Comments

An Investment to Die For: From Life Insurance to Death Bonds, the Evolution and Legality of the Life Settlement Industry

Kelly J. Bozanic*

Profiting from death may strike one as morally offensive, but the life settlement industry has created just such an opportunity. A life settlement is a transaction wherein an insured assigns the ownership interest (contract rights to the death benefit) of a life insurance policy to an investor for cash consideration. In other words, it is the sale of an economic interest in the death of the insured. As such, the industry has created a secondary market for what was once thought to be an illiquid asset: life insurance. While current market volatility makes an investment in death attractive, the life settlement industry is not without pitfalls. This Comment explores the evolution and legality of the industry as well as considerations for an individual contemplating a life settlement transaction.

* Candidate for Juris Doctor, The Dickinson School of Law of the Pennsylvania State University, 2009; Bachelor of Arts, University of California at Berkeley. I would like to thank Penn State University Professors Marie T. Reilly, Jeffrey H. Kahn and John E. Lopatka, for their guidance and generosity in teaching me. I would also like to thank Robert S. Gascon, CLU, ChFC and Stephan R. Leimberg, Esq., for their mentoring and feedback with this piece.

I. INTRODUCTION

The notion that nothing is sacred in the commodities markets is a criticism of a capitalist economy.[1] The American way is to turn a profit wherever one can, and the life settlement industry is proving true to this form.[2] The life settlement industry has cultivated a secondary market for life insurance policies,[3] offering policy owners the option of exchanging their ownership in the policy for cash consideration. As a result, the industry has, effectively, commodified death.[4] Instead of trading on earnings reports and forecasts, investors in life settlements trade on life expectancy. In today's climate of market instability and investment skepticism, an asset uncorrelated to market fluctuations (death) is an attractive, and some would say essential, addition to any portfolio.[5]

This Comment surveys the evolution of the life settlement industry and offers considerations for an individual contemplating the sale of his[6] life insurance policy. In the author's opinion, the life settlement industry is the invisible hand[7] at its best, moving assets in a free market to their highest and best use. To the unwary, however, the market for life settlements can be a dangerous frontier. A life settlement is, essentially, the sale of an economic interest in a life.[8] Absent consumer education, careful scrutiny by a policy owner's financial advisors and consumer

1. *See, e.g.*, Ellen Kelleher, *Cash in on the American Way of Death*, FIN. TIMES (London), Oct. 12, 2007, Weekend Money, at 10; Joseph Treaster, *Death Benefits, Now for the Living*, N.Y. TIMES, Sept. 27, 1998, § 3, 1; *cf.* KARL MARX, CAPITAL: VOL. 1, 927-29 (Ben Fowkes trans., Penguin Classics 1992) (1867).

2. *See, e.g.*, Kelleher, *supra* note 1, at 10; Saul Friedman, *Gray Matters; How Some Cash in When Others Cash Out*, NEWSDAY (New York), May 5, 2007, at B11; Treaster, *supra* note 1, at § 3, 1.

3. For the purposes of this Comment, any reference to life insurance will exclude term (or temporary) insurance. The nature of term insurance makes it less attractive as an investment; should an insured outlive the term of the policy, the investor has no hope of realizing any return.

4. *See, e.g.*, David W. Dunlap, *AIDS Drugs Alter An Industry's Math; Recalculating Death-Benefit Deals*, N.Y. TIMES, July 30, 1996, at D1.

5. *See, e.g.*, Jane Bryant Quinn, *Your Money or Your Life Insurance?*, THE WASH. POST, May 13, 2001, at H02; Fabrice Taylor, *Invest In A Sure Thing - Death; Paying Cash Now for Life Insurance Policies that "Mature" Later Benefits Almost Everyone*, THE GLOBE AND MAIL (Canada), Sept. 30, 2005, at 29.

6. For simplicity and readability in this Comment, the masculine pronoun will be used in all cases and is designated to encompass both feminine and masculine.

7. *See* ADAM SMITH, THE WEALTH OF NATIONS, 572 (Edwin Cannan ed., Random House 2003) (1776) (Smith posited that legislation should not interfere with contracts and that, by leaving contracts to the individual, interests would move to their highest and best use).

8. *See* Liam Pleven & Rachel Emma Silverman, *Cashing In: An Insurance Man Builds a Lively Business in Death*, WALL ST. J., Nov. 26, 2007, at A1 ("[A life settlement] lets investors essentially bet on—and profit from—other people's demise.").

protective state laws, this industry is rife with potential for abuse and fraudulent activity.[9] Yet when the transactions are legitimate and entered into with full disclosure of the consequences, a life settlement can be a great way to gain liquidity from an otherwise illiquid asset.[10]

Part I of this Comment explains the metamorphosis of a life insurance policy[11] from a contract providing security in the event of an untimely death into a security traded on the commodities markets. Case law[12] and common law property rights[13] legitimate this evolved use of a life insurance policy, so long as all parties adhere to the insurable interest requirements and relevant settlement laws.[14] Part II looks at the insurable interest laws unique to life insurance and the policy behind these laws as it pertains to a life settlement. Insurable interest ensures that a life insurance policy is not initiated as a wagering contract on human life; the requirement of insurable interest is satisfied when (1) the individual purchasing the insurance policy has a greater pecuniary interest in the continued *life* of the insured rather than in the insured's death, and (2) the purchaser lacks intent to sell the policy on the secondary market.[15]

Part III of this Comment analyzes the right to alienate a life insurance policy. A life settlement, in and of itself, does not abuse the insurance laws.[16] Selling a life insurance policy to a party lacking a pecuniary interest in the life of the insured, however, is a risk that the insured must assess before agreeing to a life settlement.[17] From a policy standpoint, the interests of promoting the free market and affirming individual property rights outweigh the paternalistic view that the government is in the better position to determine what risks an individual ought to take.[18] The assumption of risk for economic gain is a personal decision that should be left to the individual.[19]

Part IV of this Comment explains key considerations an individual must take into account when contemplating a life settlement. In addition

9. *See* discussion *infra* Part II.A.1.b.
10. *See* discussion *infra* Parts II.A.3, III.B.2.c.
11. *See, e.g.*, CAL. INS. CODE § 380 (2007) ("The written instrument, in which a *contract of insurance* is set forth, is the policy.") (emphasis added).
12. *See, e.g.*, Grigsby v. Russell, 222 U.S. 149, 157 (1911) (holding that the sale of a life insurance policy to a third-party lacking insurable interest is valid).
13. *See, e.g.*, Salt Lake Tribune Publ. Co. v. AT&T Corp., 320 F.3d 1081, 1091 (10th Cir. 2003) (noting absolute restraints on alienation of contract rights were against public policy as unreasonable incursions on the free flow of commerce).
14. *See* discussion *infra* Part III.B.2.
15. *See* discussion *infra* Part III.B.1.
16. *Id*.
17. *See* discussion *infra* Part III.B.1.d.
18. *See* discussion *infra* Part III.B.2.
19. *Id.*

to appreciating the risk of vesting a third-party with an interest in the insured's death,[20] there are financial implications for this transaction. First, a life settlement is the sale of a contract right; it is a disposition of property.[21] Unlike the death benefits of a life insurance policy,[22] proceeds from a life settlement will be treated as taxable gain.[23] Second, a life settlement is not the only way to extract liquidity from an existing life insurance policy.[24] Because the death benefits of a life insurance policy are excluded from the gross income of the beneficiary,[25] the policy is a valuable estate planning mechanism, and its worth should be seriously appraised before devising the interest therein.[26]

II. BACKGROUND

A. *The Evolution of the Life Settlement Industry*

1. *The Viatical Era*

The life settlement industry evolved from a practice called a "viatical settlement,"[27] which began in the 1980s at the height of the HIV-AIDS epidemic.[28] The sympathy engendered by suffering and financially-constrained[29] HIV-AIDS victims was fertile ground for the creation of a new investment opportunity: a secondary market for life insurance.[30] A viatical settlement enabled the owner[31] of a life insurance

20. *See* discussion *infra* Part III.B.1.d.

21. *See* discussion *infra* Part III.C.1.

22. *See* I.R.C. § 101(a)(1) (2008) (excluding death benefit from gross income of beneficiary when paid by reason of death of the insured).

23. *See* discussion *infra* Part III.C.1.

24. *See* discussion *infra* Part III.C.2.

25. I.R.C. § 101(a)(1) (2008).

26. *See* discussion *infra* Part III.C.2; *see generally* HOWARD ZARITSKY & STEPHAN LEIMBERG, TAX PLANNING WITH LIFE INSURANCE: ANALYSIS AND FORMS (2d ed. RIA Group 2008); STEPHAN R. LEIMBERG & ROBERT J. DOYLE, JR., TOOLS AND TECHNIQUES OF LIFE INSURANCE PLANNING (4th ed. Nat'l Underwriter Co. 2007).

27. *See* Life Partners, Inc. v. Morrison, 484 F.3d 284, 287 (4th Cir. 2007) ("A viatical settlement, by which a dying person is able to acquire provisions for the remainder of his life's journey by selling his life insurance policy, is thus thought to provide a viaticum."); Siporin v. Carrington, 23 P.3d 92, 93 n.1 (Ariz. Ct. App. 2001) (noting "viatical" is derived from the Latin word "viaticum," which means provision for the journey).

28. *See* John Tierney, *The Big City; In 80's, Fear Spread Faster Than AIDS*, N.Y. TIMES, June 15, 2001, at B1.

29. *See* Arthur Allen, *As They Lay Dying*, THE WASH. POST, Nov. 17, 1996, Magazine, at 13.

30. While a secondary market for life insurance has existed for well over a century, *see* Grigsby v. Russell, 222 U.S. 149, 157 (1911), the viatical settlement industry paved

policy held on the life of a terminally ill patient[32] to sell the policy to a third party for a cash settlement.[33] The value of the settlement offer was based on the face value[34] of the policy, the expected mortality of the insured, and the amount of cash build-up in the policy.[35] The new third-party policy owner would pay the premiums to sustain the policy until the death of the insured, and so, the sooner the insured was expected to die, the higher the settlement offer was likely to be.[36] A viatical settlement gave a terminally ill patient an immediate infusion of cash, which was usually necessary for medical expenses.[37]

As the new policy owner, the third-party investor would designate himself as the policy's beneficiary.[38] At the insured's death, the investor would realize his profit by collecting the policy's death benefit.[39] If all parties were honest, a viatical settlement would benefit all those involved: the settlement would provide a benefit to victims of terminal illnesses by providing liquidity from an otherwise illiquid asset, and it would be a boon to investors; after all, death is certain. While public policy arguments favored viatical settlements, the transaction did not

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the way for a mainstream adoption of this investment opportunity. *See* Matthew Goldstein, *Profiting From Mortality*, BUS.WK., July 30, 2007, at 44.

31. The owner may or may not be the insured. *See* Friedman, *supra* note 2, at B11.

32. *See* I.R.C. § 101(g)(4)(A) (2008) ("[A terminally ill patient is] an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in twenty-four months or less after the date of the certification.").

33. The cash settlement is an amount higher than the policy's surrender value but lower than the death benefit. *See* Friedman, *supra* note 2, at B11.

A life insurance policy has a dual-nature. As with the purchase of a personal home, a life insurance policy has both a personal-consumption component (insurance coverage, which has been "consumed" at the end of each year the insured is still living) and an investment component (tax-deferred cash build-up). *See generally* LEIMBERG & DOYLE, JR., *supra* note 26. Courts have long affirmed this dual nature of life insurance. *See, e.g.*, London Shoe Co. v. Comm'r, 80 F.2d 230, 231 (2d Cir. 1935), *cert. denied*, 298 U.S. 663 (1936) (relying on Lovell v. St. Louis Mut. Life Ins. Co., 111 U.S. 264, 274 (1884), and noting that a life insurance policy ordinarily combines investment with insurance protection); Century Wood Preserving Co. v. Comm'r, 69 F.2d 967, 968 (3d Cir. 1934) ("The policies of insurance here have a double aspect. They provide a present protection of ordinary life insurance and also a means of investment.").

34. The face value of a life insurance policy refers to the value of the contracted for death benefit. *See* BLACK'S LAW DICTIONARY 609 (7th ed. 1999) ("The amount payable under an insurance policy. Also termed face value; face amount insured by the policy; face of policy.").

35. *See* Janet Kidd Stewart, *Get Savvy Before You Sell Your Life Insurance Policy*, CHI. TRIB., Nov. 19, 2006, at C6.

36. *See, e.g.*, Allen, *supra* note 29, at 13; Phyllis Furman, *Who's Cashing in Your Chips? Selling off Life Insurance policies to Raise Money Grows in Popularity*, DAILY NEWS (New York), July 30, 2007, Money, at 4.

37. *See id.*; Dunlap, *supra* note 4, at D1.

38. *See, e.g.*, Treaster, *supra* note 1, at § 3, 1.

39. *Id.*

need to be legitimated on policy grounds. The Supreme Court validated the resale of a life insurance policy to a third-party a century prior in *Grigsby v. Russell*.[40]

Although the practice of viatical settlements is not inherently flawed, two issues emerged which would prove fatal to the industry. First, improvements in medical care made mortality assumptions more difficult to approximate.[41] Second, lack of regulation and the motive for profit gave way to fraudulent activity which made viatical settlements a less sound, and ultimately, disfavored investment.[42]

a. Improvements in Medical Treatment Made Death Rates More Difficult to Approximate

Improvements in medical treatment have made HIV-AIDS a "medically managed chronic condition,"[43] causing a delay in death benefit collection for investors. With HIV-AIDS patients living longer, investors were less willing to purchase their life insurance policies, and the industry began to shrink.[44] In response, viatical investors sought growth by refocusing marketing efforts on individuals with other terminal illnesses.[45] Despite the expansion of the target market, calculating accurate mortality assumptions for other terminal patients was not any easier.[46]

Viatical settlement offers varied from eighty percent of the policy face value, when the insured had six months or less to live, to less than fifty percent of the policy face value, when the insured was expected to die within twenty-four months.[47] An insured who lived a mere few months longer than expected wreaked havoc on investors' rates of return. The more an investor had to pay on the policy,[48] the less gain the investor

40. *See* Grigsby v. Russell, 222 U.S. 149, 156 (1911) (upholding right to sell ownership of life insurance policy to third party; finding that alienation of ownership is a basic property right).

41. *See* Dunlap, *supra* note 4, at D1.

42. *See, e.g.*, Quinn, *supra* note 5, at H02; Taylor, *supra* note 5, at 29.

43. Dunlap, *supra* note 4, at D1 (quoting Dr. Mervyn F. Silverman, former president of the American Foundation for AIDS Research).

44. *See* Dunlap, *supra* note 4, at D1.

45. *Id*.

46. *See, e.g.*, Treaster, *supra* note 1, at § 3, 1 ("For investment companies, profits depend on the ability to handicap death.").

47. *Id.*

48. To keep the policy from lapsing, premiums had to be paid until the death of the insured. *See* Treaster, *supra* note 1, at § 3, 1. "[Investor's] profit is the difference between what they pay out and the death benefit, which goes to them when the insured person dies. . . . Anyone who lives beyond his estimated time of death begins to cut into the profits of the buyer." *Id.*

realized from the eventual payout of the death benefit.[49] Because of the difficulty in predicting rates of return, the viatical settlement industry began to decline almost in tandem with advancements in medicine.[50]

b. Fraud in the Viatical Settlement Industry Necessitated Regulatory Oversight

The occurrence of better-than-expected longevity was not the only reason insureds were not dying "as expected."[51] Unscrupulous doctors and willing insureds perpetrated fraud on insurance companies and investors by making mortality expectations seem worse on paper than they were in actuality.[52] Investors quickly realized this trend and began to view viatical settlements as riskier than they once thought.[53] Regulatory oversight seemed necessary to help inhibit these fraudulent practices and to allay the fear that potential agents of viatical settlement investors would emerge to make sure an insured "dies on time."[54]

2. Regulating the Viatical Settlement Industry

In 1993, the National Association of Insurance Commissioners ("NAIC")[55] adopted the Viatical Settlements Model Act ("Model Act") in an effort to regulate the growth of the industry.[56] The Model Act requires that the viatical settlement provider must be licensed to sell life

49. *See id.*; *see also* Dunlap, *supra* note 4, at D1.

50. *See* Dunlap, *supra* note 4, at D1.

51. *Id*.

52. *See, e.g.*, Quinn, *supra* note 5, at H02; Taylor, *supra* note 5, at 29.

53. Kelleher, *supra* note 1, at 10 ("[T]he greatest risk [to investors] is that sellers of policies will live longer than expected.").

54. Friedman, *supra* note 2, at B11 ("Said Steve Leimberg, a Pennsylvania financial advisor: How well would you sleep at night knowing that your life insurance is owned by Tony Soprano and his rate of return will depend on how quickly you die?") (internal quotes omitted); *cf.* Warnock v. Davis, 104 U.S. 775, 779 (1881) (stating that where the party taking the policy is directly interested in the early death of the insured, such policies have a tendency to create a "desire for the event").

55. Established in 1871, the NAIC is comprised of the insurance commissioners from each of the fifty states. *See* NAIC.org, About the NAIC, http://www.naic.org/index_about.htm (last visited Jan. 23, 2008). Because the states have not delegated authority to the NAIC, the body is not vested with regulatory power over the states. *Id.* The NAIC does, however, publish model acts, which the states may choose to adopt, and it is responsible for establishing the statutory insurance accounting principles. *Id.*

56. VIATICAL SETTLEMENTS MODEL REGULATION (Nat'l Ass'n of Ins. Comm'rs 2006). The National Association of Insurance Commissioners (NAIC) developed the current Viatical Settlements Model Act and Regulation over eleven years, from 1993 to 2004 (the Model), some version of which has been adopted by as many as forty states. *See* Jennifer K. Schroeder, *United States: Developments in Life Settlement Regulation*, MONDAQ BUS. BRIEFING, June 20, 2006, http://www.mondaq.com/article.asp?articleid=40520.

insurance in the state where the insured resides.[57] If the state does not issue a life insurance license, the Model Act requires the viator[58] to comply with certain disclosure requirements.[59] The goal of the Model Act is to inhibit fraudulent transactions and ensure accountability through a regulated market.[60]

In 1996, Congress followed suit by passing the Health Insurance Portability and Accountability Act ("HIPAA"). When an insured is terminally or chronically ill, HIPAA excludes from taxable income the proceeds from the sale of their life insurance policy to a viatical settlement provider.[61] This provision afforded viators the same tax-exempt status of the viatical settlement payment as the death benefit payout would be to the beneficiary.[62] Section 101(g) of the Internal Revenue Code ("IRC") incorporated guidelines from the NAIC Model Act as preconditions to enjoying this preferred tax treatment.[63]

Increased regulation may have helped to allay fear of fraudulent investor activity, but the problem of mortality prediction with terminal patients remained.[64] Yet, in spite of the volatility of investors' profits caused by unpredictable mortality, attraction to the idea of investing in death remained high.[65] An interest in death is desirable for its independence from market covariance: death rates are not affected by changes in federal interest rates or earnings reports.[66] Investors found a way to reduce their risk and maintain their ability to profit from mortality

57. *See* VIATICAL SETTLEMENTS MODEL ACT § 3 (Nat'l Ass'n of Ins. Comm'rs 2006); VIATICAL SETTLEMENTS MODEL REGULATION § 3 (2004). Currently twenty-six states have licensing requirements for viatical and life settlement providers. *See* Goldstein, *supra* note 30, at 44.

58. Life Partners, Inc. v. Morrison, 484 F.3d 284, 287 (4th Cir. 2007) ("In the language of the industry, the insured is the viator who sells his policy at a discount to a provider of the viaticum.") (internal quotes omitted).

59. Section 8 of the Model Act requires the viatical settlement provider to make extensive disclosures to the viator, and section 9 regulates the settlement process and post-sale relationship of the provider and the viator. *See* VIATICAL SETTLEMENTS MODEL ACT §§ 8-9 (Nat'l Ass'n of Ins. Comm'rs 2006).

60. *See Life Partners*, 484 F.3d at 299.

61. I.R.C. § 101(g)(1) (2008).

62. *Compare* I.R.C. § 101(a)(1) (2008) (excluding death benefits from beneficiary's gross income if paid by reason of the death of the insured) *with* I.R.C. § 101(g)(2) (2008) (treating viatical settlement as an amount paid by reason of the death of insured).

63. *See Life Partners*, 484 F.3d at 299-300 (noting Congress extended tax benefits to viators who complied with safeguards of the Model Act and Regulations and also indicating Congressional concern with the "pitfalls" of an unregulated viatical market).

64. *See* Arthur Fliegelman, *Psst! Wanna Buy a Used Life Insurance Policy?*, MOODY'S INVESTORS SERV., Feb. 2006, 96492.

65. *See* Treaster, *supra* note 1, at § 3, 1.

66. "[Death] is an asset class that isn't going away." Goldstein, *supra* note 30, at 44 (quoting David Dorr, president and CEO of Life-Exchange Inc.).

by targeting the next most obvious market: senior-citizens, or the senior market.[67]

3. *The Senior Market and the Birth of Life Settlements*

For over two centuries, the life insurance industry has employed actuarial science to determine the premium-structure of life insurance policies.[68] The same data is now being "recycled" and used in life insurance's secondary market.[69] Applied to the senior market, actuarial science enables investors to achieve more accurate mortality expectations.[70] This increased accuracy makes the rates of return in the senior market more predictable than the market for terminal patients.[71] Because of more predictable rates of return, the transaction, now called a life settlement,[72] carries lower risk than a viatical settlement.[73] The investment risk in life settlements is tied only to accuracy in mortality predictions, which, because of actuarial data, is more accurately impounded into the value of the settlement offer.[74] With expected yields that are high and risk levels that are relatively low, the life settlement industry offers investors a way to diversify risk in their portfolios without the market covariance associated with most investments.[75]

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67. *See* Goldstein, *supra* note 30, at 44; Rebecca Knight, *A Safer Way of Dicing with Death*, FIN. TIMES (London), March 5, 2005, at 24.

68. *See* Joanna Chung & Gillian Tett, *Death and the Salesmen*, FIN. TIMES (London), Feb. 24, 2007, at 26 (outlining history of actuarial science in issuing government backed bonds, a practice that gradually became part of the life insurance industry).

69. Knight, *supra* note 67, at 24 (noting that Axis Capital Management's hedge fund utilizes an underwriting company to determine when people will die).

70. *Id*.

71. Currently, there is no "miracle cure" for old age. Because a huge amount of data is available to actuarial scientists, mortality assumptions for seniors are far easier to predict than in the case of individuals suffering a disease or other illness. *See* Kelleher, *supra* note 1, at 10.

72. Life settlements are distinct from viatical settlements, which solely refer to a transaction for the contract rights to the death benefit of a terminally ill individual, though both viatical and life settlements are governed by the VIATICAL SETTLEMENTS MODEL ACT. *See* Jennifer K. Schroeder, *United States: Fourth Circuit Rules That Virginia Viatical Settlement Regulation Does Not Violate the Dormant Commerce Clause*, MONDAQ BUS. BRIEFING, June 24, 2007, http://www.mondaq.com/article.asp?articleid=49378.

73. *See* Kelleher, *supra* note 1, at 10.

74. *See* Kelleher, *supra* note 1, at 10; *see also* Kimberly Miller, *Donor Pitches Life Insurance to Raise FAU Millions*, PALM BEACH POST, May 2, 2007 at 1A.

75. In the author's opinion, investing in life settlements is an inspired idea; when you get past the ghoulishness of it, everyone will surely die. *See* Goldstein, *supra* note 30, at 44; Kelleher, *supra* note 1, at 10.

4. The Emergence of "Death Bonds," Securitizing Life Settlement Pools

Wall Street has introduced the most recent, and perhaps intriguing, development in the life settlement industry.[76] Though understandably cautious,[77] investment banks are creating a quasi-bond out of life settlements by securitizing them.[78] This macabre investment is known as a "Death Bond," though the technical—and less chilling—label is a "life-settlement backed security."[79]

Securitization is a structured finance process whereby illiquid assets (payment obligations) are transformed into liquid assets (securities).[80] In the case of a life insurance policy, the payment obligation is the insurance company's promise to pay the contracted-for death benefit upon the death of the insured.[81] Securitization of life insurance policies can be understood as a three-step process. First, a financial intermediary, typically an investment bank, acquires a series of life insurance policies through life settlements.[82] Recall that what is acquired in a life settlement is the payment obligation (a contract right) of the death benefit upon death of the insured. Second, the policies are aggregated by risk into a pool; risk is measured, *inter alia*, by the mortality expectation of the insureds.[83] Finally, the pool is divided into fractional interests (securities), and sold to investors.[84] Due to the law of large numbers,[85]

76. *See* Goldstein, *supra* note 30, at 44.

77. *See id.* (noting the desire of firms to keep a low profile until there is more legitimacy associated with the market); *id.* ("[Goldman Sachs] is quietly building up its own subsidiary under the nondescript name Eastport Capital.").

78. *See id*. Securitization is a structured finance process by which payment obligations are acquired, classified into pools, and fractional interests therein are offered to investors. *See* S.L. SCHWARCZ, B. MARKELL & L.L. BROOME, SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS § 1 (Lexis Nexis 2004).

79. Goldstein, *supra* note 30, at 44.

80. *See* SCHWARCZ, MARKELL, & BROOME, *supra* note 78, at § 1.

81. A life insurance policy is a contract—the promise to pay an annual premium is given in consideration for the insurance company's promise to pay a benefit upon the death of the insured. *See* RESTATEMENT (SECOND) OF CONTRACTS § 17 (1981).

82. *See, e.g.*, Goldstein, *supra* note 30, at 44; Treaster, *supra* note 1, at § 3, 1.

83. *See, e.g.*, Goldstein, *supra* note 30, at 44; Kelleher, *supra* note 1, at 10.

84. *See, e.g.*, Goldstein, *supra* note 30, at 44; Kelleher, *supra* note 1, at 10.

85. The law of large numbers is a statistical theorem which asserts that the long-term stability of a random variable can be approximated given a sample of independent and identically distributed random variables with a finite expected value. *See* Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1150 (Fed. Cir. 1993) (internal citations omitted) (noting that through the law of large numbers, insurance reduces risk in a common fund). With respect to life settlements, this means that the larger the amount of data (death rates) available to actuaries, the more accurate their mortality assumptions will become, which in turn, will result in a smooth income stream for investors in life settlement pools. For reading on the law of large numbers generally, *see* GEOFFREY

the bundling of risk across many policies and subsequent allocation to many investors, no one investor is unduly exposed to excess risk as he has only a fractional interest in one specific individual's life.[86] All investors enjoy an interest in an asset that generates a smooth stream of income as insureds die and their life insurance policies pay off.[87]

As discussed above,[88] a life settlement-backed security is not subject to market volatility, and as mortality assumptions improve, life settlement-backed securities' rates of return will rise.[89] An increase in rates of return will make the industry even more attractive to private and institutional investors seeking to hedge against the uncertainties of assets highly correlated with the market.[90] With industry growth, the potential for abuse and other legal issues also rises, making regulatory oversight necessary.[91]

B. *The Legal Implications of Life Settlements*

The life settlement market grew out of the remnants of the viatical market, and while the transactions are inherently distinct,[92] they raise many of the same legal issues. The first issue is the potential for fraud.[93] The second issue is the circumvention of the insurable interest laws.[94] The third issue is whether the sale of a life insurance policy is contrary to public policy and should be restricted. The fourth issue is the proper tax treatment of a life settlement transaction.[95] This Comment now delves into the analysis of these issues.

GRIMMETT & DAVID STIRZAKER, PROBABILITY AND RANDOM PROCESSES, (2d ed., Oxford University Press 1992).

86. *See, e.g.*, Goldstein, *supra* note 30, at 44; Kelleher, *supra* note 1, at 10.

87. According to Business Week, the return is steady at eight percent. *See* Goldstein, *supra* note 30, at 44; *see also* Matthew Vincent, *A Matter of Life and Death in the Market*, FIN. TIMES (London), Sept. 7, 2007, at 5.

88. *See* discussion *supra* Part II.A.2; *see also* sources cited *supra* notes 66-67.

89. *See* Kelleher, *supra* note 1, at 10.

90. The growth of the life settlement industry is astonishing. In fact, it is estimated that by 2030, the market for life settlement-backed securities will be a $160 billion a year. *See* Kelleher, *supra* note 1, at 10**.**

91. *See* Ronald Panko, *Growth of Life Settlements Tied to Accountability*, A.M. BESTWIRE, Nov. 21, 2005, http://www.lisassociation.org/vlsaamembers/news/files/vlsaanews_A.M._Best_Company_21_Nov_2005_Growth_of_Life_Settlements_Tied.htm.

92. *See* discussion *infra* Part III.C.1.

93. *See* discussion *infra* Part III.A.

94. *See* discussion *infra* Part III.B.1.

95. *See* discussion *infra* Part III.C.1.

III. ANALYSIS

A. The Fraudulent Practice of Stranger-Originated Life Insurance ("STOLI") and the Risk Associated with STOLI in Life Settlement-Backed Securities

On the surface, the high expected returns and low risk associated with a life settlement and a life settlement-backed security seem like an investor's dream. The life settlement industry has not been plagued by the same difficulties in mortality prediction and blatant dishonesty of doctors and insureds that the viatical settlement industry experienced.[96] The life settlement industry, however, has its own latent risks which are just now coming to light. As the saying goes, "pigs get fat, but hogs get slaughtered." The "hogs" of the life settlement industry are those who seek fraudulent ways of expanding the market.[97]

1. The Supply-Constraints of the Life Settlement Market Give Way to STOLI

The life settlement market is considered supply-constrained, because there are a limited number of life insurance policies available for sale.[98] An investor seeking to increase the supply of life insurance policies available for sale on the secondary market can only do so through fraudulent means: inducement.[99] By inducing[100] senior-citizens

96. *See* discussion *supra* Part II.A.1.

97. The source of this maxim is unclear, though its meaning is sound. A pig is understood to be someone who pushes the proverbial envelope and benefits, whereas a hog is understood to be someone who crosses the line and ends up paying a dear price.

98. At any given time, the market for life settlement is constrained by the following factors: policies on senior-citizens over seventy, policies that have been owned for at least two years, and policies that have a face value in excess of $100,000. *See* Suneet Kamath & Timothy Sledge, *Life Insurance Long View—Life Settlements Need Not Be Unsettling*, BERNSTEIN RES. CALL, Mar. 4, 2005, at 8. These constraints are not mandated by statute, but are the generally accepted parameters in order for the policy to be worth more to an investor in the secondary market than its cash surrender value to an insured. *Id.* In spite of this, estimates put the life settlement industry at upwards of $160 billion by 2030. *Id.*

99. *See, e.g.*, Stephan Leimberg, *Stranger Originated Life Insurance: A Free Lunch Or A Prelude To Acid Indigestion?*, FORTY-FIRST ANN. HECKERLING INS. ON EST. PLAN., § 4 (Matthew Bender 2007); J. Alan Jensen & Stephan Leimberg, *Stranger-Owned Life Insurance: A Point/Counterpoint Discussion*, 33 ACTEC J. 110, 110 (2007).

100. Instances of inducement have involved offers of cruises, theater tickets and "free" insurance coverage for the two years. *See* Goldstein, *supra* note 30, at 44.

Inducements offered in originating a STOLI policy have yet to be challenged as violations of the insurance anti-rebating statutes. Anti-rebating statutes in some states make it a felony to offer any inducement to acquire insurance. *See, e.g.*, CAL. INS. CODE to take out a life insurance policy on their life with the intention of later selling their interest in the policy to the investor, an investor is able to reduce the supply constraint. This practice is known as stranger-originated life insurance ("STOLI"), and is nothing more than a collusive attempt to skirt the insurable interest laws.[101]

2. *STOLI Violates the Insurable Interest Laws*

Life insurance cannot be purchased with the intent to later sell it to an individual lacking insurable interest.[102] A life insurance policy must be bought in good faith, and a STOLI policy, by definition, is not so conceived. The key is to determine who initiates the purchase of the life insurance policy and for what purpose. As the Supreme Court noted in *Grigsby v. Russell*, a policy that is incepted under the "cloak" of insurable interest, when there actually is none, is a wagering contract on human life and is void as a contravention of public policy.[103] Those who are caught participating in this practice should be penalized as criminals engaging in insurance fraud, a felony in most jurisdictions.[104]

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§ 750 (2007) ("Any person who offers, delivers, receives, or accepts any rebate, refund, commission, or *other consideration*, whether in the form of *money or otherwise*, as compensation or inducement to or from any person for the referral or procurement of clients, cases, patients, or customers, is guilty of a crime.") (emphasis added).

A thorough analysis of the anti-rebating statutes is beyond the scope of this Comment, though it is the author's position that individuals participating in STOLI practices as either insureds or investors ought to be punished to the fullest extent of the law. In light of anti-rebate statutes, *additional* criminal sanctions may be imputed to an *investor* engaging in any such offerings of benefits as inducement to insurance.

101. The requirement of insurable interest is discussed in detail *infra* Part III.B.1. For an in-depth look at the implications of STOLI, *see* Leimberg, *supra* note 99 at § 4.

102. *See* Grigsby v. Russell, 222 U.S. 149, 156 (1911) ("[C]ases in which a person having an interest lends himself to one without any as a cloak to what is in its inception a wager have no similarity to those where an honest contract is sold in good faith."); Life Prod. Clearing LLC v. Angel, 530 F. Supp. 2d 646, 656 (S.D.N.Y. 2008) (denying judgment on pleadings in life settlement case when issue is intent of the decedent insured in procuring life policy); *see also* discussion *infra* Part III.B.1.

103. *See Grigsby*, 222 U.S. at 156.

> Only one who obtains a life insurance policy on himself "on his own initiative" and in good faith—that is, with a genuine intent to obtain insurance protection for a family member, loved one, or business partner, rather than an intent to disguise what would otherwise be a gambling transaction by a stranger on his life—may freely assign the policy to one who does not have an insurable interest in him.

Life Prod. Clearing LLC, 530 F. Supp. 2d at 653.

104. If insurance fraud is not reason enough, there are many other reasons why STOLI should not be entertained by an individual, no matter how great the inducement by the investor seemingly is. A critical assessment of the negative side-effects of STOLI on an individual's financial health is outside the scope of this Comment, but for more information, *see* Jensen & Leimberg, *supra* note 99, at 110.

3. The Impact of STOLI on Investors in Life Settlement-Backed Securities

The impact of STOLI on investors in securitized pools becomes even more complicated. An investor in a life settlement pool is several steps removed from the policy creation stage.[105] Because an investor is removed, discovering the risk associated with STOLI is difficult, not to mention costly, to obtain. Traditionally, the issuer and underwriter of a security have the duty to discover latent risk in the offering of securities through the use of a credit rating agency.[106] In the case of life settlement-backed securities, however, credit rating agencies (as well as state regulatory bodies) presently lack reliable current and historic data with which to estimate the probability or magnitude of risk associated with STOLI loss.[107] When the difficulties of assessing STOLI risk are coupled with the necessity of the application of actuarial science for predictions regarding payment obligations (death benefits),[108] a life settlement pool seems uniquely difficult to value. Like the problems of sub-prime default in the mortgage industry's tranches[109] of mortgage-backed investments,[110] the possibility that some or all of the payment

105. While most investors in a life settlement pool are institutions, and not individuals, discovering STOLI is still a difficult task. *See* Goldstein, *supra* note 30, at 44. For the purpose of understanding the difficulty of an investor discovering STOLI, note that there are several links in this transaction chain. STOLI begins with an individual (owner) who purchases a policy with the intent to re-sell to an investor. The owner then engages in a life settlement transaction, usually with a life settlement company (LSC). The third link is when the LSC sells the same policy to an intermediary who becomes the "issuer." The issuer aggregates several policies and arranges for an "underwriter" to rate and transfer fractional interests in the aggregated pool (the life settlement-backed securities). The transfer (by sale or otherwise) of the interests in the pool is the fourth link. This explanation is over-simplified, but it illustrates the point that a purchaser of a life settlement-backed security is far removed from the initial fraud of STOLI. *See* SCHWARCZ, MARKELL, & BROOME, *supra* note 79, at § 1.

106. *See id.* at § 14.

107. STOLI risk raises a *sui generis* issue for the rating agencies, because STOLI does not correlate with other market trend indicators. STOLI risk is latent in the policies themselves and it is not tied to market performance. *See* Vikas Bajaj, *Mortgages Grow Riskier and Investors are Attracted*, N.Y. TIMES, Sept. 6, 2006, at C1 (discussing credit rating agencies sensitivity to fluctuations in default rates).

108. Contrast this with default rates on home mortgages as to which there is a mountain of data smoothed out over millions of individual obligations that make predictions about default risk ranges (e.g., prime v. sub-prime) relatively easy and cheap.

109. *See, e.g.*, Edward Yardini, *Global Wealth Will Act as an Economic Shock Absorber*, FIN. TIMES (London), Aug. 1, 2007, at 36 (explaining the "tranche warfare" that is occurring with respect to investments backed by mortgage payment obligations and the sub-prime market).

110. *See, e.g.*, E. Scott Reckard, *Mortgage Losses Slam Irvine Broker*, L.A. TIMES, June 22, 2007, at C3 (discussing problems with securities backed by mortgage payment obligations).

rights in a pool of life insurance policies are STOLI, is latent risk to a life settlement-backed security investor.[111] The risk is that if the interest from which the security derives its value fails,[112] either the issuer of the security or the investor, or both, will have to absorb the loss.[113] If a life insurance company successfully challenges the validity of a policy on the ground that it was purchased with the intention of re-selling it, the policy will be deemed void *ab initio*.[114] If a STOLI policy gets securitized, and its STOLI nature exposed by the insurer, it will negatively impact the pool in which it is securitized.[115]

111. Life settlement-backed securities are analogous to securities backed by mortgage obligations issued by a REIT (real-estate investment trust). *See* Goldstein, *supra* note 30. The difference is in the nature of the underlying income-generating asset. In the case of life settlement-backed securities, the securitized asset is the insurer's obligation to pay benefits to the insureds' assignees when the insured dies. In the case of securities backed by mortgage obligations, the securitized asset is the borrowers' obligation to pay home mortgage debt to retail mortgage issuers. *See* Charles Stone & Anne Zissu, *Securitization of Senior Life Settlements: Managing Extension Risk*, 13 J. DERIVATIVES 66 (2006) (proposing model by which life settlement-backed securities can be valued, but this model does not account for STOLI).

112. Meaning the insurer refuses to pay the death benefit on account of fraud, e.g., STOLI.

113. When an interest ("bond") in a pool of life settlement-backed securities is purchased, the investor is purchasing the issuer's promise to pay a fixed payout over time. *See* SCHWARCZ, MARKELL, & BROOME, *supra* note 79, at 71-73. If the pool does not yield what the issuer thought it would (due to STOLI or other fraud), then the positive difference between the payout obligation and the pay in (purchase price of the bonds) shrinks and this loss is borne by the issuer. *Id.* If, however, the terms of the bond provide for a reduction in payout if the pool is later found to be infected with STOLI, then the investors will bear the loss, because their payout will decline. *Id.* Put another way, who bears the loss of STOLI depends on the terms of the bonds and ultimately on the solvency of the issuer. *Id.*

114. Most state insurance laws provide that an insurance carrier is the only party with standing to challenge a lack of insurable interest. *See, e.g.*, Rice v. Wal-Mart Stores, 2003 D.N.H. 166, 166 (D.N.H. 2003) ("New Hampshire embraces the majority rule that 'only the insurer can raise the object of want of insurable interest.'" (citing Couch on Insurance, 3 Couch § 41:5 (3d ed. 1995))).

115. While it is true that all investments have risk, the risk associated with STOLI policies is different. Risk in the stock market is understood at the time of investment, even stocks which consistently perform well are bound to have bad days. As with securities backed by mortgage obligations tied to the sub-prime market, however, the issue is the lack of transparency in the front-end of the transaction. Investors in the same type of security pool may come to find that their payouts are different on account of the nature of the underlying payment obligations. *See* John Spencer et al., *Monte Carlo Round Table—Soft Market Strategies*, REINSURANCE MAG., Oct. 2, 2007, at 22 (noting increased transparency in the mortgage industry may help market stability).

4. Regulatory Response to STOLI in the Life Settlement Industry

a. NAIC Amendments to the Viatical Settlement Model Act are Criticized

The NAIC responded to the STOLI issue by amending the NAIC's Model Act to specifically target the practice of STOLI.[116] However, the amendments have drawn staunch criticism from proponents of the life settlement industry.[117] The amendments are criticized as being over-broad,[118] because they subject all individuals who utilize premium financing[119] in acquiring life insurance to regulation as viatical settlements; meaning, the ban on reselling the policy to an investor is extended from two to five years.[120] The effect of this classification is argued to be a burden on the free alienation of property.[121] As convincing as that argument may seem, it is inaccurate. In fact, the amendments do allow settlements after only two years even when premium financing is utilized in several instances.[122] A policy may be settled after two years if the loan financing the policy is based on solely

116. *See, e.g.*, Jim Connolly, *Are Today's Battle's Déjà Vu All Over Again?*, NAT'L UNDERWRITER, April 30, 2007, at 27.

117. *See* Scott Cipinko, *A Big Hole in the NAIC's New Viatical Model Amendments*, NAT'L UNDERWRITER, April 30, 2007, at 79; Stephan L. Washington, *The NAIC's Proposed Amended Viatical Settlements Act*, CAL. BROKER MAG., June 2007, http://calbrokermag.com/Magazine/story/june07/washington.htm.

118. Doug Head, speaking as the executive director of the Life Insurance Settlement Association (LISA) says, "[The amendments are] an attack on consumer rights and protections, they sweep everyone into a regulatory net. STOLI abuse is cause for concern, but the abuse should be dealt with through targeted, well-crafted regulation, not through an overarching rollback of consumer rights." Telephone interview with Doug Head, Executive Director, Life Insurance Settlement Association, in Orlando, Fla. (Jan. 21, 2008) [hereinafter Head Interview].

119. Premium financing is a method of funding the purchase of life insurance for those individuals who have high net worth, but who either do not have or do not want to use liquid capital to pay the premiums on a policy. Telephone Interview with Robert S. Gascon, CLU, ChFC, Regional Director, Penn Mutual Life Insurance Company, in Irvine, Cal. (Oct. 30, 2007) [hereinafter Gascon Interview I]. Premium financing plans allow a policy owner to borrow the money to pay the life insurance premiums, thus keeping capital free to be used more efficiently elsewhere. *Id.* Collateral for the loan usually consists of personal assets and can be reduced over time by cash accumulated within the policy being financed. Because STOLI is often acquired using investor-financing, it was presumed additional inquiries on all policies so acquired would abate the practice of STOLI. *Id.*

120. *See, e.g.*, Washington, *supra* note 117.

121. *See, e.g.*, Jim Connolly, *New York Superintendent Dinallo Pressing For Change On Many Fronts*, NAT'L UNDERWRITER, June 18, 2007, at 7.

122. *See* Open Letter from Stephan R. Leimberg, Esq., CEO, Leimberg Information Services Inc., President, Leimberg Associates, Inc., to Illinois Legislators (March 2008) (on file with author).

the policy's cash surrender value, no life expectancy evaluation has been made by investors, and there has been no "agreement or understanding to settle."[123] Furthermore, there is no wait for settlement if the status of the insured changes, e.g., the insured is diagnosed with a terminal illness, is predeceased by a spouse, retires, has a change in marital status or becomes disabled.[124] Additionally, the amendment imposes no moratorium on a life settlement of a policy when the policy owner uses his own funds (no premium financing) to purchase the life insurance.[125] Opponents of the amendments tout the infringement of property rights as reason to dismiss them as over-broad, yet these opponents fail to realize that property rights are only accorded to good faith purchasers.[126] The so-called "regulatory net" of the amendments is sufficiently crafted so as to allow policy owners who have purchased in good faith to sell their interest without encumbrance.[127]

b. Insurance Companies Amend Applications to Discover STOLI at Policy Inception

The NAIC is not the only group concerned with STOLI; most insurance companies rightly recognize their obligation to prevent this practice, and have altered their application forms to include questions regarding the intended use of policies.[128] It remains to be seen if these changes will reduce the prevalence of STOLI. One potential impediment to the effectiveness of the alterations stems from the nature of the relationship between the life insurance companies and the "agents" selling the policies. Life insurance "agents" are not agents in the legal sense at all, they are independent contractors, known as "independent producers" or "brokers" in the industry.[129] This arrangement allows each broker to sell life insurance policies from several different insurance companies.[130] The brokers are paid on a commission basis, creating

123. *Id.*
124. *Id.*
125. *Id.*
126. *See* Grigsby v. Russell, 222 U.S. 149, 156 (1911).
127. For a comprehensive exposition of regulation targeting the practice of STOLI, *see* Kenneth W. Kingman & Stephan R. Leimberg, *Deterring Stranger-Originated Life Insurance: Two New Model Life Settlement Acts*, EST. PLAN. (forthcoming July 2008).
128. Companies such as Pacific Life, Penn Mutual Life, AXA Equitable Life, MONY Life, and West Coast Life Insurance have all amended their applications to include questions about the intended use of the policy and, specifically, whether the insured intends to sell the policy in a viatical or life settlement transaction. (Unpublished applications, on file with author).
129. *See* Gascon Interview I, *supra* note 119.
130. *See* Head Interview, *supra* note 118.

incentives for impropriety. As with unscrupulous mortgage salesmen,[131] brokers are not always willing to forego writing a policy on account of potential STOLI.[132] Further, as the risk of mortgage-defaults is not borne by the mortgage salesman,[133] STOLI-loss is not borne by the broker, and in each case, the commission on the loan/policy is theirs to lose.[134] It is difficult to say how best to resolve this incentive-problem, though the burden seems to rest with the insurers. If insurers are consistent in terminating their relationships with brokers who write STOLI policies, brokers will quickly become limited in the products they offer, making them uncompetitive and ultimately removing the incentive to write a STOLI policy. Though imposing consequences on the broker may help abate the practice of STOLI, it cannot be the only solution. A broker could unknowingly write a STOLI policy, leaving the insurer with the costly task of detecting STOLI and asserting the lack of insurable interest defense.[135] Given the current insurable interest laws, the burden of discovering STOLI, despite costs, seems to rest on the shoulders of the insurance companies.[136]

B. The Legality of a Life Settlement

Insurance companies are understandably cautious with respect to life settlements; they are in the business of providing insurance to individuals, because it is a powerful financial planning tool.[137] The sale of a policy strips from the individual many of the advantages that come with life insurance, putting insurance companies in a precarious position

131. *See, e.g.*, Annette Haddad, *Mortgage Broker Group Takes on Issue of 'Predatory' Lending*, L.A. TIMES, Aug. 6, 2004, at C2.

132. Head Interview, *supra* note 118.

133. *See* The Economist Special Report, *On Credit Watch*, THE ECONOMIST (U.S. Ed.), Oct. 20, 2007, http://www.economist.com/specialreports/displaystory.cfm?story_id=9972531.

134. Gascon Interview I, *supra* note 119.

> There has always been an adversarial relationship between agents and home offices. Agents are independent producers, not employees, who may have contracts to sell insurance products from several insurance companies. If an agent violates his duty to an insurer, the insurer will terminate his contract. But, if an agent violates a duty to a client, the client can take him to court. Clearly, in the agent's eyes, the higher obligation goes to the client. Theoretically, these obligations should be coextensive, but so far, that has not been the case.

Id.

135. *See* discussion *supra* Part III.A.1.

136. *See infra* note 146.

137. Gascon Interview I, *supra* note 119.

between advocating against life settlements[138] and promoting a product in which they do not believe. Aside from determining whether a life settlement is in the best interest of a client, insurance companies and legislators[139] must determine if a life settlement is a legal transaction.

1. Understanding the Insurable Interest Requirement in Light of Life Settlements

a. The Origins of Insurable Interest

The concept of life insurance was initially rejected by many members of the population as immoral.[140] Although the importance of life insurance is now readily apparent because of its ability to hedge against the risk of unexpected death, many viewed it as little more than gambling.[141] In Britain, life insurance contracts were purchased on the lives of prominent individuals in poor health or individuals being tried for capital crimes, a practice known as "death pooling."[142] In 1774, however, the British Parliament enacted the first Life Insurance Act, which required that life insurance policies have insurable interest in order to be valid.[143] The Life Insurance Act made it a crime to use life

138. Head Interview, *supra* note 118 ("Insurance companies' efforts to prohibit, ban, even fire people who engage in assisting clients with appropriate settlements are terrible. This is a gag-rule—called such in New York.").

139. Letter from Richard Neal & Phil English, Chairman and Ranking Member of Select Revenue Measures Subcomm. of H. Comm. On Ways and Means, to Henry Paulson, Sec. of the Treas. (Nov. 16, 2007), *available at* http://www.naifa.org/advocacy/frontline/advocacyupdates/documents/11.16.07Letter_Reps_Neal_English.pdf (recommending the Treasury issue a "Notice" outlining tax consequences of STOLI).

140. *See* VIVIANA A. ROTMAN ZELIZER, MORALS AND MARKETS: THE DEVELOPMENT OF LIFE INSURANCE IN THE UNITED STATES 45-46 (Colum. Univ. Press 1979).

> In the minds of many, life insurance was simply a new speculative fund-raising device to substitute the floundering lotteries and the unsuccessful tontines. Its alleged lottery spirit became a major source of prejudice against it . . . early forms of life insurance were outright bets on human lives . . . in eighteenth-century England, insurance and wagering went hand in hand, and it has been alleged that no form of gambling became so varied, so universal, so wasteful or so demoralising as insurance.

Id. (internal quotes omitted).

141. *See id.*

142. *See, e.g.*, ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 20-24 (LexisNexis 3d ed. 2002); Laura Pederson-Pieterson, *Minding Your Business; The Ghoul Pool: Morbid, Tasteless and Popular*, N.Y. TIMES, June 7, 1998, at 12.

143. The act is known as the Life Assurance Act 1774, and it is still in effect in the United Kingdom to this day. 12 Geo. III, c. 48, 1 (1774) (Eng.). It provides:

> From and after the passing of this Act no insurance shall be made by any person or persons . . . on the life or lives of any person . . . wherein the person . . . on whose account such policy or policies shall be made, shall have no interest, or by way of gaming or wagering.

insurance as a form of gambling.[144] By the mid-nineteenth century, nearly every state in the United States had enacted insurable interest laws, and it remains a state-governed matter today.[145] Simply stated, insurable interest laws are designed to deal with the nature of the relationship between the policy owner and the person whose life has been insured.

b. How Courts Define Insurable Interest

Although each state has its own insurable interest law,[146] the Supreme Court has generally defined insurable interest as the "reasonable expectation of advantage or benefit from the continuance of [the insured's] life,"[147] and "the essential thing is that the policy shall be obtained in good faith, and not for the purpose of speculating upon the hazard of a life in which the insured has no interest."[148] Stated

Id.

144. *Id.*

145. *See* statutes cited *infra* note 146; *see also supra* note 55 and accompanying text.

146. ALA. CODE § 27-14-3(F) (2007); ALASKA STAT. § 21.42.020(A) (2007); ARIZ. REV. STAT. § 20-1104(A) (2007); ARK. CODE ANN. § 23-79-103(A) (2007); CAL. INS. CODE § 10110.1 (2007); COLO. REV. STAT. § 10-7-115 (2007); 18 DEL. CODE ANN. § 2704(A) (2007); D.C. CODE § 31-4716 (2007); FLA. STAT. § 627.551(2) (2007); GA. CODE ANN. § 33-24-3(E) (2007); HAW. REV. STAT. § 431:10-204 (2007); IDAHO CODE ANN. § 41-1804(1) (2007); 215 ILL. COMP. STAT. 5/224.1 (2007); IND. CODE ANN. § 27-8-3-8 (2007); KAN. STAT. ANN. § 40-450(A) (2007); KY. REV. STAT. ANN. § 304.14-040(2) (2008); LA. REV. STAT. ANN. § 22:613 (2007); 24-A ME. REV. STAT. ANN. § 2404 (2007); MD. CODE ANN., INSURANCE § 12-201(A) (2007); MASS. GEN. LAWS § 500.2207(1) (2007); MICH. COMP. LAWS § 500.2207 (2008); MINN. STAT. § 61A.074 (2007); MISS. CODE ANN. § 83-5-251(1) (2007); MONT. CODE ANNO. § 33-15-201(1) (2005); NEB. REV. STAT. § 44-704 (2007); NEV. REV. STAT. ANN. § 687B.040(1) (2007); N.H. REV. STAT. ANN. § 408:2 (2007); N.J. STAT. ANN. § 17:35-11 (2007); N.M. STAT. ANN. § 59A-18-4(A) (2007); N.Y. INS. LAW § 3205(B) (2007); N.C. GEN. STAT. §§ 58-58-70, 58-58-86 (2007); N.D. CENT. CODE § 26.1-29-09.1(1) (2007); OHIO REV. CODE ANN. §§ 3911.09, 3911.091 (2008); 36 OKLA. STAT. ANN. TIT. 36, § 3604(A)(1) (2007); ORE. REV. STAT. §743.024(1) (2005); 40 PA. CONST. STAT. ANN. § 512 (2007); R.I. GEN. LAWS § 27-4-27(A) (2007); S.C. CODE ANN. § 38-63-100 (2006); S.D. CODIFIED LAWS § 58-10-3 (2007); TENN. CODE ANN. § 56-7-101(A) (2007); TEX. INS. CODE ANN. § 1103.053 (2007); UTAH CODE ANN. § 31A-21-104(1) (2007); VA. CODE ANN. § 38.2-301 (2007); WASH. REV. CODE ANN. § 48.18.030(1) (2007); W. VA. CODE R. § 33-6-2(A) (2007); WIS. STAT. ANN. § 631.07(1) (2006); WYO. STAT. ANN. § 26-15-102(A) (2007). Both Massachusetts and Connecticut rejected the British Life Assurance Act of 1774, electing instead to leave insurable interest requirements within the province of common law. *See* Loomis v. Eagle Life Ins. Co., 72 Mass. 396, 398 (Mass. 1856) ("The case in this state must be governed by the rules and principles of the common law, there being no regulation of the subject by statute"); Bevin v. Connecticut Mut. Life Ins. Co., 23 Conn. 244, 251 (Conn. 1854) (noting that Britain's Gambling Act principles, 12 Geo. III, c. 48, 1(1774) (Eng.), were "in affirmance" of the principle of common law).

147. Warnock v. Davis, 104 U.S. 775, 779 (1881).

148. Conn. Mut. Life Ins. Co. v. Schaefer, 94 U.S. 457, 460 (1876).

differently, insurable interest is found when an individual has a greater interest in the survival of the insured than in the insured's death.[149]

c. The Dual Policy Rationales Underlying the Insurable Interest Laws

The dual policy rationales underlying this doctrine are as follows: first, to prevent wagering on human life and second, to prevent those individuals who would bring about the premature death of the insured from acquiring an interest in another's life.[150] Insurable interest ensures that life insurance is used to provide security to loved ones or creditors in the event of an untimely death, not as a wagering contract on human life.[151] Insurable interest acts as a safeguard against speculating on human life, such that insurance on the life of another may only be held by one whose interest in the continued life of the insured individual is greater than his interest in the death of the insured.[152] Insurable interest also hedges against unnecessary risk to human life. By limiting the class of persons who might be tempted to place a wager on life, the insurable interest requirement decreases the chances of crimes inspired by such a wager.[153]

In addition to requiring insurable interest, many states have enacted additional statutes which will trump a beneficiary's right to the death benefit under an insurance contract in the event of a "modification by circumstance," e.g., slaying.[154] For example, "slayer statutes" protect an insured from a beneficiary's potential incentive to kill the insured for his death benefit.[155] These statutes are grounded in the equitable principle that a wrongdoer should not profit from his crime, thereby keeping the slayer from collecting the death benefits of an insurance policy.[156]

149. *Id.* (holding that an applicant for a life insurance policy on the life of another has an insurable interest in that other's life only if he has a pecuniary interest in the continued life of the person whose life he seeks to insure).
150. *See* Leimberg, *supra* note 99 at § 4; ZARITSKY & LEIMBERG, *supra* note 26.
151. *Id*.
152. *See* Conn. Mut. Life Ins. Co. v. Luchs, 108 U.S. 498, 505 (1883).
153. *See* Grigsby v. Russell, 222 U.S. 149, 155 (1911).
154. *See, e.g.*, FLA. STAT. § 732.802 (2007) (revoking slayer's interest in the death benefits of a life insurance policy of slain decedent on account of slayer's act of felonious and intentional killing of the decedent).
155. *Id*.
156. *See, e.g.*, Mut. Life Ins. Co. v. Armstrong, 117 U.S. 591, 598 (1886) (holding that a beneficiary of an insurance policy could not collect insurance proceeds after feloniously killing the insured).

d. Who Generally Has Insurable Interest

An individual has an insurable interest in his own life and in the lives of others with whom he has a particular relationship.[157] Insurable interest in the life of another encompasses close familial relationships, e.g., blood affinity, whether or not "capable of pecuniary estimation,"[158] as well as those relationships with demonstrable economic dependencies, including but not limited to key employees of a corporation, business partners, or those in a debtor-creditor relationship.[159] Generally, with respect to insurable interest in the life of a close family member, the insurance protection sought is not restricted to a certain dollar amount.[160] In contrast, a creditor has insurable interest in the life of his debtor only to the extent of the amount of the debt.[161]

When an individual wishes to procure life insurance on the life of another, he must possess an insurable interest in the proposed insured's life or the policy will be void.[162] The purpose of the insurable interest requirement is to ensure that life insurance is purchased for a proper use and not as a form of wagering on human life.[163] A salient point for the life settlement industry, however, is that when an individual procures life

157. *See* Conn. Mut. Life Ins. Co. v. Schaefer, 94 U.S. 457, 460 (1876) (outlining history of insurable interest and noting insurable interest is found when individuals are connected by certain relationships).

158. Warnock v. Davis, 104 U.S. 775, 779 (1881).

159. *See* United States v. Supplee-Biddle Hardware Co., 265 U.S. 189, 195 (1924) (holding a company had an insurable interest in life of president); *Conn. Mut. Life Ins. Co.*, 94 U.S. at 461 (determining that a creditor may obtain insurance on the life of his debtor for the purpose of securing his debt).

160. An individual is said to have "unlimited insurable interest in his own life." Mut. Sav. Life Ins. Co. v. Noah, 282 So. 2d 271, 273 (Ala. 1973). Yet, just because an individual has unlimited *insurable* interest in his life does not mean he has unlimited *economic* interest in his life. *See* Gascon Interview I, *supra* note 119. Insurance companies limit the maximum life insurance coverage available to an individual by a formula that includes, where applicable, current income, estate tax liability plus annual growth (usually equal to three to six percent per year for ten years), reasonable business liability (key-person insurance, executive benefit plans funded with life insurance, debt reduction, buyout agreement funding, etc.). *Id.*

161. *See* Cammack v. Lewis, 82 U.S. 643, 648 (1872) ("[Creditor] could, in equity and good conscience, only hold the policy as a security for what [debtor] owed him when it was assigned, and such advances as he might afterwards make on account of it, and that the assignment of the policy to him was only valid to that extent.").

162. There is a split among courts on whether the insured individual need be informed that one with insurable interest in his life is purchasing insurance. *Compare* Ellison v. Straw, 92 N.W. 1094, 1097 (Wis. 1902) (ruling policies obtained without consent are valid as long as there is insurable interest) *and* Cook v. Bankers Life & Cas. Co., 406 S.E.2d 848, 851 (N.C. 1991) (same) *with* Ramey v. Carolina Life Ins. Co., 135 S.E.2d 362, 365 (S.C. 1964) (holding policies obtained without consent of insured are void as contrary to public policy).

163. *See* Hopkins v. Hopkins, 614 A.2d 96, 98 (Md. 1992) (noting primary purpose of insurable interest is to prevent wagering).

insurance on his own life, he may designate anyone he chooses as the beneficiary of the policy without regard to insurable interest.[164] The general logic is that the insured is in the best position to determine the risk he is willing to assume, and the insured will probably not designate an individual who is likely to kill him.[165]

e. When Insurable Interest is Necessary

State law governs when insurable interest is required.[166] Typically, life insurance requires that an insurable interest be present only at the *creation* of the policy;[167] this principle is rooted in the common law, and affirmed by the Supreme Court.[168] The primary rationale for requiring insurable interest only at policy creation, and not at the time the loss is suffered, is that life insurance does more than merely indemnify against a risk.[169] While life insurance is a capital asset,[170] an investment mechanism[171] and a powerful estate-planning tool,[172] the prevailing purpose of life insurance is to provide security.[173] Understanding what

164. *See* Clements v. Terrell, 145 S.E. 78, 81 (Ga. 1928) (stating an individual may designate as beneficiary an individual who has no insurable interest).

165. *See* Peter Nash Swisher, *The Insurable Interest Requirement For Life Insurance: A Critical Reassessment*, 53 DRAKE L. REV. 477, 487 (2005).

166. *See* statutes cited *supra* note 146.

167. Opponents of the life settlement industry may want to assert that insurable interest ought to exist at both policy inception and at collection of death benefits. There is some state statute support for this notion as well, *see* IND. CODE ANN. § 27-8-3-8 (2007); however, in the opinion of the author, insurable interest is proper only at policy inception. To find otherwise would result in arbitrary line-drawing with respect to beneficiary designation and face value of policies.

168. *See* Conn. Mut. Life Ins. Co. v. Schaefer, 94 U.S. 457, 463 (1876) (relying on English precedent and holding policy valid despite cessation of insurable interest).

169. *See* Gascon Interview I, *supra* note 119 ("Life insurance is more than an indemnity contract; it is also a vital estate-planning tool."). Contrast life insurance with property insurance, where the purpose is to merely insure against loss of that property. *Cf.* Howard Fire Ins. Co. v. Chase, 72 U.S. 509, 512 (1866) (stating *property* insurance is an indemnity contract, if insured has no interest for which he can be indemnified, the contract is void as contrary to public policy).

170. I.R.C. § 1221(a) (2008) ("For purposes of this subtitle, the term capital asset means *property held by the taxpayer* [whether or not connected with his trade or business].") (internal quotes omitted) (emphasis added). Though there are statutory exclusions to this provision, life insurance is not excluded. This is significant, because as a capital asset, life insurance policies are property. *See* Grigsby v. Russell, 222 U.S. 149, 156 (1911); *see also* discussion *infra* Part III.B.2.

171. *See supra* note 33 and accompanying text.

172. For a discussion of the multiple uses of life insurance, *see* LEIMBERG & DOYLE, JR., *supra* note 26. *See also*, John H. Langbein, *The Nonprobate Revolution and the Future of the Law of Succession*, 97 HARV. L. REV. 1108, 1115 (1984) (outlining the reasons for will substitutes such as life insurance).

173. Robert H. Jerry, II, *May Harvey Rest in Peace: Lakin v. Postal Life and Casualty Company*, 2 NEV. L.J. 292, 305 (2002) ("For individuals, insurance makes possible the preservation of work and accumulated savings, the maintenance of lifestyles and

the security (cash death benefit) really affords is perhaps the key to understanding the reason insurable interest is only required at the creation of the policy.

The security afforded by life insurance is intended to hedge against losses suffered when an individual dies.[174] Measuring actual pecuniary loss in the event of death is no easy task.[175] In addition to quantifiable losses (funeral expenses, lost wages, etc.), intangible losses and future pecuniary losses are far more difficult to approximate.[176] For instance, a parent has an insurable interest in the life of a child despite the fact that the parent is not financially dependant upon the child.[177] On the occasion of the untimely death of the child, the parent may collect the death benefit without establishing actual pecuniary losses that amount to the value of the death benefit.[178] Thus, life insurance stands in contradistinction to property insurance where an individual may not maintain insurance on property in which he has no insurable interest.[179]

f. What Insurable Interest Laws Mean for Life Settlements

The insurable interest laws do not pose a problem for a legitimate, non-STOLI, life settlement. The insurable interest laws ensure that those

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prosperity, and the realization of future dreams that would be dashed by unexpected loss but for the presence of insurance.").

174. *See, e.g.*, Foster v. Hurley, 826 N.E.2d 719, 727 (Mass. 2005) (noting the primary purpose of life insurance is to provide security).

175. *See, e.g.*, Carter v. Williams, 792 A.2d 1093, 1097 (Me. 2002) (noting the inherent difficulty of measuring pecuniary loss in the event of death).

176. *Id*.

177. Warnock v. Davis, 104 U.S. 775, 779 (1881).

178. To draw an analogy to tort law, note that recovery is permitted for the death of a child in a wrongful death action. *See* Green v. Bittner, 424 A.2d 210, 212 (N.J. 1980) ("[A] verdict finding no damages for the death of a child should ordinarily be set aside by the trial court. . . . To sustain such a verdict would result in a return to the outmoded doctrine that a child is a liability-not an asset." (citing Bohrman v. Pa. R. Co., 93 A.2d 190, 195 (N.J. Super. Ct. App. Div. 1952))). Likewise, perhaps insurable interest implicitly recognizes that prospective loss, pecuniary or not, may properly be insured against. For example, the court in *Green v. Bittner* noted specifically that damages "should not be limited to the well-known elements of pecuniary loss," and instead noted that loss of companionship, advice and future care of parents in old age should be considered by the jury. *Id*. The holding in *Green* demonstrates the difficulty in the valuation of life. By contrast, property is generally not as difficult to value, and so property insurance does require actual quantifiable loss at the time the claim is made. This means that in the case of property insurance, financial loss suffered by the insured because of the relationship (insurable interest) that existed between the insured and his property, is a prerequisite to collecting the insurance benefit.

179. *See* Howard Fire Ins. Co. v. Chase, 72 U.S. 509, 512 (1866) (stating property insurance is an indemnity contract, where insured has no personal interest for which he can be indemnified, contract is void as contrary to public policy, and noting such a contract would create an interest in the destruction of property).

who seek to purchase a policy on the life of another only do so with the proper intent.[180] That is, the policy purchaser intends to protect against the risk of death and is not wagering on mortality.[181] If the policy is purchased when a legitimate insurable interest exists, then the holder should not be presumed to be participating in an illegal wagering contract.[182]

Opponents of life settlements may argue that insurable interest must exist at both creation of the life insurance policy and at collection of the death benefit.[183] Seemingly, this argument makes sense given the concerns of public policy. For, if lack of insurable interest is the hallmark of a forbidden wagering contract, then subsequent cessation of insurable interest should void an interest in a life insurance policy, thus preserving the policy goals. This was the position taken by the Court of Appeals for the Sixth Circuit in *Russell v. Grigsby*, before it was reversed by the Supreme Court.[184]

In *Grigsby*, the Supreme Court did not overrule the insurable interest requirement completely, but merely limited it. The Court implies two arguments against voiding a policy when insurable interest ceases. First, the Court held that though an individual lacking insurable interest could not *purchase* an interest in the life of another, one who had purchased a policy with proper insurable interest could then *assign* the interest to an individual who lacked insurable interest.[185] The Court noted that the danger of granting "a general license to all to insure whom they like" is very different from the specific assignment found in *Grigsby*.[186] This is analogous to the designation of beneficiaries; an insured may choose his beneficiary, and the beneficiary need not have insurable interest.[187] Likewise, an insured may choose to whom he assigns his policy, and likely will not select an individual whom he believes would bring about his early demise. The Court's opinion suggests that the power to vest another with an interest in one's death is left to the individual and not the government.

180. *See, e.g.*, Herman v. Provident Mut. Life Ins. Co., 886 F.2d 529, 535 (2d Cir. 1989) (remanding case for determination of whether insurable interest existed at the time the life insurance policy was taken out, and indicating the intent of the party was critical).

181. *See* Grigsby v. Russell, 222 U.S. 149, 155 (1911).

182. *See* Hopkins v. Hopkins, 614 A.2d 96, 98 (Md. 1992).

183. *See* Russell v. Grigsby, 168 F. 577, 579 (6th Cir. 1909), *rev'd*, Grigsby v. Russell, 222 U.S. 149 (1911).

184. *Id*.

185. *Grigsby*, 222 U.S. at 156.

186. *Id.*

187. *See, e.g.*, Clements v. Terrell, 145 S.E. 78, 81 (Ga. 1928) (holding that an individual may designate as beneficiary one who has no insurable interest).

Second, the Court noted that life insurance was more than a mere indemnity contract and, as a result, cessation of insurable interest by assignment does not void the policy.[188] Life insurance is one of the "best recognized forms of investment and selfcompelled [sic] saving;"[189] to restrict assignment to those who had insurable interest would "diminish appreciably the value of the contract in the owner's hands."[190] Given that the asset underlying the contract of assignment was a property right (contract rights to the death benefit payment obligation), the Court held that upholding the assignment, despite cessation of insurable interest, was necessary to give life insurance the ordinary characteristic of property—free alienability.

A life insurance policy is an asset and, as with all assets, there may come a time when they do not hold the same value that they once did. Allowing an individual to sell his policy and, in return, gain a cash benefit, affirms his property rights and enhances the utility of his policy.[191] As long as there was insurable interest when the policy was created, the policy can be sold on the secondary market and remain valid despite a subsequent lack of insurable interest.[192] As with beneficiary designation, the insured is vested with the right to assume the risk of a third party holding an interest in his death.[193] The question then arises: as a society, do we really want to allow an individual to alienate this interest?

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188. *Grigsby*, 222 U.S. at 157.

189. *Id.* at 156.

190. *Id.*

191. Head Interview, *supra* note 118.

> The Life Insurance Companies have long held their policy-owners captive. A life settlement turns the tables on the companies and gives consumers another option. This option of a life settlement will force insurance companies to become more competitive and to offer their policy-owners the best options available. After all, the agent owes fiduciary duties to their clients; if a life settlement policy makes sense, there is no reason an agent should be inhibited from offering that option to a client.

Id.

192. *See* Bersch v. VanKleeck, 334 N.W.2d 114, 116 (Wis. 1983) (applying Wisconsin law, court recognizes general rule that the rights of a beneficiary are not "automatically affected" by a divorce).

193. The law permits a policy owner to designate a policy beneficiary who may or may not have insurable interest. *See, e.g.*, Am. Cas. Co. v. Rose, 340 F.2d 469, 471 (10th Cir. 1964) (noting that in absence of contrary statute, insured was free to designate any beneficiary he "saw fit" regardless of insurable interest); Ducros v. Comm'r, 272 F.2d 49, 50 (6th Cir. 1959) ("[A]n individual taking out insurance on his own life has a right to designate anyone he chooses as his beneficiary, irrespective of whether such beneficiary has an insurable interest in his life."). Likewise, a policy owner may elect to devise his rights in the policy to an individual who also lacks insurable interest. *Grigsby*, 222 U.S. at 157.

2. *Market Alienability of Life Insurance*

a. A Life Settlement is the Sale of an Economic Interest in a Life

The freedom to alienate is an important "stick" in the "bundle" of property rights.[194] As discussed, and not surprisingly, the Supreme Court has upheld the right to alienate a life insurance policy.[195] It is unlikely that the Court's decision will change any time soon,[196] but the issue is whether it is proper to allow unrestricted alienation of life insurance.

A life insurance contract, unlike a stock or a bond, is valued according to the mortality of the insured, effectually making it a longevity-derivative.[197] By selling a life insurance policy, the seller is actually selling an interest in the life of the insured. Only when the insured dies will the investor recover on his investment, and the sooner the insured dies, the greater the return on the investment will be.[198]

The government has determined that there are certain goods and "property rights" which are simply inalienable.[199] Acting in the public's interest, the government substitutes its judgment for that of the populace (paternalism), and determines that certain things are just not salable.[200] These restrictions are generally justified in light of preserving the well-being of society.[201] Arguably, the government regulates not to restrict

194. Though the source of this metaphor is unclear, it is used to help explain how ownership in a single piece of property (the bundle) can have separate rights (the sticks), one of which is the right to transfer, either by gift or sale, one's interest in the property.

195. *See Grigsby*, 222 U.S. at 157.

196. There is some authority that suggests that a change in the insurable interest of the policy owner (as would be with a policy sale) is distinct from the designation of a beneficiary lacking insurable interest. *See* Roundtree v. Frazee, 209 So.2d 424, 426 (Ala. 1968) (holding an assignment of a policy is not the same as designation of beneficiary); The Franklin Life Ins. Co. v. Hazzard, 41 Ind. 116, 121-22 (1872) (holding no one should hold an interest in the life of another if he lacks insurable interest in that life, and it makes no difference if the policy was acquired by purchase and assignment or from insurer directly). In the opinion of the author, the distinction ought to be between good faith purchase and STOLI.

197. *See* 12 C.F.R. pt. 3 app. A § 1(c)(13) (2008) ("[A] derivative contract means generally a financial contract whose value is derived from the values of one or more underlying assets**,** reference rates or indexes of asset values."). A life insurance contract derives its value from the mortality of the insured.

198. *See* sources cited *supra* note 54.

199. For the purposes of this Comment, "alienation" will be understood to mean salable in the market.

200. For example, Cuban cigars, human organs or blood, recreational drugs, marital support rights or infants are inalienable.

201. To say that something is inalienable in the market place is not to say that the ownership interest cannot be transferred through other means, such as by gift. *See* Benjamin Hippen, *The Case for Kidney Markets*, NEW ATLANTIS, Fall 2006, at 47. In fact, certain property rights, like blood donations, are encouraged to be gifted because of

freedom, but to enhance it and benefit society as a whole.[202] Perhaps, in certain contexts, the alienability of life insurance should also be subject to the paternalistic exercise of regulation.

On the other hand, allowing life settlements to be freely transacted creates a more efficient market for consumers.[203] Continued growth in the life settlement industry will likely result in an increase of market participants, and an increase in market participants means more competition.[204] With more investors bidding for the interests in available life insurance policies, the prices offered for settlements will increase. The relationship between price and quantity is a basic supply and demand relationship. An increase in the value of settlement offers is cash in the pockets of seniors looking to sell their policies.

b. A Life Settlement May Benefit an Investor More than the Seller of the Policy

Selling an interest in one's life is arguably risky business. Our insurable interest laws are proof of legislators' desire to prevent wagering contracts on human life.[205] As discussed above,[206] however, when an individual has legitimately entered into an insurance contract with no intent to resell the contract to someone lacking insurable interest, he should have the freedom to later decide to sell his interest in the

restrictions on salability. *See generally*, Margaret Jane Radin, *Market-Inalienability*, 100 HARV. L. REV. 1849 (1987).

202. One may contend that any paternalistic justification for a restriction on one's personal rights is an infringement on personal freedom. There are, however, certain concepts which are understood to be necessary for society to flourish. For example, an individual has a right (freedom) to do as he pleases, but he may not commit a crime with impunity. There is a restriction of his freedom by saying that he is not free to commit a crime; however, in order to maintain order in society, this is a necessary restriction of freedom. Another illustration of this is the principle that one cannot consent to be murdered. *See, e.g.*, *In re* Joseph G., 667 P.2d 1176, 1178-79 (Cal. 1983) (acknowledging that assisting a suicide is a felony); Donaldson v. Lungren, 2 Cal. App. 4th 1614, 1619 (Cal. Ct. App. 1992) (stating decedent had no constitutional right to an assisted suicide and could not consent to murder). Extended back further, one arrives at the concept of negative liberty, where an individual must, for the sake of society, cede his personal freedoms to the state. *See, e.g.*, THE FEDERALIST NO. 2, 15 (John Jay) (Clinton Rossiter ed., Signet 1961) (1787) ("Nothing is more certain than the indispensable necessity of Government, and it is equally undeniable, that whenever and however it is instituted, the people must cede to it some of their natural rights, in order to vest it with requisite powers.").

203. *See* Leegin Creative Leather Prods. v. PSKS, Inc., 551 U.S. ___, 127 S. Ct. 2705, 2728, 168 L. Ed. 2d 623, 651 (2007) (Breyer, J., dissenting) (noting new entry into a market may bring increased competition with the net effect benefiting consumers).

204. *See generally* HAL R. VARIAN, MICROECONOMIC ANALYSIS, 238 (W.W. Norton & Co. Ltd. 3d ed. 1992).

205. *See supra* notes 134-50 and accompanying text.

206. *See* discussion *supra* Part III.B.2.

contract to a third-party.[207] Case law clearly supports this practice,[208] so the real concern over life settlements seems to be elusive. According to Doug Head of the Life Insurance Settlement Association ("LISA"),[209] the life insurance companies fear change.

> There are some people who don't want to see the client as anything but a captive to the company. The assumption was that once a customer was captured, he is [the company's] forever, but now [life settlements give] consumers a way out. Now life insurance companies will have to compete more.[210]

If Mr. Head is correct, then permitting unrestricted life settlement transactions would be in the public's best interest, because it will diminish the monopsony power of the insurance companies.[211]

On the other hand, unrestricted salability of life insurance policies has the potential to negatively impact society as a whole. The prevalence of life settlements, and the potential for STOLI, has already caused some insurance companies to raise premium rates on the senior bracket.[212] With an increase in premium rates, individuals who would otherwise procure insurance for legitimate purposes may be dissuaded from doing so. If policy principles are to encourage individuals to have insurance, then maybe restricting life settlement transactions could be justified on the ground that life settlements are creating a barrier for individuals to acquire life insurance. Another possible "side-effect" of an increase in life settlements is an unduly tempting offer to sell a policy, leaving families without the security that life insurance affords.

The fact remains that life insurance provides many positive benefits.[213] Selling off the right to those benefits could be short-sighted

207. *Id*.

208. *See, e.g.*, *Grigsby*, 222 U.S. at 157.

209. "The mission of the Life Insurance Settlement Association is to promote the development, integrity and reputation of the life settlement industry and to promote a competitive market for the people it serves." LISAAssociation.org, Welcome to the Life Insurance Settlement Association, http://www.lisassociation.org/ (last visited Jan. 29, 2008).

210. Head Interview, *supra* note 118.

211. *See* Ron Panko, *A Matter of Trust; Financial Planning; Insurance Market*, A.M. BESTWIRE, Dec. 1, 2002, at 22 ("Until recent years, life insurance policies were bound by a monopsony, in which there was only one buyer for the instrument. If a consumer wished to sell a life insurance policy, the only buyer was the company that originally sold it.").

212. *See* Goldstein, *supra* note 118 (noting AIG, the world's largest insurer, has "hiked" premiums for customers over seventy, in effort to reduce the likelihood a policy will be STOLI).

213. Telephone Interview with Stephan R. Leimberg, Esq., CEO, Leimberg Information Services Inc., President, Leimberg Associates, Inc., in Havertown, Pa., and

on the part of the insured. More importantly, once an insured sells his policy, he may be precluded from obtaining another one.[214] For many, a life settlement makes no financial sense, but it should not be the government's role to prevent individuals from making bad investment decisions.

c. *Caveat Emptor*; A Life Settlement is Lawful, but Should Be Entered Into with Extreme Caution

A life settlement transaction is a valid exercise of an individual's property rights,[215] and the transaction should be allowed; however, a life settlement may not be a prudent financial decision for everyone. Perhaps only a very narrow slice of the potential market for life settlements would truly benefit from this sort of transaction. For the government to restrict alienation of a policy in order to "protect" individuals from making a bad investment choice, however, would be to over-step the bounds of the free market.[216] In the opinion of the author, the owner, and not the government, is in the better position to calculate investment risk.

Perhaps the better solution, then, is consumer education. An individual should not only understand that he is selling an interest in life, but also that a life settlement may have an unfavorable financial impact. Presently, life settlement companies require consent of the insured to sell the interest in the policy.[217] Although this requirement is a start, more is needed. When life settlement pools are securitized, the process is essentially unregulated because the Securities Exchange Commission ("SEC"), whose authority over securitized life settlement pools is uncertain, currently has no regulatory oversight of the life settlement-backed security issuance.[218] Until the states and courts decide what to do

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author of numerous books and articles on life insurance, life settlements, and insurable interest (Oct. 6, 2007).

> If life insurance is such a good deal for investors, why not buy it and keep it for your family? At the least, policy owners should insist on a "hold" (keep) or "fold" (sell) analysis that ascertains if there *is* a need, the *extent* of that need, and alternative means of financing needed insurance—before selling an existing policy on your life to strangers.

Id.

214. *See* sources cited *supra* note 160.

215. *See* discussion *supra* Part III.B.2.c.

216. *See, e.g.*, *Global Economics: Hearing of the H. Comm. of Banking and Financial Services*, 105th Cong. (1998) (statement of Rep. Ron Paul, Member, House Comm. of Financial Serv.) ("[W]e have a great deal of faith and confidence in freedom, free choices and capitalism.").

217. *See* VIATICAL SETTLEMENTS MODEL REGULATION § 9(A)(5) (Nat'l Ass'n of Ins. Comm'rs 2006).

218. *See* SEC v. Life Partners, 102 F.3d 587, 588 (D.C. Cir. 1996) (holding that a life settlement fails prong three of the *Howey* test for an investment contract, which requires

with this issue, an individual interested in life settlements ought to proceed with extraordinary caution.

C. Considerations Before Selling a Life Insurance Policy

1. Understanding the Tax Consequences for Life Settlements; Life Settlements are Distinct from Viaticals Under the Code

An individual contemplating a life settlement must understand the potential tax consequences[219] of such a transaction.[220] Neither the IRC nor policy rationale supports exclusion of the proceeds from a life settlement transaction from federal income taxation.[221] The amount realized from the sale should be treated as a disposition of property with all of the applicable tax consequences.[222]

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profits of a security to be dependent upon the efforts of others; noting that the profits are dependent upon the mortality of the insured and not an on-going common enterprise). *But see* SEC v. Mut. Benefits Corp., 323 F. Supp. 2d 1337, 1343-44 (11th Cir. 2004) (declining to follow the court's "bright-line rule" in *Life Partners*, and instead holding viatical settlements are investment contracts under the *Howey* test), *aff'd*, 408 F.3d 737 (11th Cir. 2005), *cert. denied*, 128 S. Ct. 17, 168 L. Ed. 2d 793 (2007).

219. According to Diana Helfgott and Anna Petinova of the IRS, life settlement taxation is just now coming under review. Because the auditing process takes several years, the Service is just now getting into the years where life settlement transactions are in the tax returns. *Life Insurance Securitizations Will Become Subject to Closer Study, IRS Officials Said*, [Jan.-June] Fed. Tax & Accounting Rep. (BNA) No. 198, at G-5 (Oct. 15, 2007).

220. The author neither endorses nor discourages a life settlement transaction. A life settlement should be approached with caution and counsel; whether it is the best decision for an individual is dependent upon the particular facts and circumstances.

221. I.R.C. § 101(a)(1) (2008) ("[G]ross income does not include amounts received (whether in single sum or otherwise) under a life insurance contract, *if such amounts are paid by reason of the death of the insured*.") (emphasis added).

222. There is uneasiness in the insurance industry that because life settlements inherently change the character of insurance, an increase in the participation of these transactions will spoil the preferred tax treatment of I.R.C. § 101(a)(1) for all those insured. Though it is possible that Congress would step in and *over*-regulate the industry by removing the preferred tax treatment of insurance because of the abuse that is possible through a life settlement, it would make no sense. The abuse possible in the life settlement industry is no different than other forms of fraud possible in the insurance industry. By punishing all insured individuals for potential abuse by a small sub-set of the insured population, Congress would effectually provide a disincentive to procure insurance, and this is simply not in accord with public policy. The better solution is two-fold: First, find ways to motivate insurers to be more effective discerners of fraud at the front-end of the transaction or, in other words, when the policy is created. Second, treat insurance policies that have become *solely* investment vehicles (as evidenced by a life settlement transaction) as a disposition of property, taxable as income under the provisions of I.R.C. § 1001 (2008).

Public policy promotes life insurance because it provides security in the event of death.[223] For this reason, the Code affords special tax treatment to the death benefits of life insurance.[224] A life settlement, however, changes the character of the income derived from the life insurance policy.[225] Income received from a life settlement transaction is not received on account of the death of the insured.[226]

One could argue that because the proceeds from a viatical settlement are not paid by reason of the death of the insured, life settlement transactions should also enjoy the same tax-treatment by analogy. Presumably, the disparate tax treatment is because the IRS does not believe an individual is willing to die in order to take advantage of a tax shelter. In the case of a viatical settlement, under which the insured has been declared terminal,[227] the terminal status of the insured allows the income from the viatical settlement to be excluded from gross income as an amount paid by reason of the death of the insured.[228] This Code provision creates a legal fiction, but the fiction is necessary to promote a public purpose, that of getting cash into the hands of an individual who may have great need of it.[229] Like a viatical settlement, a life settlement is a devise of the security afforded by the policy in exchange for a present cash benefit.[230] Unlike a viatical settlement, however, the policy owner in a life settlement transaction is not terminally ill, thus explaining the unequal tax treatment.[231]

223. The Supreme Court underscored the policy behind the preferred tax treatment of life insurance in Helvering v. Le Gierse, 312 U.S. 531, 539 (1941) ("That life insurance is desirable from an economic and social standpoint as a device to shift and distribute risk of loss from premature death, is unquestionable.").

224. This differs from other types of insurance, for instance, property/casualty insurance. To the extent that an individual's personal casualty gain exceeds his adjusted basis in the lost property, he will pay capital gains tax. I.R.C. § 165(h)(2)(B) (2008).

225. Even if it could be argued that life settlement proceeds should theoretically be treated as a death benefit, case law is filled with courts' willingness to look past form to substance. *See, e.g.*, *Helvering*, 312 U.S. at 540-42 (determining that death benefit was not excludable from gross income, because insurance policy was entered into solely for the purpose of avoiding estate taxation).

226. I.R.C. § 101(a)(1) (2008) excludes from gross income "amounts received (whether in single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured." I.R.C. § 101(g) (2008) treats the amount received on account of a viatical settlement as an amount received by reason of the death of the insured.

227. I.R.C. § 101(g)(2)(A) (2008).

228. *Id*.

229. *See* discussion *supra* Part II.A.1.

230. *See* discussion *supra* Part II.A.3.

231. "[A terminally ill patient is one] who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification." I.R.C. § 101(g)(4)(A) (2008)

2. When Seeking Liquidity, Policy Owners are Not Captive to Life Settlements—Some Alternatives

A policy owner seeking an immediate benefit from his life insurance policy is not captive to the life settlement market. An insured should always consult with his financial advisor for a full appraisal of his options. Generally, an individual contemplating the sale of a life insurance policy should take into account the reason that he is interested in selling. Is the policy owner unable to make the policy payments, and thus seeks to be relieved of the obligation of premium payments? Or is he interested in gaining immediate liquidity? Based on the position of the policy owner, most all life insurance companies have tailored alternatives to meet the policy holder's needs. While the options available to a policy owner will vary by the terms of the policy itself, this section outlines a few of the common alternatives.[232]

a. Options if Policy Owner is Having Trouble with Payments

If a policy owner is having trouble making the policy payments, then there are several options. First, the insured can elect to reduce the policy's death benefit, which reduces the annual premium payment.[233] Second, an insured may elect an option known as a "reduced paid up" policy, in which the insurance company takes the amount of cash value accrued in the policy and buys a new policy on a single-premium basis.[234] The new policy's face value will be reduced from the old policy, but the insured will have no future premium obligations and the policy will last for life.[235] A third option is to convert a permanent policy into a term policy.[236] This option allows the owner to stop paying premiums and begin using the policy's cash accumulation value[237] to fund future premiums.[238] In this scenario, the policy owner would

232. Each of the options discussed in this subsection were advanced by Robert S. Gascon, CLU, ChFC, Regional Director of The Penn Mutual Life Insurance Company, in a Telephone interview in Irvine, Cal. (Jan. 19, 2008) [hereinafter Gascon Interview II]. They are meant to be illustrative only of options which are presently offered by one insurance company, The Penn Mutual Life Insurance Company, and should not be construed to be either an exhaustive list or a recommendation; depending on the terms of the policy held, some options may not be available. The options highlighted in this section are applicable to Whole-Life policies only. Other forms of permanent (cash-value) policies may have analogous options, not mentioned herein.

233. Gascon Interview II, *supra* note 232.

234. *See id*.

235. *See id*.

236. *See id*.

237. *See* sources cited *supra* note 33.

238. Gascon Interview II, *supra* note 232.

maintain the same death benefit, but only for a period of time.[239] The policy would eventually lapse due to the lack of premiums and cash values to sustain it.[240]

Another, perhaps more creative, option is to take out a personal loan or even re-finance a home, if possible, to pay premiums.[241] This option may serve as a great way to release equity that is gaining virtually zero interest in favor of a potential death benefit that will be excluded from gross income[242] and more than return the interest payments paid. Similarly, a policy owner could choose to make a gift of the policy to a family member who can afford to pay the premiums of the contract.[243] From a family-financial-health perspective, life insurance is a valuable asset to maintain. Any option that would afford the policy holder the ability to keep the policy in force should be given serious thought.

b. Options if the Policy Holder is in Need of Liquidity

In addition to the above options, several other alternatives may permit a policy owner to extract a current cash benefit from the policy without selling his interest. First, if the insured is classified as "terminal,"[244] an insured may acquire an accelerated death benefit.[245] Accelerated death benefits work differently from company to company, but generally they allow the policy owner to receive a significant portion of the death benefit (sometimes as high as eighty percent) that would otherwise be paid to the beneficiaries upon the death of the insured.[246] Accelerated death benefits are excluded from gross income tax under IRC § 101(g)(1).[247] Typically, the balance of the face amount will be paid to the beneficiaries, less interest, upon the insured's death.[248]

Two additional options are a policy-loan and partial-cash surrender. A policy-loan allows a policy owner to borrow against the contract,

239. *See id.*
240. Once a whole life policy has been so converted, the conversion is irrevocable. Gascon Interview II, *supra* note 232.
241. *Id*.
242. I.R.C. § 101(a) (2008).
243. Gascon Interview II, *supra* note 232.
244. *See* I.R.C. § 101(g)(2)(B)(ii) (2008) (providing definition of "terminally ill insureds").
245. Gascon Interview II, *supra* note 232.
246. *See id*.
247. I.R.C. § 101(g)(1) (2008) (treating amounts received under a life insurance contract on the life of a terminally or chronically ill individual as paid by reason of the death of the insured); I.R.C. § 101(a)(1) (2008) (excluding amounts received under a life insurance contract from gross income if such amounts are paid by reason of the death of the insured).
248. Gascon Interview II, *supra* note 232.

which works similarly to borrowing against equity in a home.[249] The loan is excluded from gross income when received,[250] but must be paid back before the insured dies or the outstanding amount of the loan will reduce the death benefit.[251] A partial-cash surrender allows a policy owner to withdraw some of the funds that have accumulated in the investment (cash) portion of the policy.[252] The difference between a loan against the policy and a partial-surrender is that there is no interest accrued in a partial surrender,[253] but a partially-surrendered policy runs the risk of lapsing due to insufficient cash reserves remaining in the policy to sustain it.[254]

Far from being formulaic, the alternatives to life settlements must be carefully considered with a trusted financial advisor. Each individual's financial picture is unique and a variety of factors will need to be considered. The original purpose of the life insurance policy, the current needs and financial state of the policy owner, are just a few of these factors. In general, the determination will be a two-step analysis. First, a policy owner will need to determine what his current needs are, and this must be considered in light of his overall estate plan. Second, a policy owner must consider the economic consequences both to himself presently and to his estate, for any change in his insurance coverage. These same considerations may also be applied to the decision to transact a life settlement.[255] For example, it may be the case that an insurance policy is no longer needed, but a life settlement would have tax consequences and transaction fees which make the settlement too costly to execute. Only with a full understanding can an individual make wise financial decisions.

IV. CONCLUSION

The life settlement industry is a testament to the power of the free market.[256] From life insurance providing a family with security, to securities which derive their value from mortality, the life settlement industry is evidence of the spirit of capitalism alive in the American economy.[257] An individual's need for insurance may change, and the value of a life insurance policy to an individual may diminish over time.

249. *See id*.
250. I.R.C. § 72(e)(4)(A) (2008).
251. Gascon Interview II, *supra* note 232.
252. *See id*.
253. *See id*.
254. *See id*.
255. *See* Stephan R. Leimberg et al., *Life Settlements: How to Know When to Hold and When to Fold*, EST. PLAN. (forthcoming Aug. 2008).
256. *See* discussion *supra* Parts II.A, III.B.2.
257. *See* discussion *supra* Part II.A.

By enabling life settlement transactions, the freedom inherent in the American economy is affirmed: the right of free alienation of property.[258] The life settlement industry is in accord with case precedent and common law property rights,[259] and while it may not be a good decision for many, the right to make a poor or risky investment choice is the prerogative of the individual, not the government.[260]

As with many markets, the pitfalls of abuse and fraud will plague the industry, but proper regulation may ameliorate the pervasiveness of these problems.[261] Finding ways to encourage the full use and application of the insurable interest laws in discovering STOLI at policy application is of paramount importance.[262] Imposing strict criminal sanctions on those who willingly engage in insurance fraud, in any form, is essential to stabilizing the industry.[263]

Sophisticated financial models for risk calculation, both of STOLI and mortality expectation, are necessary for the life settlement-backed security market to thrive.[264] Reliable models for risk calculation will enable credit-rating agencies to confidently grade the life settlement-backed securities,[265] further enhancing consumer confidence in the investment.[266] With possible regulatory oversight of the SEC, the market for these securities will be further protected.[267]

While a potentially lucrative option, a life settlement must be carefully evaluated by an individual policy owner.[268] A life settlement is the sale of a contract, the contract right to a death benefit,[269] which means the purchaser of a life insurance policy profits only when the insured dies.[270] This risk must be fully appreciated by the insured. The tax implications for a life settlement transaction are also unclear, though the proceeds from a life settlement are all but certainly included in gross income.[271] The maintenance of a life insurance policy for estate planning purposes or otherwise brings many benefits, and a policy owner ought to consider each option available under his policy before determining to sell

258. *See* discussion *supra* Part III.B.2.
259. *See supra* note 40 and accompanying text.
260. *See* discussion *supra* Part III.B.2.
261. *See* discussion *supra* Parts II.A.2, III.A.4.
262. *See supra* notes 116-33 and accompanying text.
263. *See supra* note 100 and accompanying text.
264. *See supra* text accompanying notes 105-15.
265. *Id*.
266. *Id*.
267. *See supra* notes 217-18 and accompanying text.
268. *See* discussion *supra* Parts III.B.2.c, III.C.
269. *See supra* note 81 and accompanying text.
270. *See supra* notes 51-54 and accompanying text.
271. *See* discussion *supra* Part III.C.1.

his interest.[272] Most importantly, the policy owner must realize that he is not captive to any market—insurance company or life settlement. An individual has the *freedom* to engage in the transaction that makes sense to him personally, and that is a benefit that, so far, there is no way to sell.

272. *See* discussion *supra* Part III.C.2; *see also supra* note 213 and accompanying text.