Chawla, Irrevocable Life Insurance Trusts, and the Insurable Interest Problem

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Introduction

Although it is a concept with solid policy underpinnings and a long pedigree, the notion of "insurable interest" has, until recently, been given little thought by the planning community. That changed dramatically with the ruling of the U.S. District Court for the Eastern District of Virginia in *Chawla v. Transamerica Occidental Life Insurance Company*.[1] In that case, the court, applying Maryland law, determined that a trust established by the decedent insured did not have an insurable interest in the decedent's life, and therefore the policy issued by the insurer (Transamerica) was void. Although this aspect of the court's ruling was overturned on appeal, the case nevertheless served to bring to light a problem lurking in the laws of many states: that a common planning device, namely the irrevocable life insurance trust, or ILIT, may lack an insurable interest in the life of its settlor, and therefore the policy issued to the trust may be void.

This article examines some of the implications for planners of the *Chawla* decision and the issues it raises, as well as some of the policy concerns supporting the insurable interest rule. After a brief discussion of the rule itself, the article examines the facts of the case, its implications for planners who establish ILITs, and the larger (and more contentious) issue of "stranger owned life insurance," or SOLI. The article concludes with a recommendation that states examine their insurable interest statutes, with an eye toward conforming them with modern practice, particularly regarding trust ownership of policies.

Insurable Interest: Background and Policy Considerations

"Insurable interest" is an ambiguous term that is often misunderstood by the public. It is important to the placement and ongoing validity of an insurance contract. The term has been often glossed over as an irrelevant formality, leading over time to inconsistencies among states' interpretations and invalid schemes that prey on its vulnerability. To understand insurable interest laws more fully, one must consider their origin.

In the early eighteenth century, life insurance planning resembled more a Vegas casino run by the Sopranos than the established and respected industry it is today. This was especially true in England. The purchase of life insurance was like roulette. The market was open, allowing anyone to buy insurance on the life of another in the form of a wager. One could purchase a policy on another’s life without the owner knowing the insured, or vice versa. If the insured happened to die within the time period prescribed in the policy, there would be a

[1] 2005 WL 405405 (E.D. Va. 2005) (hereinafter Chawla).

payoff. There was no requirement that the owner of the policy have any interest whatsoever in the life of the insured beyond the policy (which even today remains, in a sense, a bet that the insured will not live to his or her full life expectancy). This lack of structure caused devastation and corruption in the marketplace, which drove England to make changes. In 1774 it issued The Life Assurance Act. Section I of the 1774 Act provided:

> [N]o insurance shall be made by any person . . . on the life or lives of any person, or the person or persons for whose use, benefit, or an whose account such policy or policies shall be made, shall have no interest, or by way of gambling or wagering: and that every assurance be made contrary to the true intent and meaning hereof shall be null and void to all interests and purposes whatsoever.[2]

The 1774 Act sought to establish an insurable interest in the form of a potential pecuniary loss, stemming from a legal obligation, that is suffered on the death of the insured. Put another way, the applicant for a policy on the life of another had to have a monetary interest in the continued life of the person who was insured.[3] English law required, and permitted, only this pecuniary interest to establish an insurable interest. If there was no such interest, the policy was voidable—that is, the insurer was under no obligation to honor the contract and pay the death benefit.

Over time, most states in the U.S. have codified the insurable interest rules to include a broader set of standards than those set forth in the 1774 Act. In addition to the presence of a pecuniary interest, most contemporary insurable interest statutes provide that an insurable interest can also be established by people who are related by blood. As the Supreme Court stated in Warnock v. Davis,[4]

> It is not easy to define with precision what will in all cases constitute an insurable interest, so as to take the contract out of the class of wager policies. It may be stated generally, however, to be such an interest, arising from the relation of the party obtaining the insurance, either as creditor of or surety for the assured, or from ties of blood or marriage to him, as will justify a reasonable expectation of the advantage or benefit of the continuance of his life. It is not necessary that the expectation of the advantage of benefit always be capable of a pecuniary estimation.[5]

Although most states have codified the insurable interest rules, there remains a lack of uniformity in their interpretation and application. There are many cases in

[2] The 1774 Life Assurance Act.
[3] Halford vs. Kymer (1830) 10 B&C 724; Law vs. London Indisputable Life Policy Co (1855).
[4] 104 US 775 (1882).
[5] Id. at 779.

which identical, or nearly identical, statutes in different states have produced completely different results. For example, a court in one state may hold that a familial relationship alone is enough to support an insurable interest, while another state court may determine that there is not a strong enough pecuniary interest between parties to establish such an interest.

Another area in which states apply different interpretations of insurable interest has stemmed from cases where the insured's estate finds the beneficiary to have no insurable interest and therefore no claim to the proceeds.[6] Insurance companies have been sued in these cases on the basis that there was not an insurable interest upon application. Some states, for example North Dakota and Texas, support the notion that the consent of the insured upon application (or lack thereof) is an essential element in resolving subsequent claims of lack of insurable interest. North Dakota's insurable interest laws specifically state, "written consent of the insured individual is required if the personal insurance purchased names the corporation or the trustee of a trust as a beneficiary."[7]

An important point to discuss is the issue of policies that are assigned. An assignee does not necessarily have to have an insurable interest. Historically, assignments have been used to cover the debts and other obligations where a pecuniary interest exists. In recent years, there have been policies put in place with the pre-meditated plan of assigning and selling them to a third party in the settlement market. In the view of many, this practice has reintroduced an element of gambling, which runs counter to spirit of the insurable interest rule. However, case law supports the validity of assigning the policy or the death benefit after a policy has been issued. Both New York lower court cases, *Garrison v. Garrison*[8] and *Corder v. The Prudential Insurance Company*,[9] state that an insured who acquires a policy on his or her own life has an absolute right to assign it to whomever he or she wishes. These cases cite New York's own insurance law Sec. 3205(b)(1) in support of this conclusion.[10]

The *Chawla* Case

The *Chawla* case itself, apart from its unusual facts, is unremarkable. The plaintiff, Vera Chawla, applied to the defendant, Transamerica Occidental Life Insurance Company ("Transamerica"), for a $1,000,000 policy on the life of the decedent, Harald Geisinger.[11] Transamerica rejected the application on the grounds that Chawla did not have an insurable interest in Geisinger's life. The plaintiff reapplied for the same coverage, this time in her capacity as Co-Trustee

[6] "McKinney's N.Y. Insurance Law", 3205(b)(1) & (2)
[7] North Dakota – Insurable Interest Laws 26.1-29-09.1
[8] 151 N.Y.S.2d 341 (App. Div. 1956).
[9] 248 N.Y.S. 2d 265 (S. Ct. 1964).
[10] The CPA Journal, January 1992.
[11] The decedent's name is spelled "Giesinger" in the caption of the District Court's opinion and throughout the Court of Appeals's opinion.

(along with Geisinger) of a trust established by Geisinger. This time, the policy was issued. Coverage was subsequently increased to $2,450,000.

When Geisinger died, Transamerica rescinded the policy, denied the claim, and returned the premiums to the plaintiff, on the grounds that the decedent had not disclosed material medical information on the application. Plaintiff then sued Transamerica, which answered by asserting not only that material misrepresentations had been made on the application, but also that the plaintiff had no insurable interest in the life of the decedent. The opinion of the District Court was issued as a ruling on the parties' cross-motions for summary judgment. In finding for Transamerica, the court based its opinion primarily on its finding that the decedent had made numerous material misrepresentations and omissions on the insurance application.[12] The court concluded on the evidence that, had the decedent disclosed these facts to Transamerica, the company would not have issued the policy, at least not on the same terms.

However, the court went further in its analysis. In addition to the material misrepresentation issue—which itself was enough to decide the case in Transamerica's favor—the court also ruled on the insurable interest question, again finding in favor of the defendant. The court concluded that the plaintiff's case failed as a matter of law because the trust did not have an insurable interest in the decedent's life, a necessary precursor for the issuance of a valid policy. In reaching this conclusion, the court applied the Maryland insurable interest statute, which provided in part that no person could purchase an insurance contract on the life of another unless the benefits were payable to (1) the insured; (2) the insured's personal representative; or (3) a person with an insurable interest in the individual insured at the time the insurance contract was made.[13] For anyone other than a close legal or blood relative, the statute provided that an insurable interest consisted of "a lawful and substantial economic interest in the continuation of the life, health, or bodily safety" of the insured.[14] However, "an interest that arises only by, or would be enhanced in value by, the death . . . of the individual" was not an insurable interest.[15] The court concluded:

> [T]he Trust had title to the decedent's residence. During his lifetime, the decedent possessed the right to receive all income from the Trust and the right to occupy the residence. However, upon the death of the decedent, the Trust assets were distributed to Plaintiff who sold them for an amount in excess of the mortgage. Consequently, the Trust promised to gain more assets upon the decedent's death, i.e., death benefits under the policy, than it would have in the event the decedent lived. Further, the Trust suffered no

[12] The decedent failed to disclose, among other things, that he had undergone surgery for a brain tumor; that a shunt had been inserted after that surgery to relieve an accumulation of fluid; and that he had a history of alcohol abuse. Chawla, at *9-10.
[13] Md. Code Ann., Ins. § 12-201.
[14] Id. § 12-201(b)(3).
[15] Id.

> detriment, pecuniary or otherwise, upon the death of the decedent.[16]

Therefore, the trust had no insurable interest in Geisinger's life.

This reasoning raised more than a few eyebrows in the planning community.[17] Admittedly, the *Chawla* case itself involved relatively unusual (and, in the sense of the legal aphorism, "bad") facts. However, the case called into question whether the insurable interest rule (whether in statutory or common-law form) might be applied more broadly, and particularly to one of the most common planning devices: the irrevocable life insurance trust.

On appeal, the Fourth Circuit affirmed the lower court's granting of summary judgment to Transamerica. However, the court noted that the misrepresentation issue alone was sufficient to decide the case in the insurer's favor. The court concluded that "[the district court's] alternative ruling appears to have unnecessarily addressed an important and novel question of Maryland law. And, as a general proposition, courts should avoid deciding more than is necessary to resolve a specific case."[18] Therefore, the Appeals Court vacated this part of the lower court's decision.

For the moment, then, the issue has been put to rest. However, the bell cannot be unrung. As one noted practitioner pointed out, the District Court's opinion in *Chawla* did not introduce a new concern into this area of the law; rather, it served to bring a long-held, if largely unspoken, concern of many practitioners to light.[19] Prior to examining this concern in some detail, this article will briefly review the concept of the irrevocable life insurance trust.

The Irrevocable Life Insurance Trust

The irrevocable life insurance trust ("ILIT") has long been a staple of effective wealth transfer tax planning, and its basic concepts are well-known and widely accepted. Under Section 2042 of the Internal Revenue Code, a decedent's estate includes the value of the proceeds of any policy of insurance on the decedent's life payable to the decedent's estate, or with regard to which the decedent at the time of his or her death possessed any "incidents of ownership."[20] While an insured can divest him- or herself of the "incidents of ownership" over a policy by transferring it to another, such a transfer is subject to the "three-year rule" of Code Section 2035. In other words, if an insured

[16] Chawla, at *15.
[17] See, e.g., Crenshaw, "A Matter of Trusts," Wash. Post (Feb. 20, 2005); see also Christerson, "Trust doesn't have 'insurable interest'," Tax Topics (Mar. 28, 2005); Mancini, "The Chawla Case, Insurance Trusts and the Insurable Interest Rule: 'Houston, We Have a Problem'," 31 ACTEC J. 125 (2005) (hereinafter Mancini).
[18] Chawla v. Transamerica Occidental Life Ins. Co., 440 F.3d 639 (4th Cir. 2006), at 648.
[19] See Mancini, supra, at 125, 137.
[20] I.R.C. § 2040(2).

transfers a policy and dies within three years of the transfer, the proceeds are "brought back" into his or her estate and taxed at their full value.

In response to these difficulties, practitioners developed the irrevocable life insurance trust. In brief, the ILIT is a trust that is designed to purchase and hold a policy of insurance on the life of an insured grantor. At the insured's death, the proceeds of the policy are receivable by the Trustee, who holds them for the benefit of the beneficiaries under the terms of the trust agreement. At no time does the insured possess or exercise any ownership over the policy.[21] Likewise, the trust may purchase insurance on the life of the grantor and pay premiums thereon, but it is not required to do so.[22] The trust typically is unfunded or only minimally funded, with the grantor making periodic gifts to the trust that the trustee uses to pay insurance premiums (again, at the trustee's discretion). Assuming that the trust is properly structured and administered, the insurance proceeds are not included in the decedent's estate.

Although it is primarily a transfer tax strategy, the ILIT offers additional advantages over outright ownership by the beneficiaries--for example, the insured's children. The trust can provide a source of liquidity for an otherwise illiquid estate if the trustee is authorized to make loans to the estate or to purchase estate assets. It can provide management and protection for beneficiaries who are minors or otherwise incapable of managing substantial sums on their own. Perhaps most importantly, it affords flexibility. The interests of multiple beneficiaries can be structured to suit the circumstances. Thus, to take perhaps the simplest example, the proceeds can be held in trust for the insured's spouse for life, with the remainder to be divided among the insured's children, whether outright or in further trust. This is particularly appealing (and common) in the case of a second marriage.

In the context of the insurable interest rule, all of the advantages of the ILIT may in fact turn out to be problems. It is the trust's very "separation" from the insured grantor that calls into question whether, under statutes like Maryland's, the trust does indeed have an insurable interest in the life of its grantor. It is to these questions that the analysis now turns.

The ILIT and Insurable Interest

As an initial matter, the Maryland statute contains language that, if applied broadly, likely would invalidate most insurance contracts other than those specifically addressed by other parts of the statute (i.e., the individual insured and his or her personal representative, close family members, certain business associates, charities in specified circumstances). Recall that, for these "third

[21] To that end, it is imperative that someone other than the insured serve as Trustee.

[22] This is done to avoid the argument that the decedent exercised such control over the trust as to render the Trustee his or her agent. In this regard, see Estate of Headrick v. Commissioner, 93 T.C. 171 (1989), aff'd, 918 F.2d 1263 (1990), acq. This opinion, which was reviewed by the entire Tax Court, is regarded as a "road map" to drafting and administering a successful ILIT.

party" policies, the Maryland statute specifically disqualifies as an insurable interest a monetary interest in the life of the insured that "arises only by, *or would be enhanced in value by*, the death . . . of the individual."[23] It is difficult, if not impossible, to imagine an ILIT that does not meet this description. During the life of the insured, the typical insurance trust does not hold more than the policy and serves as a "conduit" for premium payments. In such circumstances, the trust *qua* trust cannot help but have a monetary interest in the life of the insured that is "enhanced in value" by the death of the insured. Indeed, the whole purpose of the arrangement is to capture the value that arises under the insurance contract by reason of the death of the insured.

Part of the conceptual difficulty in applying this analysis to an ILIT as the *Chawla* court did is that a trust is not an "entity" with a separate legal existence. Perhaps it might be more accurate to say that it is not *just* an entity; it also is a form of split ownership wherein the legal and equitable interests in the trust property are divided between the trustee and the beneficiaries, respectively. Therefore, to regard the trust as only an entity is insufficient to determine its true nature. A sensible approach to applying the insurable interest rules to trusts, and one taken by several states,[24] is to "look through" a trust to the underlying interests, and to provide both that the Trustee has an insurable interest in the life of the individual settlor of the trust, and that the trust has an insurable interest in the life of any other person in the same proportion as the beneficiaries of the trust. In other words, if all of the beneficiaries (for example, the insured's spouse and descendants) have an insurable interest in the life of the insured, the trust has the same insurable interest.

In those states that take this approach, the insurable interest problem for most ILITs simply disappears. If the individual insured (or insureds)[25] are the settlors of the trust, the trustee by statute has an insurable interest in their lives, and no further difficulty exists. In those rare cases in which a trust owns a policy on the life of someone other than the settlor of the trust, as long as the beneficiaries have an insurable interest in the life of that insured, again there is no difficulty with the trust's procurement of the policy—which also seems a sensible approach from a policy perspective.

However, as should be clear, not all states take this approach—indeed, Georgia for one amended its statute only this year, specifically in response to the issues raised by *Chawla.*[26] Unless and until some measure of uniformity is attained, practitioners should be cognizant of the law likely to apply to the trusts they set up, and the potential pitfalls if the trust lacks and insurable interest in the life of the client. Before suggesting an approach to address this issue, we will address a countervailing phenomenon that, while relatively recent, also harkens

[23] Md. Code Ann., Ins. § 12-201(b)(3) (emphasis added).
[24] See, e.g., Del. Code Ann. Tit. 18, § 2704(c)(5); Ga. Code Ann. §33-24-3(c).
[25] Many ILITs are set up to hold second-to-die policies insuring the joint lives of a married couple.
[26] Author James R. Robinson is a member of the Legislative Committee of the Fiduciary Section of the State Bar of Georgia, which was instrumental in drafting the amendments to Georgia's insurable interest statute.

back to the concerns giving rise to the original 1774 Act: the phenomenon of stranger-owned life insurance.

Insurable Interest and "Stranger Owned Life Insurance"

There is a strategy being aggressively pitched by promoters known as Stranger Owned Life Insurance (SOLI). The idea combines a pool of private investors, life insurance, annuities and, oftentimes, a charity and its donors forming a strategy for the ostensible benefit of all parties involved. Here is the framework of how it is typically pitched when a charity is involved:

- A number of investors form a fund that is typically leveraged with debt.
- The investors find a charity willing to ask its largest and typically older donors to be insured. The “benefit” to the charity is that it will receive a portion of the death benefit when the donor dies. A sweetener is often added up front in the form of a payment of some amount to the charity.
- The donor(s) are insured typically with a large life insurance contract. Oftentimes, a “life only” annuity is also purchased as a way to pay the premiums and service any debt the investors have taken on. The goal for the investors is to negotiate the most favorable risk class with the lowest premiums for the life insurance, while placing an annuity with the least favorable underwriting, resulting in an actuarial shorter life expectancy and higher annuity payout.
- Upon the death of the donor, the investors recoup their investment via the death benefit, while the charity might receive approximately 5% of the proceeds.

The majority of the advantages of the scheme are with the investors and promoters. The investors’ aim is to create a profitable pool of insureds, while the promoters make substantial fees and commissions up front. The promoters sell the concept to charities as being beneficial for them and the donors. Nothing could be further from the truth. The bottom line is that the charities’ involvement represents a way for the investors to legitimize the process in the eyes of regulators and to establish an insurable interest where there otherwise would be none.[27] Additionally, it provides a ready made pool of people to insure rather than having to do “one off” transactions one person at a time. Charities are also willing to listen and cooperate in the face of a difficult fund raising climate.

The unfortunate part of this concept is that all the downside falls to the charity and the insured, not to mention the collateral damage that could affect the insurance industry. The charity risks losing its tax-exempt status as a charity under Code Section 501(c)(3) by accepting an inducement. Additionally, the paltry amount of death benefit received by the charity could be deemed unrelated

[27] A charity typically has an insurable interest in the life of a donor. See, e.g., Ga. Code Ann. § 33-24-3(j).

business taxable income (UBTI) if it is viewed as debt financed income.[28] Finally, a donor who is willing to be insured to "help the charity" that later finds out that his or her insurability was used to put money in the investors' pockets. It doesn't seem sensible for a charity to risk losing its exempt status, create UBTI and drive major donors away for a possible 5% of a death benefit that may or may not be paid.

The SOLI scheme underscores the policy justifications behind the insurable interest rule. One of the most important principles of insurable interest that is generally accepted, despite the lack of uniformity among the states, is that the purchaser must have a reasonable expectation to benefit from the continued life of the insured. As it relates to SOLI, the investors have no interest in the continued life of the donors being insured. It recalls the days of buying insurance as merely a form of wagering, the very practice that the original 1774 Act sought to curtail.

Many states continue to be lobbied by promoters attempting to soften the insurable interest laws to allow SOLI transactions. This is causing the insurance authorities in some states more closely to scrutinize transactions involving insurance trusts.[29] This could potentially disallow legitimate transactions in the future. Another damaging side effect is the negative spotlight cast on the insurance industry as a whole. It would be very unfortunate to lose the tax-favored benefit of life insurance due to the mass commoditization of unsavory schemes in the marketplace.

A Legislative Proposal

The foregoing discussion of stranger-owned life insurance emphasizes the continuing, legitimate policy concerns underpinning the insurable interest rule. However, as the *Chawla* case demonstrates, many insurable interest statutes may reach legitimate transactions, as well as questionable ones. In the wake of *Chawla,* several states have recognized this problem and have taken corrective action. For example, the Georgia Legislature enacted this year a set of amendments to its insurable interest statute that quite adequately address the *Chawla* problem while not opening the gates to abusive transactions such as many SOLI schemes. In brief, the amended Georgia statute provides the following:

- The trustee of a trust established by an individual settlor has an insurable interest in the life of the settlor, and the same insurable interest in the life of any other individual as does the settlor.

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[28] See I.R.C. §§ 512(b)(4), 514(a).
[29] See, e.g., New York State Ins. Dep't, General Counsel Op. 05-12-15 (Dec. 19, 2005) < http://www.ins.state.ny.us/ogco2005/rg051215.htm>; Opinion of Utah Ins. Comm'r Bulletin 2006-3 (July 10, 2006) < http://www.insurance.utah.gov/bulletin/2006-3.htm>.

- The trustee of a trust has the same insurable interest in the life of any other individual as does any beneficiary of the trust with respect to proceeds of insurance on the life of such individual or any portion of such proceeds that are allocable to such beneficiary's interest in such trust.

- If multiple beneficiaries of a trust have an insurable interest in the life of the same individual, the trustee of such trust has the same aggregate insurable interest in such individual's life as such beneficiaries with respect to proceeds of insurance on the life of such individual or any portion of such proceeds that is allocable in the aggregate to such beneficiaries' interest in the trust.[30]

In other words, the Georgia statute now recognizes the peculiar nature of a trust as a collection or bifurcation of ownership interests and "looks through" the trust-as-entity to the nature of those interests.

It might be argued that expanding the insurable interest statute to trusts in this way introduces the possibility of further abuse. A trust might be used as a "front" to purchase an enforceable policy in much the same way as a charity, as discussed in the previous section. However, the statute can—and should—limit such abusive situations by restricting the universe of insureds in which the trust as owner of the policy may have an insurable interest. Unlike the broad allowance for charities, the "trust exception" in a statute like Georgia's requires that the entity's constituents have an insurable interest in the life of the insured. The trust cannot be a "stranger" to the insured. While one may perhaps envision a scheme in which a trust named beneficiaries for the sole purpose of generating an insurable interest where there otherwise would be none, the statute addresses this by limiting the trust's interest to the beneficiary's interest, at least where someone other than the settlor is the insured.[31]

Moreover, given the common, widespread, and legitimate use of ILITs, the potential problem illustrated by *Chawla* seems far more significant than the possibility that a creative (if unscrupulous) planner might develop a transaction that puts the statute to a use for which it was not intended. On balance, states with insurable interest statutes (like Maryland) that do not adequately address the question of trust ownership of life insurance would be well-advised to revisit their statutes with an eye toward conforming them to modern practice and practical use. Otherwise, more cases like *Chawla* might well loom on the horizon.

[30] Ga. Code Ann. § 33-24-3(c).
[31] One also might conceive of a scheme whereby a trust was a participant in a pre-arranged plan to bootstrap the trust's interest for the benefit of unrelated investors—i.e., a life settlement arrangement. While a discussion of the life settlement market is beyond the scope of this Article, it might be pointed out that one does not need a trust to accomplish this result, although in certain situations (e.g., minor beneficiaries) its use might be advantageous. One might also envision a trust created by an individual settlor for the benefit of investor "beneficiaries," but again, the same result might be accomplished without the use of a trust; indeed, a trust might be a hindrance in such circumstances.

Conclusion

While the *Chawla* case involved a set of unusual, if not bizarre, facts, the District Court's ruling served to expose a problem lurking in the insurable interest statutes of many states. The SOLI phenomenon underscores the continuing relevance of the insurable interest rule. However, as *Chawla* illustrates, many states' codifications of that rule fail to take into account the common and legitimate use of trusts in life insurance and estate planning. Until these states address this issue—and doing so seems, not only advisable, but imperative—planners setting up ILITs in those jurisdictions must be sensitive to the potential impact of the rule on the trusts they draft.