

**INSURABLE INTEREST
A TOPIC OF INCREASING INTEREST**

Gary C. Harriger, Esq.
410.659.7755

21:30 Hrs. May 10, 2004, Murphy's Irish Pub: Near Paris Island South Carolina. Lance Corporal Tyler Reed and Lance Corporal John Stone have just ordered their third beer and have been discussing their deployment to Iraq in one week.

“Well we are finally getting to go overseas. I am kind of excited about being part of the Iraq operation.” Reed observes.

“Yeah, I understand it is brutally hot this time of year.”

“By the way did that insurance agent, Ben Planner, talk to you about buying life insurance?” inquires Reed.

“Yeah, but with the military insurance we get, and since I am single, I do not see the need. I think mom and dad will be taken care of if something happens to me,” responds Stone.

“Your right. But I was thinking. Now don't get me wrong. I don't think anything is going to happen, but you know those insurgents are causing a lot of problems. I was thinking you and I enlisted together and went through basic together and well, if something was to happen to me I would feel good knowing at least you benefited from it in some way,” Reed notes.

“What are you suggesting?” asks Stone.

“Well that insurance agent said we could get up to \$250,000 cheap term insurance from G I Life Insurance Company and I was thinking that if we each took out a policy, and if one of us doesn't make it, the other could live pretty well. You are always talking about getting a Porsche someday.”

“Hmm, interesting idea,” responds Stone.

09:30 Hrs. May 11, 2004, Offices of Ben Planner.

“What can I do for you boys this morning?” asks Planner.

“Well, you were talking to us about life insurance the other day, and at the time we did not think we needed any. Then John and I were talking and we have decided to each buy a \$250,000 life insurance policy, and we are going to name each other as beneficiary of the policy,” explains Reed.

“I hate to tell you this, but there is a problem with what you want to do. The company will not issue the policies that way,” explains Planner.

“Why not?” asks Stone.

“Because you do not have insurable interest in each others lives. See, the law and insurance companies require that a person must have an insurable interest in a person's life in order to purchase insurance on that person. Insurable interest means that you either are related by blood or marriage, have a financial interest in the continued life of one another or an interest engendered by love and affection. Unless you boys qualify under the “don't ask, don't tell” policy, there does not appear to be an insurable interest,” Planner notes.

“So that's it?” ask Reed.

“Well, hum, there may be a way to accomplish what you want. You see there is another legal principle that says a person has unlimited insurable interest in his own life.” Planner explains.

“What does that mean?” inquires Stone.

“What we can do is have both of you complete applications for life insurance. You will each name your estate as beneficiary. At the same time you can sign change of beneficiary forms naming the other as beneficiary. You see, insurable interest legally only has to exist at the time the policy is issued. So I will hold the change forms here and as soon as the policies are issued, I will file the change forms with the company,” suggests Planner.

All agreed that this was the way to go. The plan was put into effect, the applications were submitted, and after the policies were issued, Ben Planner duly filed the change of beneficiary forms with G I Life.

05:17 Hrs. August 8, 2004, Airport Road Baghdad, Iraq: An American convoy is traveling along the Airport Road when a roadside bomb is detonated and a Marine Humvee is caught in the explosion. Three Marines are killed, including Lance Corporal Tyler Reed.

Lance Corporal John Stone files a claim with G I Life. Before the claim is processed Tyler Reed’s parents Bill and Sylvia Reed learn of the existence of the policy and file a claim with G I Life challenging John Stone’s right as a beneficiary because of a lack of insurable interest. G I Life begins an investigation, and upon discovering the facts surrounding the application and issuance of the policy, denies liability claiming the policy was void for lack of insurable interest at time of issue.

This is a fictional story, but if it was an actual event, how would these issues be resolved? Since 1774 and the enactment of the English Statute of George III¹, which made reference to “mischievous kind of gaming” and prohibited “the making of insurance on the lives . . . wherein the assured shall have no interest,” there has been a legal requirement for insurable interest in the purchase of life insurance. Prior to that time it had become a common practice to take out life insurance policies on other persons for speculative purposes. Until recent years it was relatively rare for insurable interest to be an issue in a life insurance contract.

Insurable interest has arisen in several contexts recently. In January of this year the Federal District Court for the Eastern District of Virginia ruled, in *Chawla v. Transamerica*², under the facts of that case, that under Maryland law a trust had no insurable interest in the life of a decedent. The decedent in this case applied for a life insurance policy and attempted to name the wife of his urologist as beneficiary of the policy. The company refused to issue the policy because of a lack of insurable interest. The decedent reapplied naming a trust as beneficiary. The beneficiary of the trust was the same person originally named as beneficiary. There was extensive misrepresentation of the insured’s medical history. Upon the insured’s death, the company contested the policy for misrepresentation and a lack of insurable interest. The court held for the insurer finding misrepresentation and voiding the policy. Then the court went on to declare that in addition to misrepresentation, the policy was also void because the trust lacked insurable interest.

Maryland’s insurable interest law is similar to that of other states³. Generally the statute says that a person may procure a policy on his own life for the benefit of any person. The requirement for insurable interest applies when one undertakes to purchase insurance on another’s life. This would seem to imply that as long as a person is applying for a policy on his own life they could name anyone they wish as beneficiary. According to the facts as set forth in the court’s opinion in *Chawla*, the insured applied for the insurance coverage and named the trust as beneficiary. In another Maryland case, *Beard v. American Agency*⁴, an owner of a farm applied for coverage naming the tenant on his farm as beneficiary. There was a lease agreement between the parties, which could be terminated with six months notice by either party. The tenant had no funds to purchase the farm and the life insurance in the amount of \$1,000,000 was issued with the tenant as beneficiary to enable the tenant to purchase the farm upon the insured’s death. The relationship of the parties was listed as “business partners.” The true relationship between the parties was not disclosed to the insurer. The court held there was no insurable interest in this case and voided the policy, because the beneficiary had no real financial interest in the continued life of the insured. Of note is

the fact that in both of these cases the courts voided the policies for lack of insurable interest, even though the insured had consented to and applied for the coverage.

The *Chawla* case has engendered a lot of concern from estates and trust lawyers who believe the court was saying or implying that trusts in general would lack insurable interest. The court in its holding did use broad language. Most insurance lawyers think, however, that the decision was fact specific, and that the court was saying that you cannot create an insurable interest through a trust when none existed in the first place. The estates and trust lawyers fear that insurers will routinely issue cases with trusts as beneficiaries and then contest the policies at time of claim, alleging lack of insurable interest. The life insurance industry does not believe this is likely, and points out that the insurable interest cases in Maryland have to date all involved misrepresentation. The *Chawla* case is now on appeal to the 4th Circuit Court of Appeals and the industry is filing an amicus brief requesting clarification of the insurable interest issue. Late in the 2005 legislative session of the Maryland General Assembly, House Bill 1608 was introduced. The bill was introduced during the last few weeks of the session and never came out of committee. There may be another attempt of clarify the insurable interest statute during the 2006 session. Stay tuned.

Another area of current interest relating to insurable interest is the area of so called Investor Owned Life Insurance (IOLI) or Charitable Owned Life Insurance (CHOLI). These are basically hedging transactions whereby a person allows investors, by means of a trust, to purchase both a life insurance contract and an annuity on that person's life. The trust is named beneficiary and, after paying the investors the amount used to purchase the annuity, the excess proceeds are paid to a charity. The amount paid to the charity is generally in the area of two to five percent. An attempt was made to pass legislation that would permit the sale of these products in Maryland during the 2004 legislative session, which failed to receive approval from the Maryland General Assembly. To date no further attempts have been made.

Insurable interest issues have been raised from time to time in the area of life settlements. Life settlements are distinct from viatical settlements. In the case of a viatical settlement, the policy is sold by an insured, to a third party, after the insured has been diagnosed with a serious medical condition, and when death is likely within a year or so. In a life settlement, an insured sells his life insurance policy to a third party, and there is no immediate anticipation of death. Since the requirement for insurable interest is that it exists at time of issue, there is no insurable interest issue unless the policy was purchased with the sale contemplated at the time of purchase. The issue of insurable interest could arise in cases involving so called "clean sheeting", where a policy is purchased and no medical history is disclosed, i.e. the true medical condition of the insured is hidden or misrepresented. The policy is purchased with the intent to immediately transfer it to a third party.

So assuming South Carolina's insurable interest laws are similar to Maryland's, what would be the likely outcome of the claim by the Reeds and the denial of coverage by G I Life?

First, the claim by Mr. and Mrs. Reed would likely be denied. The effect of lack of insurable interest is to void the policy. Generally, only the insurance company can raise the issue of insurable interest⁵. The public policy behind this rule apparently is that the insurance company, being a party to the contract, has a legitimate interest in raising the lack of an insurable interest, whereas nonparties have no such standing to raise any lack of an insurable interest⁶. Therefore it is likely that Mr. and Mrs. Reed's claim would be denied.

How successful will G I Life be in declaring the policy void for lack of insurable interest? Corporal Stone will likely argue that Corporal Reed had an insurable interest in his own life and every right to take out insurance for the benefit of his estate. His decision to change the beneficiary is irrelevant so long as insurable interest existed at the time of issue. G I Life will argue that because the change of beneficiary forms were signed at the same time as the application for insurance, the true intent was to name Corporal Stone. The true beneficiary of the policy was misrepresented to G I Life and had the company known the true nature of the transaction it would not have issued the policy. Therefore the policy should be void for lack of insurable interest.

If you were on the jury, how would you decide?

¹ 14 Geo. III, c. 48 (1774).

² *Chawla v Transamerica Occidental Life Ins. Co.*, No. 03-1215 (ED Va. Feb. 3, 2005).

³ Md. Code Ann., Ins. Sec. 12-201(a)(1) An individual of competent legal capacity may procure or effect an insurance contract on the individual's own life or body for the benefit of any person.

(2) Except as provided in subsection (c) of this section, a person may not procure or cause to be procured an insurance contract on the life or body of another individual unless the benefits under the insurance contract are payable to:

- (i) the individual insured;
- (ii) the individual insured's personal representative; or
- (iii) a person with an insurable interest in the individual insured at the time the insurance contract was made.

⁴ *Beard v. American Agency Life Ins. Co.*, 550 A.2d 677, 680 Md. 156 (1988).

⁵ *Ryan v. Tickle*, 210 Neb. 630, 316 N.W. 2d 580 (1982).

⁶ See generally Vance on Insurance, 199-200 (3d ed. 1951) and 3 Couch on Insurance 2D. Sec. 24:6 - 24:7 (1984).