representations requested within a policy application are not static, and the insurance carrier has wide latitude to alter these questions to ascertain issues pertaining to the existence of a valid insurable interest. As a result, the carrier's application can serve as a first line of defense against undesirable life insurance practices like STOLI. The insurance carriers bear some portion of the burden to fortify their policy applications to discover whether an insurable interest exists, and ferret out potential abuses, prior to policy issuance. The applicant's contemporaneous burden to be truthful, and not make material misrepresentations on an well crafted insurance application will serve to ensure the presence of a bona fide insurable interest as a life insurance policy is issued.

V. THE DEVELOPMENT OF LIFE INSURANCE AS PERSONAL PROPERTY

A. INTRODUCTION

Life insurance contracts developed from a simple, nontransferable contract providing security for the insured's family into its modern form,

has been taken out on his life. *Ramey v. Carolina Life Ins. Co.*, 135 S.E.2d 362 (S.C. 1964).

⁶⁷ *Overstreet v. Ky. Cent. Life Ins. Co.*, 950 F.2d 931 (4th Cir. 1991); *Liberty Nat. Life Ins. Co. v. Weldon*, 100 So.2d 696 (Ala. 1958); *Life Ins. Co. of Georgia v. Lopez*, 443 So.2d 947 (Fla. 1983); *Bajwa v. Metropolitan Life Ins. Co.*, 804 N.E.2d 519, 533-35 (Ill., 2004).

which includes an investment or savings component.⁶⁸ Life insurance contracts are a type of personal property called a “chose in action.”⁶⁹ A chose in action gives the person holding the chose “the liberty of proceeding in the courts of law.” The holder has a right to pursue an action in damages or to compel the payment of money due.

Historically, English law did not recognize the existence of intangible personal property. As such, the chose in action was a nontransferable right that could be exercised only by its original holder.⁷⁰ An attempted assignment of a chose in action gave no rights to the assignor.⁷¹ But the commercial desirability of permitting the assignability of contract rights and the right to sue on those rights eventually prompted innovation allowing transferability of the chose in action.

Initially, an assignment could only be made indirectly, with the assignee pursuing a cause of action in the assignor’s name.⁷² Modern law dispenses with this requirement, allowing the assignor to bring suit in his own name.⁷³

B. HISTORICAL DEVELOPMENT OF LIFE INSURANCE CONTRACTS AS TRANSFERABLE PERSONAL PROPERTY

Life insurance is a particular form of property subject to a set of rules crafted in response to its unique nature. Until the early 1900s, these

⁶⁸ See Comment, *The Assignment of Life Insurance as Collateral Security for Bank Loans*, 58 YALE L.J. 743, 743-44 (1949).

⁶⁹ See *Central Nat. Bank v. Hume*, 128 U.S. 195, 207-208 (1888); *Warnock v. Davis*, 104 U.S. 775, 781-82 (1881); *Russell v. Grigsby*, 168 F. 577 (6th Cir. 1909). The phrase “chose in action” is a Norman French meaning, essentially, “right in action.” The chose in action stands in contrast to the “chose in possession,” which refers to a right of possession in movable personal property. Joseph James Darlington & Joshua Williams, *A TREATISE ON THE LAW OF PERSONAL PROPERTY* 6-11 (T. J.W. Johnson 1891).

⁷⁰ 1 SAMUEL WILLISTON, *THE LAW OF CONTRACTS* § 405 (Baker, Voorhis & Co. 1924). The advent of the transferability of the chose in action was stalled by the fear that transferability would encourage the offense of maintenance, the encouragement of a lawsuit by an uninterested party, here the transferee. See Darlington, *supra* note 69 at 7-9.

⁷¹ See Darlington & Williams, *supra* note 69 at 6-7.

⁷² *Id.* at 8-10.

⁷³ *Id.* at 10-11.

peculiarities stalled the development of life insurance as an investment and savings vehicle.⁷⁴

One of the primary factors that limited or eliminated the investment value of pre-20th century life insurance contracts was their limited transferability. Although technically transferrable or assignable as security for a debt, under American law it was the beneficiary and not the insured or purchaser of the policy who had the power to assign the policy.⁷⁵

Generally, 19th century life insurance policies were strictly a contract providing for a payout to beneficiaries on insured's death. Life insurance afforded protection to the insured's family should he meet an untimely end.⁷⁶ These policies did not generally allow the insured to change the policy's beneficiary.⁷⁷

Policy beneficiaries were deemed to have an irrevocable vested interest in the policy, which protected the beneficiary's interest in the policy from the insured's creditors.⁷⁸ While the insured was under no obligation to continue making premium payment, the beneficiary was permitted to keep his or her vested interest in policy proceeds alive by making the premium payments.⁷⁹

Nineteenth-century insurance contracts, as indicated, did not usually provide the insured with an option to change policy beneficiaries;⁸⁰ this was true even where the insured kept the policy in his physical possession and paid all premiums on the policy.⁸¹ And because policies did not typically provide for any payout other than a death benefit, an insured did not have any power over the policy.⁸² The insured's only role was to purchase the policy and pay the premiums. After the policy was issued, the

⁷⁴ See generally Comment, *supra* note 68 at 743-44.

⁷⁵ See *id.* at 746.

⁷⁶ Charles Kelley Knight, HISTORY OF LIFE INSURANCE IN THE UNITED STATES TO 1870, 132-160 (1920) (unpublished Ph.D dissertation, University of Pennsylvania) available at <http://books.google.com> (describing the development of life insurance from 1861-1870, a time of innovation that would permanently alter the purpose of life insurance).

⁷⁷ See Comment, *supra* note 68, at 746; *Douglass v. Equitable Life Assurance Soc.*, 90 So. 834, 835-36 (1922). See also *Vance*, *supra* note 15, at 407.

⁷⁸ *Yore v. Booth*, 42 P. 808, 808 (Cal. 1895).

⁷⁹ See *Vance*, *supra* note 15 at 201 (noting that payment of premiums by one who does not have an interest in the life insurance policy does not confer an ownership interest in payor.)

⁸⁰ See Comment, *supra* note 68, at 46-48.

⁸¹ See *Yore*, 42 P. at 808. See generally Comment, *supra* note 68, 743-44, n.9.

⁸² See Comment, *supra* note 68, at 745.

insured had no further say in the disposition of the policy, other than to cut off premium payments. As a result, an assignment of the policy was only valid if the beneficiary was a party to the assignment.⁸³ Because the insured had no control over a policy once it was issued, the insured did not have an interest in the policy that was capable of assignment. Beneficiaries, on the other hand, had a vested interest in policy proceeds that was capable of transfer or assignment to a third party.

When a life insurance policy did not reserve the insured's right to change the beneficiary, under the vested interest rule, the policy's beneficiaries had a vested interest in the life insurance policy. A beneficiary's vested interest could not be defeated by action of the insured, except to the extent permitted by the policy.⁸⁴ In contrast, when a policy reserved the insured's right to change the policy's beneficiary, the insured had only an expectancy in policy proceeds.⁸⁵

In the late 19th century, insurers began to include provisions in their policies granting the insured the right to change the policy beneficiary.⁸⁶ This change was made, in part, as a response to the fact that, in most cases, the vested interest rule defeated the intent of the insured who purchased life insurance. Most insureds purchased policies to protect family members in the event of the insured's death. But the identity of dependent family members and their favor with the insured was likely to change during the insured's lifetime. An insured's ex-spouse, for instance, was a permanent beneficiary of the policy regardless of the insured's wishes or whether the ex-spouse continued to rely on the insured for support.⁸⁷

In addition to permitting insureds to change policy beneficiaries during the life of the policy, life insurance companies also conceived of innovations like legal reserve life insurance, which introduced the concept of policy surrender value and produced new forms of insurance like whole life and universal life insurance.⁸⁸ These changes transformed life insurance

⁸³ *Id.* at 747.

⁸⁴ *Filley v. Ill. Life Ins. Co.*, 93 Kan. 193 (Kan. 1914); *Van Bibber's Adm'r, & Co. v. Van Bibber*, 82 Ky. 347, 350 (Ky. 1884).

⁸⁵ *See Comment, supra* note 68, at 48-50.

⁸⁶ *See N. Y. Life Ins. Co. v. Daley*, 143 P. 1033 (Cal. Ct. App. 1914); *Douglass v. Equitable Life Assurance Soc'y.*, 90 So. 834, 835-36 (La. 1922).

⁸⁷ *Conn. Mut. Life Ins. Co. v. Schaefer*, 94 U.S. 457, 459-63 (1876); *Begley v. Miller*, 137 Ill.App. 278 (1907) *Land v. West Coast Life Ins. Co.*, 270 P.2d 154, 156-57 (Or. 1954).

⁸⁸ *See Vance, supra* note 68 at 344. Whole life insurance has a level premium for the life of the insured and accumulates value, permitting the insured to borrow against the policy during his or her lifetime. Like whole life insurance, universal

from a contract only providing for payment of a death benefit to a full-featured savings vehicle. With the steady development of rules and industry norms that transformed life insurance from simple insurance to an investment and savings product, life insurance was soon touted as an alternative to other investment products and bank savings accounts.⁸⁹

Once these new contracts that permitted the insured to change beneficiaries made their way to the courts, the issue arose as to whether the insured must replace the beneficiary with the assignee in order to transfer the beneficiary's rights in the contract to the assignee. Most courts quickly realized that to withhold the assignee's rights in the contract where the beneficiary of the contract was not changed to reflect the assignment was to ignore the reality of the situation. The insured's right to change beneficiaries of a policy came to be viewed as an election by the insured to keep beneficial ownership for himself during his lifetime.⁹⁰ An insured with the power to change the policy beneficiary has the power to assign the policy, thus effectively cutting off any interest the original beneficiary had in the policy. Many courts viewed assignment of a policy as, in effect, an exercise of the insured's power to change the policy's beneficiary.⁹¹

C. MODERN APPROACH TO ASSIGNMENT

Today, most states permit the assignment of a life insurance policy as long as the assignment is not entered into as cover for a wager policy.⁹² A validly issued life insurance policy, purchased by the insured, is absolutely assignable, whether as collateral for a loan or in an absolute sale, without restriction. As such, a validly issued policy may be assigned to a person without an insurable interest in the insured's life.⁹³

In spite of the assignability of life insurance policies, a minority of jurisdictions limit the amount of a policy's death benefit that is payable to a

life insurance also accumulate internal value. In contrast to a whole life policy, a portion of each universal life policy premium is allocated to cost of insurance, with the remainder being allocated to policy buildup. BLACK'S LAW DICTIONARY 805 (6th ed. 1990).

⁸⁹ See Comment, *supra* note 68, at 344.

⁹⁰ See *id.* at 749.

⁹¹ *Rawls v. Am. Life Ins. Co.*, 36 Barb. 357 (N.Y. Gen. Term. 1862); See Comment, *supra* note 68, at 49 n. 46.

⁹² See *supra* Part II.

⁹³ See *e.g.*, *Russell v. Grigsby*, 168 F. 577 (6th Cir. 1909); *Corning Bank & Trust. Co. v. Foster*, 74 S.W.2d 797 (Ark. 1934); *Lanier v. Shuman*, 24 S.E.2d 55 (Ga. 1943). See generally 30 A.L.R. 2d 1310 § 16 (2009).

creditor of the insured. Because a life insurance policy is often irreplaceable, such as when the insured is elderly or in poor health,⁹⁴ many jurisdictions restrict the extent to which a creditor is permitted to collect the policy's death benefit. When a policy is assigned to a creditor as security for a debt, the creditor's interest in the policy's proceeds cannot exceed the debt owed by the insured to the creditor. But full-assignment or sale of a policy does not result in a mere creditor's interest in policy proceeds. The assignee is entitled to full payment of the policy's death benefit.⁹⁵

VI. THE DEVELOPMENT OF THE SECONDARY LIFE INSURANCE MARKET

A. GENESIS OF VIATICAL AND LIFE SETTLEMENTS

Life insurance developed from an unassignable right to payment of a death benefit into its present form as a full-featured savings vehicle. For most of its history, life insurance was intended primarily to provide security for the insured's family after the insured's death. Recent developments, however, are "turning life insurance on its head."⁹⁶ With \$26 trillion in life insurance policies in force in the US, it was only a matter of time before investors sought out ways to tap into this uncorrelated asset class.⁹⁷

Prior to the 1980s, the business of buying and selling life insurance policies was not a robust industry. While life insurance policies were regularly bought and sold, the transactions did not take place in a developed market but occurred in relative isolation. The AIDS crisis of the 1980s and 90s, however, generated substantial interest in the purchase and sale of life insurance policies. With limited treatment options, individuals diagnosed with AIDS had radically reduced life spans, dramatically increasing the value of their life insurance policies. Viatical settlement companies sprang up, willing to purchase policies from the terminally ill insured for prices far in excess of the policy's surrender values, but at a price low enough to net the company a profit when the insured died. When

⁹⁴ See Comment, *supra* note 68, at 745.

⁹⁵ See *St. John v. Am. Mut. Life. Ins. Co.*, 13 N.Y. 31 (N.Y. 1855).

⁹⁶ See Robert S. Bloink, *Premium Financed Surprises: Cancellation of Indebtedness Income and Financed Life Insurance*, 63 THE TAX LAWYER 283, 286 (2010).

⁹⁷ See Anderson, *supra* note 2. The value of a life insurance policy is uncorrelated to the performance of other markets, so life insurance offers a measure of perceived stability in the current tumultuous financial environment.

antiretroviral drugs began to extend the life expectancy of people infected with HIV, viatical settlements quickly expanded to include terminal illnesses other than AIDS.⁹⁸

B. THE SECONDARY MARKET FOR LIFE INSURANCE

Sensing the nearly endless supply of life insurance policies sitting idle in the hands of insureds and their families, the viatical settlement industry rapidly expanded into the life settlement market, offering elderly insureds who are not terminally ill the option of selling their life insurance policies for cash in excess of the surrender value of the policy.

The life settlement industry provides a steady stream of new policies for the secondary market, but demand for investor-owned life insurance policies far exceeds supply. This mismatch generated a demand for policies not purchased through life settlement channels. Banks, hedge funds and private equity groups saw the viatical markets and its permutations as a door into the profitable longevity of risk markets that had largely been the exclusive domain of insurance carriers for centuries.⁹⁹

Wall Street imposed an asset backed securities¹⁰⁰ paradigm upon secondary life settlements and viatical markets with the hope the market would grow and develop as the mortgage market had developed 20 years

⁹⁸ See generally *Life Partners, Inc. v. Morrison*, 484 F.3d 284 (4th Cir. 2007); Bloink, *supra* note 96; Alexander D. Eremia, *Viatical Settlement and Accelerated Death Benefit Law: Helping Terminal, but not Chronically Ill Patients*, 1 DEPAUL J. HEALTH CARE L. 773 (1997).

⁹⁹ See Anderson, *supra* note 2. Life settlement and viatical settlement involve the sale of a life insurance policy to a third party for less than the face value of the policy and prior to its maturity. The settlement amount is generally greater than the total amount of premiums and fees paid by the insured. In both types of settlement the purchaser will receive payment of death benefits on the policy. Life settlement is the sale of a life insurance policy on the life of a party who is not “terminally or chronically ill.” In viatical settlement, the insured is usually “terminally or chronically ill,” resulting in a shorter life expectancy than predicted by mortality tables. BLACK’S LAW DICTIONARY 1497 (9th ed. 2009). See generally Patrick D. Dolan, *Securitization of Life Settlements, Structured Settlements, and Lottery Awards*, NEW DEVELOPMENTS IN SECURITIZATION 2008 (Practicing Law Institute, Commercial Law and Practice Course Handbook Series, PLI Order No. 14108, 2008).

¹⁰⁰ Asset backed securities are securities that are secured by pooled, generally illiquid, assets such as mortgages, life insurance policies, or student loans. BLACK’S LAW DICTIONARY 1476 (9th ed. 2009).

earlier.¹⁰¹ The investment calculus turned on mitigating the actuarial risk by aggregating large pools of insurance policies and an endless supply of cheap money to fund the ongoing premium obligations. Obtaining these large portfolios of insurance policies containing the right mix of premium costs and insureds' predicted mortality became an increasing problem.¹⁰²

To generate a pool of policies significant enough to satisfy demand and to smooth the actuarial risk inherent in smaller pools, the market developed strategies designed to cut the insured out of the process. For investors, the ideal would be to directly purchase life insurance policies without the insured's involvement; however, the insurable interest requirement necessitated the crafting of complex strategies designed to utilize an insured's unlimited insurable interest in his own life to purchase policies that could not be issued directly to the investor. Stranger-owned life insurance is one of those strategies.

VII. STRANGER-OWNED LIFE INSURANCE (STOLI)

A. INTRODUCTION

Stranger-owned life insurance (STOLI) refers to the practice of purchasing a life insurance policy with the intent to transfer the policy to a third party.¹⁰³ STOLI takes many forms, but in general, it is an arrangement designed to acquire and transfer a life insurance policy to investors.¹⁰⁴

Typically, a STOLI arrangement is initiated by someone other than the insured, such as an insurance broker, attorney, or other third party who approaches the insured and initiates the insured's involvement in the program. Though stranger or investor initiation of the purchase of the policy is typical it is not universal.¹⁰⁵

Investors and third parties secure the participation of insureds with incentives and promises of profits when the policy is sold. Incentives may include a lump-sum payment at the policy's purchase, partial payment of

¹⁰¹ See Anderson, *supra* note 2; Rachel Emma Silverman, *Letting an Investor Bet on When You'll Die: New Insurance Deals Aimed At Wealthy Raise Concerns; Surviving a Two-Year Window*, WALL ST. J., May 26, 2005, at D1.

¹⁰² See Bloink, *supra* note 96.

¹⁰³ See Best, *supra* note 59, at 912-13.

¹⁰⁴ See Stephan R. Leimberg, *Stranger Originated Life Insurance (STOLI): What Counsel (and What Every Advisor) Must Absolutely Positively Know!*, SP037 ALI-ABA 573 (2009).

¹⁰⁵ See *id.*

policy proceeds to the insured's family, or "free" insurance for the duration of the contestability period.¹⁰⁶

STOLI arrangements often delay transfer of ownership of the life insurance policy or ILIT from the insured to investors until after the policy's incontestability period has passed, believing that the incontestability clause will shield the STOLI policy from challenge by the insurer.¹⁰⁷

Insureds will generally be unwilling or unable to pay the premiums and other fees necessary to keep a high-value policy in force until the policy's incontestability period has passed. While investors may directly pay fees and premiums, premium financing—the use of borrowed funds to finance life insurance premiums—is the preferred method for making premium payments on a STOLI policy. In a premium financing arrangement, the premium finance lender—which may be a company specializing in such lending, a traditional lending institution like a bank, or even an insurance company—pays policy premiums on behalf of the borrower-insured. The cost of the loan, including interest and fees, may be billed to the insured or rolled into the loan.¹⁰⁸

At the close of the premium finance loan period—which may range from a year to policy maturity—the insured must either: (1) repay the loan, including interest and fees, (2) roll the premium finance loan into a new loan, or (3) surrender the policy (and any additional collateral supplied by the borrower) to the premium finance lender.¹⁰⁹

Premium finance makes it unnecessary for investors to directly pay premiums and fees to the insurance company, which may alert the company that the policy is part of a STOLI arrangement and trigger an investigation that could end in rescission of the policy. Premium finance also facilitates separation between investors and the insured by providing putative cover for the true nature of the arrangement.¹¹⁰

In traditional premium finance, the insured debtor generally intends on holding the insurance policy until its maturity. Traditional premium finance facilitates estate liquidity for wealthy insureds. Typically the

¹⁰⁶ See *id.* An incontestability clause specifies a time limit on the insurer's right to revoke a policy based on the insured's misrepresentations. All jurisdictions require life insurance contracts to include an incontestability clause, most requiring an incontestability period no longer than two years from the date the policy is issued. *Id.*

¹⁰⁷ See *id.*

¹⁰⁸ See Bloink, *supra* note 96, at 284.

¹⁰⁹ See *id.* at 284-85.

¹¹⁰ See *Id.* at 287.

premium finance loan is secured by the insurance policy and is fully recourse as to the insured. In contrast, when used in a STOLI arrangement, a premium finance loan will often be nonrecourse to the insured. STOLI-based nonrecourse premium finance was sold as essentially riskless for the insured, but insurance company pushback and insurable interest concerns have drastically reduced the availability of nonrecourse premium financing.¹¹¹ Partial-recourse premium financing (e.g. a premium finance loan that is 25% recourse to the insured) has generally replaced nonrecourse premium finance; but partial-recourse premium finance is not always used to facilitate STOLI arrangements. Regardless of the type of premium finance used, in a STOLI arrangement the insured does not intend on purchasing long term life insurance coverage but only intends to hold the policy for the duration of the contestability period. After the contestability period, the insured expects to sell the policy at a profit.¹¹²

When premium financing is used to fund a STOLI policy, the insured is given three options at the close of the contestability period:

- (1) The insured can take ownership of the policy by paying off the loan, including principal, interest and fees. The loan can be refinanced with another lender or paid off in cash.
- (2) The policy can be sold on the secondary market. The insured will retain any profit on the sale after the premium finance loan and fees are paid off.
- (3) The insured can surrender the policy to the lender in satisfaction of the loan. The lender will then sell the policy on the secondary market.

The insured is very unlikely to take the first option since the insured was probably not in the market for a life insurance policy when entering into the arrangement. Because the first option is effectively off-limits to the insured, the real purpose of the arrangement—moving the life insurance policy into the secondary market—is essentially guaranteed by the STOLI plan.

¹¹¹ See *id.* See also *Lincoln Nat. Life Ins. Co. v. Calhoun*, 596 F.Supp.2d 882, 884-86 (D. N.J. 2009); Eryn Mathews, Notes and Commentaries, *STOLI on the Rocks: Why States Should Eliminate the Abusive Practice of Stranger-Owned Life Insurance*, 14 CONN. INS. L.J. 521, 525-37 (2008).

¹¹² See *Calhoun*, 596 F.Supp.2d 885.

B. USE OF IRREVOCABLE LIFE INSURANCE TRUSTS IN STOLI ARRANGEMENTS

STOLI policies are often purchased through an irrevocable life insurance trust (ILIT). A premium finance loan will be made to the ILIT, which owns the policy from issuance to maturity. Rather than directly transferring ownership of the policy to investors, the trustee of the ILIT is changed to a trustee chosen by the premium finance company. The beneficiary is also changed so that beneficial ownership and control of the policy passes to the investors without signaling the change to the company that issued the policy.

C. IMPACT OF STOLI ON THE INSURABLE INTEREST REQUIREMENT

A central concern with STOLI arrangements is their relationship with the insurable interest requirement. As discussed in sections II and III, the insurable interest requirement exists to limit the issuance of wager policies and prevent the moral hazard due to the beneficial owner's financial interest in the insured's premature death. In STOLI transactions, the party who is ultimately intended as the beneficial owner of the policy will not have an insurable interest in the insured's life at the time the policy is issued.¹¹³

In tension with the insurable interest requirement is the well-settled principle that a life insurance policy is freely transferrable once the policy is validly issued. This principle permits an insured to purchase a policy of life insurance and transfer the policy to any person, including someone without an insurable interest, subject to very few restrictions. At first glance, the free transferability of life insurance would seem to vindicate STOLI as a legitimate practice. After all, the insured, who has an unlimited insurable interest in his own life, purchases the policy and exercises his legal right to transfer the policy to whomever he chooses.¹¹⁴ But the foray

¹¹³ Although STOLI has received significant bad press in recent years, it is worth noting that the better-received life settlements implicate the same policy concerns motivating the backlash against STOLI arrangements. After all, an investor purchasing a policy in a life settlement has the same incentive to see the insured meet an early death as the investor purchasing a policy issued directly into a STOLI arrangement.

¹¹⁴ In a small minority of jurisdiction (e.g. New York), lack of an insurable interest does not void a policy, but triggers a procedure for equitable distribution of policy proceeds, the lawsuit will be between investors and the insured decedent's

of the capital markets into life insurance has exploited the tension between the competing policy considerations affecting the insurable interest requirement and has stretched the requirement to the point of breaking.

D. RECENT STOLI CASES

1. Phoenix Life v. Lasalle Bank

In the typical modern insurable interest case, an insurance carrier is asking the court to issue a declaration that a life insurance policy held by an investment group is void *ab initio* for lack of an insurable interest. For instance, in *Phoenix Life v. Lasalle Bank*, a decision handed down in 2009 by the U.S. District Court for the Eastern District of Michigan, a life insurance policy was assigned to a lender as security for a nonrecourse premium finance loan. Phoenix, who issued the policy, sought a declaratory judgment that the policy was void *ab initio* for lack of an insurable interest. Coventry, the investment group, argued that Phoenix's motion should be dismissed because, in their view, Phoenix's insurable interest argument was based entirely on the fact that the policy premiums were paid by a premium finance loan. Coventry argued that this fact was insufficient as a matter of law to establish that the policies were issued without an insurable interest. The court disagreed, holding that Phoenix's allegation that the insured purchased the policy with the intent to absolutely assign the policy to Coventry was sufficient to "state a claim for rescission based on the lack of an insurable interest." Under Michigan law, assignment of a validly issued life insurance policy to someone without an insurable interest is permitted. But a complete assignment of an insurance policy made simultaneous with issuance of the policy violates the insurable interest requirement. Such an assignment is void because the assignment is made in bad faith for the purpose of circumventing the insurable interest requirement.¹¹⁵

estate. See e.g. *Life Prod. Clearing LLC v. Angel*, 530 F.Supp.2d 646. See *supra* text accompanying notes 55-56.

¹¹⁵ *Phoenix Life Ins. Co. v. LaSalle Bank N.A.*, Nos. 2:07-cv-15324, 2009 WL 877684, at *12 (E.D. Mich. Mar. 30, 2009). See also *AXA Equitable Life Ins. Co. v. Infinity Financial Group, LLC*, 608 F.Supp.2d 1349, 1352-53, 1356-57 (S.D.Fla. 2009) (holding that an assignment of a life insurance policy may not be made where an agreement to assign the policy existed prior to the issuance of the policy or contemporaneously therewith.)

2. Sun Life v. Paulson

Sun Life v. Paulson, a 2008 Federal District Court of Minnesota case, involved facts similar to those in *Phoenix Life v. Lasalle*. Sun Life brought suit for a declaratory judgment that the policy issued on Paulson's life and subsequently purchased by Coventry was void for lack of an insurable interest. Sun Life's claim was based on their assertion that at the time the insured purchased the policy, he intended to sell the policy to a third party without an insurable interest in Paulson's life. As in *Phoenix Life*, the court considered a motion to dismiss by Coventry.¹¹⁶

Assuming the facts of the plaintiff's complaint to be true, including the plaintiff's assertion that the insured purchased the policy with the intent to transfer it to a person without an insurable interest, the court found that the policy was not void for lack of insurable interest.¹¹⁷ Of primary importance to the court was the fact that there was no evidence that Paulson colluded with anyone else when purchasing the policy. In the court's view, in order for a life insurance policy to be void *ab initio* for lack of an insurable interest, not only must the insured purchase the policy with the intent to transfer the policy to a party without an insurable interest in violation of the good faith requirement, but the policy must be "procured under a scheme, purpose, or agreement to transfer or assign the policy to a person without an insurable interest in order to evade the law against wagering contracts." As a result, if an insured purchases an insurance policy with the intent to transfer the policy to a person without an insurable interest in the insured's life, but the insured has not identified a particular purchaser for the policy, the policy is not void and the transfer is valid. In the district court's view:

Paulson's intent is... irrelevant without facts or allegations suggesting that a third party lacking an insurable interest intended, at the time Paulson procured the [policy], to acquire the policy upon expiration of the contestability period. Likewise, Coventry's later acquisition of the [policy] is irrelevant without similar facts or allegations regarding its intent at the time Paulson procured the insurance.¹¹⁸

¹¹⁶ *Sun Life Assur. Co. of Canada v. Paulson*, No. 07-3877, 2008 WL 451054, at *1 (D. Minn. 2008).

¹¹⁷ *Id.* at *2.

¹¹⁸ *Id.*

3. Lincoln National Life Insurance Co. v. Calhoun

Lincoln National Life Insurance Co. v. Calhoun, arose under facts similar to those in *Paulson* and *Lasalle*. As in *Paulson*, the insured purchased a high-value policy with the intent to sell the policy on the secondary market. The court did not arrive at a holding with respect to whether a scheme is necessary for a policy to be found void *ab initio* for lack of an insurable interest. But, in contrast to *Paulson*, the court denied the defendant's motion for dismissal. The court viewed New Jersey law as unsettled on the question of whether mutual intent—of the insured and a third party without an insurable interest in the insured's life—is necessary for a policy to be found void for lack of an insurable interest or whether unilateral intent of the insured is sufficient. Recognizing that “compelling policy considerations are raised by either position,” the court viewed dismissal of the plaintiff's claim as premature because, the court said, the issues of intent implicated by the case were better decided after the plaintiff had further opportunity to discover whether Calhoun had an arrangement with a particular purchaser when he bought the policy. If Calhoun had an arrangement with a third-party purchaser at the time he purchased the policy, it would be unnecessary for the court to decide the question of whether unilateral intent is sufficient to void the policy since, in that case, mutual intent would be present.¹¹⁹

4. Summary of the Typical Contemporary Case

Though each of the preceding three cases were decided on motions to dismiss rather than at trial, the decisions are important because they examine the insurable interest requirement in the face of uniquely modern factual allegations while simultaneously reaffirming the importance of the traditional doctrine. *Lasalle* takes the tradition tack, looking for facts indicating that the arrangement was entered into, and the policy purchased, for the purpose of subverting the prohibition on wager policies.¹²⁰ *Paulson*, like *Lasalle*, looks for facts indicating that the policy was a wager policy, but narrows the traditional rule by including an additional constraint on its application—the requirement that the policy be issued as part of scheme involving the insured and another person.¹²¹ In light of the policy

¹¹⁹ *Lincoln Nat'l. Life Ins. Co. v. Calhoun*, 596 F.Supp.2d 882, 890 (D. N.J. 2009).

¹²⁰ *LaSalle Bank N.A.*, 2009 WL 877684, at *7.

¹²¹ *See Paulson*, 2008 WL 451054, at *2.

considerations driving the insurable interest requirement, the court in *Paulson* may narrow the insurable interest requirement too far. A policy issued to an insured who, from the beginning, intends on selling the policy to someone without an insurable interest implicates the insurable interest requirement and runs afoul of the prohibition on wager policies to the same extent as policies purchased as part of a “scheme.”

In most of these recent cases, courts have not had to expand the scope of the insurable interest requirement or otherwise alter its applicability to successfully target and strike down STOLI transactions. The courts have, for the most part, stuck to the narrow historical definition of insurable interest, though *Paulson* did put a new spin on the insurable interest requirement by substantially narrowing it when applied to a STOLI policy. With the exception of the *Parduhn* case, discussed below, courts have consistently required the existence of an insurable interest at a single point in time, issuance of the policy, rather than requiring the existence of an insurable interest on a continuum running from issuance of the policy to its maturity.

5. An Anomalous Case —Insurable Interest Required from Policy Issuance to Maturity

a. Parduhn v. Bennett

Parduhn v. Bennett and the Utah insurable interest statute under which the case was decided are an anomaly in modern insurable interest law.¹²² Rather than requiring an insurable interest only at a policy’s issuance, the Supreme Court of Utah interpreted Utah’s insurable interest statute to require a policy’s beneficial owners to have an insurable interest at all times during a policy’s existence, from issuance to maturity.

The case involved partners in a partnership with a buy-sell agreement in place. Under the agreement, if one partner died, the other partner was required to purchase the decedent partner’s partnership interest. The buy-sell agreement was to be funded by proceeds of a life insurance contract. The partners sold their business to a third party without the buy-sell agreement ever being activated and ceased doing business as a partnership. When one partner died, the other partner filed suit to establish his right to the insurance proceeds. In opposition to the surviving partner, the decedent partner’s wife argued that she had a right to the insurance proceeds.

¹²² *Parduhn v. Bennett*, 61 P.3d 982 (Utah 2002).

In many jurisdictions, each partner would likely have had an insurable interest in the other partner's life at the time the insurance contract was purchased, based on their economic relationship. The Utah insurable interest law in force at the time *Parduhn* was decided not only required an insurable interest at the time the policy was issued, but also at the time a policy is transferred to a third party and when the policy matured. The Utah Code stated that "[a] person may not knowingly procure, directly, by assignment, or otherwise, an interest in the proceeds of an insurance policy unless that person has or expects to have an insurable interest in the subject of the insurance."¹²³ This provision was interpreted to mean that a person is not permitted to have an interest in insurance policy proceeds unless that person has an insurable interest in the insured's life.¹²⁴

In addition to requiring an insurable interest at the time at transfer and at maturity, the statute specifically limited a partner's insurable interest in another partner's life to situations involving a legitimate buy-sell agreement. Without a buy-sell agreement, there was no insurable interest, regardless of any other economic relationship between the partners.¹²⁵

Based on the Utah insurable interest statute in force at the time the case was decided, the Utah Supreme Court held that the surviving partner was not entitled to the life insurance policy's death benefit because the buy-sell agreement was no longer in place when the policy reached maturity, and the partner was not permitted to receive the death benefit without an insurable interest in the deceased partner's life. By so holding, the Utah court broke with the common law and statutes in force in every other jurisdiction by effectively requiring the existence of an insurable interest on a continuum from issuance of the policy to its maturity.

The impact of *Parduhn*'s anomalous holding was limited fairly quickly by the Utah state legislature, which brought the state's insurable interest law into conformity with the rest of the country.

¹²³ UTAH CODE ANN. § 31A-21-104(1)(b) (2005) (current version at UTAH CODE ANN. § 31A-21-104 (Supp. 2010)).

¹²⁴ *See* *Parduhn v. Bennett*, 61 P.3d 982, 986-87 (Utah 2002); *See also* Harbor Funds, LLC, Utah Div. Sec., No-Action or Interpretive Letter, 2002 WL 31746494, at *2 (Nov. 6, 2002) (opinion rescinded Oct. 4, 2010 to reflect subsequent amendments to the Utah Uniform Securities Act that classify life settlements as securities even before they are sold in the secondary market).

¹²⁵ UTAH CODE ANN. § 31A-21-104(1)(b), (2)(a) (2005) (current version at UTAH CODE ANN. § 31A-21-104 (Supp. 2010)). Note that in Utah, a policy issued without an insurable interest is not void or even voidable, but the death benefit will not be paid to the named beneficiary. Rather, policy proceeds will be equitably distributed by the court. UTAH CODE ANN. § 31A-21-104(6)(b) (Supp. 2010).

b. Utah's Amended Insurable Interest Statute

The situation in *Parduhn* would not likely have the same result if the case were decided under the current Utah insurable interest statute. A 2007 amendment to Utah's insurable interest law¹²⁶ specifies that, in the case of a life insurance policy, an insurable interest need only exist on the date the policy is issued and at any later time when an interest in the policy is transferred or assigned. The insurable interest requirement need not be met at the time the policy proceeds are payable. Because *Parduhn* had an insurable interest in his partner's life and the policy was never transferred or assigned, *Parduhn* would not be required to have an insurable interest in his partner's life at the time the death benefit was paid and the payment could properly be made to *Parduhn*.

The statute probably also eliminates the absolute restriction on a partner's insurable interest to situations where a legitimate buy-sell agreement exists. While that restriction was formerly included in the definition of "insurable interest," the amended statute indicates that the former restriction is now part of a nonexclusive list of situations where an insurable interest exists. In other words, a partner's insurable interest based on a legitimate buy-sell agreement is only one example of a situation where a partner would have an insurable interest in another partner's life. Other circumstances presenting an insurable interest in a partner's life certainly exist.

VIII. MISREPRESENTATIONS ON THE POLICY APPLICATION

Though a significant portion of the dialog surrounding STOLI has centered on the insurable interest requirement, other issues are often litigated together, creating a *mélange* of related but distinct concepts and prohibitions affecting the validity of a life insurance contract. In addition to an insurer's claims for rescission due to lack of an insurable interest, carriers also typically seek rescission of the policy based on intentional misrepresentations made on the policy application. Many recent STOLI cases raise the issue of misrepresentation on the policy application in addition to lack of an insurable interest. Other than the insurable interest requirement, an insurer's right to rescind a life insurance contract based on misrepresentations made on the policy application remains the strongest enforcement mechanism available to combat STOLI.

¹²⁶ Utah's insurable interest statute explicitly permits viatical and life settlements. UTAH CODE ANN. § 31A-21-104(7) (Supp. 2010).

An insurer who becomes aware of a misrepresentation made on a policy application may generally rescind the policy by notifying the insured of the rescission and refunding any premiums paid.¹²⁷ An insurer may also sue for rescission of the policy or assert the rescission as a defense to an action on the policy. In the alternative, an insurer may also assert misrepresentation as a defense against a beneficiary's suit seeking payment of the policy death benefit after the insured death.¹²⁸

Generally, a life insurance policy is voidable by the carrier if the insured made material misrepresentations on the application for insurance. An innocent misrepresentation is sufficient grounds for rescission of a policy; it is not necessary that the misrepresentation be made intentionally or in bad faith.¹²⁹ A misrepresentation or omission is "material" if the misrepresentation or omission "can be understood to reasonably affect an insurer's decision to enter into the insurance contract."¹³⁰ In other words, the test for materiality is subjective; a misrepresentation is material if it affects the insurer's risk in entering into the contract or the amount of premiums to be charged on the policy is material.¹³¹ Materiality is not determined under an objective, reasonable insurer standard.¹³²

The policy application and the questions included therein by the insurer may be probative of materiality, since the insurer presumably chose the questions for the purpose of gauging risk and setting policy premiums. Because "[m]ateriality is determined solely by the probable and reasonable effect which truthful answers would have had upon the insurer[, t]he fact that the insurer has demanded answers to specific questions in an application for insurance is in itself usually sufficient to establish materiality as a matter of law."¹³³

¹²⁷ N. Y. Life Ins. Co. v. Marshall, 23 F.2d 225, 225 (5th Cir. 1928).

¹²⁸ Erie Ins. Exch. v. Lake, 671 A.2d 681, 686-87 (Pa. 1996); Feerman v. Eureka Life Ins. Co., 124 A. 171, 171-72, (Pa. 1924).

¹²⁹ John Hancock Mut. Life Ins. Co. v. Weisman, 27 F.3d 500, 504 (10th Cir. 1994) (applying New Mexico law).

¹³⁰ *Id.* at 506; Lincoln Nat. Life Ins. Co. v. Calhoun, 596 F.Supp.2d 882, 887 (D.N.J. 2009).

¹³¹ *Calhoun*, 596 F.Supp.2d at 887-88.

¹³² Matilla v. Farmers New World Life Ins., 960 F. Supp. 223, 226 (N.D. Cal. 1997), *aff'd*, 133 F.3d 927 (9th Cir. 1997). *See also* ALLEN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 2:26, at 110-19 (5th ed. 2007).

¹³³ Thompson v. Occidental Life Ins. Co., 513 P.2d 353, 360 (Cal. 1973). *See also* LA Sound USA, Inc. v. St. Paul Fire & Marine Ins. Co., 156 Cal. App. 4th 1259, 1266-69, Cal. Rptr.3d 917, 920-24 (2007). *See generally* WINDT, *supra* note 132, at 110-117.

Issues of misrepresentation are often intertwined with the insurable interest issue because carriers frequently include questions on policy applications that are intended to ferret out STOLI transactions that are formulated to do an end-run around the insurable interest requirement.¹³⁴ For instance, the application on which the policy in *Phoenix Life v. Lasalle* (discussed *supra*) was issued included four such questions:¹³⁵

- (1) Is “non-recourse premium financing or any other method being utilized to pay premiums in order to facilitate a current or future transfer, assignment or other action with respect to the benefits provided under the policy being applied for”?
- (2) Is there “an intent to finance any of the premiums”?
- (3) Is “the current intent... to sell the policy in the future”?
- (4) Has there “been any inducement to enter into this transaction”?

Each of the preceding four questions seeks to determine whether the insured is purchasing the policy as part of a STOLI arrangement by looking for signals that the policy is being purchased with an intent to obfuscate a violation of the insurable interest requirement. An insured who purchases a policy as part of a STOLI transaction will be forced to make a misrepresentation when answering these questions or face rejection of his or her application by the insurer. The insurer can avoid the policy at issuance by declining to issue the policy if the insured answers the questions truthfully, and may avoid the policy after issuance by rescinding the policy if the insured makes misrepresentations on the application.

The insurer is in the best position to determine whether a policy is being issued in violation of the insurable interest requirement. As discussed above, in most cases, an insurer has the opportunity to rescind a policy or seek a determination that the policy is void throughout the entire life of the policy—from the date the policy is issued to after the insured’s death. And

¹³⁴ Though the insurable interest requirement is often intertwined with claims of misrepresentation, the two issues are distinct. Of particular importance is the fact that an insurer is time barred from suing for rescission based on misrepresentation when the contestability period has passed, but is not time barred from seeking a declaration that the policy is void for lack of an insurable interest. See *supra* text accompanying notes 58-62.

¹³⁵ *Phoenix Life Ins. Co. v. LaSalle Bank N.A.*, 2009 WL 877864, at *1 (E.D.Mich. Mar. 30, 2009).

the insurer has tremendous power to craft policy applications to discover whether an insured is purchasing a policy for an improper purpose.

Determination that a policy was issued without an insurable interest has a devastating effect on the property rights of the insured, transferees and beneficiaries: such failure voids the policy, extinguishing it as if it never existed.¹³⁶ Tampering with the insurable interest requirement thus impacts all policy owners, introducing a level of uncertainty into a policy purchase. In contrast, aiming anti-STOLI enforcement efforts at the misrepresentations necessarily made on a well-crafted policy application when a policy is being purchased as part of a STOLI transaction targets only those parties making misrepresentations. As such, policymakers should be reticent about strengthening or otherwise altering the insurable interest requirement when other enforcement mechanisms—a well-designed policy application and misrepresentation detection—offer a targeted, flexible approach to combating STOLI.

IX. NAIC AND NCOIL MODEL CODES AND THEIR AFFECT ON THE INSURABLE INTEREST REQUIREMENT

States have been increasingly interested in supplementing established insurable interest law with statutes designed to identify and prohibit nascent types of transactions that violate the spirit, if not the letter, of the insurable interest requirement.¹³⁷ Two model statutes, both regulating life and viatical settlements, have been recently amended to supplement and strengthen this requirement. Prompted by increased attention on STOLI, the National Conference of Insurance Legislators (NCOIL) and the National Association of Insurance Commissioners (NAIC)¹³⁸ amended their respective model codes in 2007. Each model act has been adopted by a number of states, with some states choosing to adopt a hybrid approach incorporating elements from both acts.¹³⁹

¹³⁶ See *supra* Part III.

¹³⁷ See Leimberg, *supra* note 104, at 3.

¹³⁸ The NAIC has published hundreds of model laws covering every aspect of life insurance regulation, many of which have been enacted by state legislatures.

¹³⁹ Ariella Gasner, Note, *Your Death: The Royal Flush of Wall Street's Gamble*, 37 HOFSTRA L. REV. 599, 626-628 (2008-2009).

A. NCOIL'S VIATICAL SETTLEMENTS MODEL ACT

NCOIL adopted the Life Settlements Model Act in 2000 as an alternative to the NAIC model and amended the act in 2007 to address concerns with STOLI.¹⁴⁰ The NCOIL model includes three primary components: (1) a recommendation that states amend their insurable interest laws to cover modern permutations on the wager policy, (2) a definition and prohibition of STOLI, and (3) a moratorium on life settlements running two years after issuance of a policy.

1. Amend State Insurable Interest Statutes

NCOIL's approach to STOLI strengthens and uses traditional tools to combat wager policies, including the insurable interest requirement. Some commentators have expressed concern that the traditional insurable interest requirement is ill-suited to the modern environment in which STOLI has sprung up. Recognizing this potential weakness, a drafting note to the NCOIL 2007 Life Settlements Model Act recommends that states "amend their insurable interest laws, if necessary, to provide additional protection against trust-initiated STOLI and other schemes involving a cloak." The model act goes on to suggest a proposed statutory amendment that would specifically strike at premium financing arrangements intended to effectuate investor ownership of a life insurance policy:¹⁴¹

In accordance with *Grigsby v. Russell*, 222 U.S. 149, it shall be a violation of insurable interest for any person or entity without insurable interest to provide or arrange for the funding ultimately used to pay premiums, or the majority of premiums, on a life insurance policy, and, at policy inception have an arrangement for such person or entity to have an ownership interest in the majority of the death benefit of that life insurance policy.

¹⁴⁰ Press Release, Nat'l Council of Ins. Legislators, NCOIL Closes In On Illegal STOLI, Unanimously Adopts Amended Model Act (Nov. 20, 2007), available at <http://www.ncoil.org/HomePage/2007/LifeSettlementsPR.pdf>.

¹⁴¹ LIFE SETTLEMENTS MODEL ACT, (Nat'l Council of Ins. Legislators, Drafting Note 2007).

2. STOLI Definition

Like the NAIC model act and the traditional prohibition on wager policies, the NCOIL model act prohibits anyone from entering into a life settlement¹⁴² prior to issuance of the policy and provides for a period during which most life settlements are prohibited.¹⁴³

In contrast to the NAIC model, which does not mention STOLI by name and does not define it, the nucleus of the NCOIL model is its definition of STOLI. The model act defines “STOLI” as follows: “STOLI is a practice or plan to initiate a life insurance policy for the benefit of a third party investor who, at the time of policy origination, has no insurable interest in the insured.”¹⁴⁴

This definition essentially restates the black-letter law (*see supra*) prohibiting arrangements intended to subvert the insurable interest requirement. Going further, NCOIL’s definition also ropes in some transactions that are not explicitly covered by traditional insurable interest cases and statutes:¹⁴⁵

¹⁴² The NCOIL model act defines “life settlement contract” in essentially the same way as the NAIC model act defines “viatical settlement contract” with some minor differences. *Compare* LIFE SETTLEMENTS MODEL ACT § 2(L) (Nat’l Council of Ins. Legislators 2007) (defining “life settlement contract” as “a written agreement entered into between a Provider and an Owner, establishing the terms under which compensation or any thing of value will be paid, which compensation or thing of value is less than the expected death benefit of the insurance policy or certificate, in return for the owner’s assignment, transfer, sale, devise or bequest of the death benefit or any portion of an insurance policy or certificate of insurance for compensation, provided, however, that the minimum value for a Life Settlement Contract shall be greater than a cash surrender value or accelerated death benefit available at the time of an application for a Life Settlement Contract.”), *with* VIATICAL SETTLEMENTS MODEL ACT § 2(N)(1) (Nat’l Ass’n of Ins. Comm’rs 2010) (defining “viatical settlement contract” as “a written agreement establishing the terms under which compensation or anything of value is or will be paid, which compensation or value is less than the expected death benefits of the policy, in return for the viator’s present or future assignment, transfer, sale, devise or bequest of the death benefit or ownership of any portion of the insurance policy or certificate of insurance.”).

¹⁴³ LIFE SETTLEMENTS MODEL ACT § 11(N) (Nat’l Council of Ins. Legislators 2007).

¹⁴⁴ LIFE SETTLEMENTS MODEL ACT § 2(Y) (Nat’l Council of Ins. Legislators 2007).

¹⁴⁵ *Id.*

STOLI practices include but are not limited to cases in which life insurance is purchased with resources or guarantees from or through a person, or entity, who, at the time of policy inception, could not lawfully initiate the policy themselves, and where, at the time of inception, there is an arrangement or agreement, whether verbal or written, to directly or indirectly transfer the ownership of the policy and/or the policy benefits to a third party.

This definition sharpens the insurable interest requirement by covering indirect arrangements intended to shift a policy from an insured to investors, like nonrecourse premium financing.

3. Two-Year Moratorium on Life Settlements

The NCOIL model's two-year moratorium prohibits life settlement transactions for a two year period following issuance of the policy. This two-year ban on transfers is significantly shorter than the NAIC's five-year ban. Like the NAIC model, the NCOIL model provides exceptions to the two-year moratorium.¹⁴⁶

B. THE NAIC VIATICAL SETTLEMENTS MODEL ACT

The NAIC issued the Viatical Settlements Model Act¹⁴⁷ in 1993 in response to perceived abuses in the viatical settlement industry. Subsequently, in 2007 the NAIC adopted a revised model act to take into account significant changes in the industry, including the increasing prevalence of STOLI. In contrast NCOIL's targeted approach, which defines and prohibits STOLI, NAIC's model act attempts to strike at the economic foundations of STOLI transactions.

Rather than define "STOLI," the NAIC model act defines "viatical settlement" and proscribes a set of "prohibited practices" with respect to those viatical settlements. The model act defines "viatical settlement contract" as:¹⁴⁸

¹⁴⁶ *Id.* § 11(N).

¹⁴⁷ Originally the model was entitled "Living Benefits Model Act." The working group decided to change the title to "Viatical Settlements Model Act."

¹⁴⁸ VIATICAL SETTLEMENTS MODEL ACT § 2(N)(1) (Nat'l Ass'n of Ins. Comm'rs 2010).

[A] written agreement establishing the terms under which compensation or anything of value is or will be paid, which compensation or value is less than the expected death benefits of the policy, in return for the viator's present or future assignment, transfer, sale, devise or bequest of the death benefit or ownership of any portion of the insurance policy or certificate of insurance.

By definition, "viatical settlement contract" thus includes not only what are traditionally known as viatical settlements, but also life settlements and STOLI arrangements. Many premium finance transactions are also explicitly categorized as viatical settlements under the act.¹⁴⁹

The first layer of defense against STOLI in the NAIC model act is its prohibition of any person from entering "into a viatical settlement at any time prior to the application or issuance of a policy which is the subject of viatical settlement contract."¹⁵⁰ This provision is essentially a statutory enactment of the long-standing law in most jurisdictions: Entering into an agreement to purchase and assign a policy is an attempt to subvert the insurable interest requirement and amounts to a prohibited wager policy.¹⁵¹

The second, and most controversial, component of the model act's anti-STOLI provisions is its moratorium on life settlements in the five years after a policy's issuance. This component essentially supplements the insurable interest requirement by attacking the economic incentives driving investment in STOLI policies. Requiring a five-year wait before assignment of a policy increases the mortality risk inherent in the policy, thus reducing investors' rates of return and diminishing their incentive to use STOLI to enter the mortality markets.¹⁵²

¹⁴⁹ VIATICAL SETTLEMENTS MODEL ACT §1(N)(2) . (Nat'l Ass'n of Ins. Comm'rs 2010). Covered premium finance loans includes loans made where (1) proceeds of the loan are not used solely to cover the policy's premiums and fees, (2) the loan includes a guaranteed future viatical settlement value for the policy, or (3) the viator or insured agrees at the time the policy is issued to sell the policy at some future date.

¹⁵⁰ VIATICAL SETTLEMENTS MODEL ACT §11(A) (Nat'l Ass'n of Ins. Comm'rs 2010).

¹⁵¹ See e.g. *Warnock v. Davis*, 104 U.S. 775, at 779 (1881); *Cammack v. Lewis*, 82 U.S. 643, at 648 (1872).

¹⁵² Life Ins. Settlement Ass'n, *NAIC Model Act*, <http://www.lisassociation.org/lifeselementtruth/NAIC.html> (last visited Sept. 15, 2010).

Recognizing that a blanket five-year prohibition on life settlements could harm consumers who develop a need to sell a policy during that five-year period, the Viatical Settlements Model Act includes a number of exceptions to the five-year moratorium on life-settlements. The first category of exceptions permits a life settlement in a number of situations involving major life changes, such as when the insured is “terminally or chronically ill,” when the insured’s marriage ends due to death or divorce, or when the insured retires from full-time employment.¹⁵³ The model act also permits a settlement two years after a policy is issued as long as the insured has not been evaluated for settlement during the two-year period and, if applicable, only traditional premium finance was used to fund premium payments and fees associated with the policy.¹⁵⁴

C. RESPONSE TO THE MODEL ACTS

Some commentators and industry groups, like the Life Insurance Settlement Association (LISA) and NCOIL, worry that the NAIC approach amounts to an interference with the well-established property rights associated with life insurance policies. They worry that the exceptions to the five-year moratorium on life settlements do not go far enough to exempt legitimate settlement transactions from being categorized as impermissible life settlements.¹⁵⁵ This, they argue, undercuts the insured’s property right in the policy and harms an insured who experiences unexpected financial difficulty in the two-year period following issuance of the policy. An insured who does not satisfy one of the exceptions to the five-year moratorium will be unable to sell the policy in the first two years after the policy is issued and will be forced to let the policy lapse or accept

¹⁵³ VIATICAL SETTLEMENTS MODEL ACT §11(A)(2) (Nat’l Ass’n of Ins. Comm’rs 2010)..

¹⁵⁴ *Id.* §11(A)(3). A third exception to the five-year moratorium on settlements is for policies issued as a result of the insured’s exercise of conversion rights in a policy. *Id.* §11 (A)(1).

¹⁵⁵ Life Ins. Settlement Ass’n, *NAIC Model Act*, <http://www.lisassociation.org/lifsettlementtruth/NAIC.html> (last visited Jan. 7, 2010). A legitimate life settlement transaction is a transaction entered into by an insured who, sometime after purchasing a life insurance policy to satisfy the his or her need for life insurance, transfers the policy to a third-party because the policy is no longer needed or because other financial needs outweigh the insured’s need for a life insurance policy. Transfer of a policy to a third party when the policy was purchased with the intent to transfer it to a third party is, under the Model Act, not a legitimate life settlement transaction.

the surrender value of the policy.¹⁵⁶ This, they argue, severely undercuts the utility of a policy in the initial years of its existence.¹⁵⁷

The NAIC model act has also been characterized as an attack on the entire secondary market rather than a focused approach to eliminating STOLI. NCOIL has characterized the NAIC model act as creating “harsh barriers for consumers seeking to sell their policies and burdens for life settlement companies seeking to act in the life settlement market.”¹⁵⁸ Critics view the model act as condemning all premium financed policies and life settlements but then exempting some transactions from the group of prohibited transactions. This exceptions-based approach is also criticized as providing “opportunities” to circumvent the law by crafting STOLI transactions that satisfy the exceptions.¹⁵⁹

Other commentators have dismissed criticisms of the NAIC model act as exaggerations of a few isolated instances where an insured will not be permitted to engage in what would otherwise be a life settlement. In

¹⁵⁶ One suggested amendments to the NAIC model act includes a provision explicitly exempting insureds from the five-year moratorium if the insured has experienced a sudden decrease in net worth. This amendment has not been incorporated into the act.

¹⁵⁷ In a letter to NCOIL, Doug Head, LISA Executive Director, stated that the solution to the STOLI problem lies in state insurable interest statutes rather than in upturning established law. He also expressed concerns with the five-year moratorium, believing that it “harms legitimate life settlements” while failing to address STOLI. In his view, the NAIC model paints with too broad a brush, not only catching legitimate life settlement transactions, but also missing a significant number of STOLI transactions. Also commenting on the NCOIL approach, Representative George J. Keiser, of the North Dakota State Legislature, stated that “STOLI occurs at the front-end of a life insurance sale. By defining STOLI, and strengthening reporting requirements and penalties for participating in STOLI, the NCOIL model gets at the heart of what needs to change. We hope that states considering amendments to existing laws, or new life settlements statutes, will be well-served by the NCOIL proposal.” Press Release, Nat’l Conference of Ins. Legislators, NCOIL Closes in on Illegal STOLI, Unanimously Adopts Amended Model Act (Nov. 20, 2007), available at <http://www.ncoil.org/HomePage/2007/LifeSettlementsPR.pdf>.

¹⁵⁸ Nat’l Conference of Ins. Legislators, *Effective Methods to Stop STOLI*, http://www.lisassociation.org/lifesettlementtruth/ban_STOLI.html (last visited Sept. 15, 2010).

¹⁵⁹ Laura Graesser, *What's Going On in the Life Insurance Business: Regulating Life Settlements*, LIFE INS. SELLING, apr. 2008, at 8, available at <http://www.lifeinsuranceselling.com/Issues/2008/4/Pages/What-s-Going-On-Regulating-Life-Settlements.aspx>.

their view, the five-year moratorium is an absolute bar that will instantly eliminate most STOLI transactions. They argue that the right to sell or assign a life insurance policy has never been absolute, and that the right to transfer a life insurance policy has always been weighed against the potential harm created by permitting such an assignment. Any restriction on an insured's rights to assign a policy must be weighed against the harm caused by STOLI, they argue, and any harm created by the NAIC approach is far outweighed by its benefits.¹⁶⁰

The recent enactment of NCOIL-influenced statutes by New York¹⁶¹ and California¹⁶² may signal a momentum shift from the NAIC model to the NCOIL model, but the dust is still settling. Regardless of how the battle between the two predominant model codes plays out, the coming decade is likely to see a further honing of insurable interest statutes as state legislatures wrestle with STOLI and its progeny. Like the mid 19th century, the early 21st century is likely to be viewed as a seminal, innovative period for life insurance and the laws shaping and defining its boundaries.

X. CONCLUSION

The current debate over the insurable interest requirement has too often transmuted the moral hazard of the eighteenth century scoundrel, Wainwright, into the latest object of Wall Street's insatiable greed. The historic context within which the insurable interest doctrine formed cannot so simply be analogized to the current policy discussions. Though the Grisby Court's forward-thinking enunciation of the insurable interest doctrine has been black-letter law for nearly a century, Justice Holmes certainly could not have foreseen the radical changes in the life insurance industry or imagined the emergence of the asset-backed securities markets.

At the beginning of the 20th century, life insurance products consisted of little more than straight forward life insurance and the basic annuities. The vast expansion of property rights unleashed by *Grisby's* clarification of assignment principles applied to insurance products has inured to the benefit of both insurers and insureds in the form of much more marketable products that have savings components and free alienability.

¹⁶⁰ Adam S. Flood, *Stranger-Originated Life Insurance: How the NAIC Tamed an Old Dog with a New Trick* (2008), available at SSRN: <http://ssrn.com/abstract=1162492>.

¹⁶¹ N.Y. LEGIS. Law § 78 (2010).

¹⁶² CAL.INS.CODE §§ 10113.1(g)(1)(B), (w) (West Supp. 2010).

Recent initiatives addressing the abuses of the historic insurable interest concept as life insurance has been morphed into a capital markets product must be viewed in the context of the vastly different bundle of rights modern insurance policies commonly contain. Any proposal to modify insurable interest statutes that too greatly abrogates consumers' property rights in their insurance policies must be viewed as circumspect, if those same initiatives can also be construed as protecting insurance companies' monopsonistic pricing power.

While the *Grisby* court understood financial institutions such as insurance companies would profit from insured's living long, and also from earlier death in the case of annuities, any legislative proposals should not weaken insurable interest concepts so as to leave insured's exposed to the moral failings of modern-day Wainwright. Nor can the new profit motive injected into the insurance markets by Wall Street's securitization markets be allowed to create new incentives to push and parse the boundaries of insurable interest statutes. New insurable interest legislation must incorporate a restrained and balanced effort to reign in abuses of the insurable interest doctrine, and the fraudulent practices effectuating those abuses, without unduly curtailing the advantages of modern insurance products.

Some efforts to curb STOLI abuses, such as NCOIL's Viatical Settlements Model Act, and many recent court cases have taken a restrained approach to the insurable interest requirement, recognizing that a radical expansion of the insurable interest requirement is unnecessary, even in the face of modern insurance products and transactions (e.g. STOLI) without analogue at the doctrine's inception. This conservative approach to the insurable interest requirement is wise considering the drastic effect a failure of the insurable interest has on a policy, voiding it and entirely eliminating its value. Moreover, the careful crafting policy applications in an effort to expose abusive transactions or force the policy owners to make a material misrepresentation and risk holding a void or voidable policy needs to be used as an equal tool in combating such abuses. This restrained and multi-faceted approach has the further benefit of targeting offending transactions without affecting the property rights of other policy owners. The insurable interest requirement has existed for over two centuries, but is still well-equipped to serve the purpose for which it was intended: eliminating wager policies and curbing the moral hazard inherent when speculators insure the lives of unrelated third parties.

