



## INSURANCE UPDATE

### Delaware Insurable Interest Law Developments

On September 20, 2011, the Delaware Supreme Court (the “DE Supreme Court”) issued an opinion interpreting several provisions of Delaware’s Insurance Code relating to life insurance policies.<sup>1</sup> The opinion has garnered considerable attention because of its focus upon the application of Delaware’s insurable interest laws in the context of “stranger originated life insurance.” Although the opinion is specific to Delaware law, it is nevertheless relevant to participants in the life settlement market as the DE Supreme Court’s analysis may provide persuasive reasoning to the courts of other states as they are presented with similar issues.

The DE Supreme Court’s opinion derives from two separate cases pending in the United States District Court for the District of Delaware (the “District Court”).<sup>2</sup> Each of these cases involves a life insurance company seeking a declaratory judgment that a life insurance policy issued by it is void *ab initio* on the basis of the policy having been procured by means of a so-called “stranger originated life insurance” or “STOLI” scheme in contravention of Delaware’s insurable interest requirements. Because principal aspects of both cases concern issues of first impression under Delaware law, the District Court certified three questions of Delaware law to the DE Supreme Court for resolution prior to continuing with the cases.

As discussed in more detail below, the DE Supreme Court held:

- An insurer may challenge a life insurance policy for lack of an insurable interest after the expiration of the policy’s two-year contestability period.
- An insured’s intent when a life insurance policy is issued to transfer the policy does not in and of itself negate insurable interest, provided that the insured actually procures the policy in substance without an arrangement to transfer it to a third party.
- A trustee of a Delaware trust has an insurable interest in the life of the individual who creates and initially funds the trust with more than nominal funding, regardless of the insured’s intent for the beneficial interest in the trust to be transferred following the issuance of a life insurance policy to the trust.

<sup>1</sup> See *PHL Variable Ins. Co. v. Price Dave 2006 Ins. Trust*, No. 174, 2011 (Del. Sept. 20, 2011).

<sup>2</sup> See *PHL Variable Ins. Co. v. Price Dave 2006 Ins. Trust*, C.A. No. 10-964-BMS (D. Del. Nov. 12, 2010); *Lincoln Nat’l Life Ins. Co. v. Joseph Schlanger 2006 Ins. Trust*, C.A. No. 09-506-GMS, 2010 WL 2898315 (D. Del. July 20, 2010).

## **An insurer may challenge the validity of a life insurance policy based on a lack of insurable interest after the expiration of the policy's two-year contestability period.**

Like most states, every life insurance policy issued in the State of Delaware must contain an incontestability provision, which generally precludes the issuing life insurance company from being able to contest the policy after it has been in force during the insured's lifetime for a period of two years.<sup>3</sup> The application of this requirement is at issue in the two cases, since neither life insurance company filed its complaint with the District Court within the applicable two-year contestability period. However, each of the carriers contended that the policy's incontestability provision is inapplicable to its challenge, because a failure of the policy to have been issued in accordance with Delaware's insurable interest requirements means the policy is void from the outset. The DE Supreme Court agreed.

The DE Supreme Court held that the expiration of a life insurance policy's incontestability provision does not preclude an insurer from challenging the validity of the policy for lack of insurable interest under Delaware law.<sup>4</sup> In its analysis, the DE Supreme Court first concluded that a "life insurance policy lacking an insurable interest [at its inception] is void [*ab initio*] as against public policy and thus never comes into force." The DE Supreme Court then reasoned that even though the inclusion of an incontestability provision in a life insurance policy is statutorily required, the provision itself, like every other term of the insurance contract, has no application if the policy never legally came into effect. Thus, an incontestability clause does not bar an insurance company from asserting a claim on the basis of a life insurance policy lacking insurable interest, because a successful claim would render the clause unenforceable as part of a voided contract. In support of this analysis, the DE Supreme Court noted that Section 2908 of Delaware's Insurance Code mandates the inclusion of a contractual incontestability clause rather than directly banning a life insurance carrier from contesting a policy after the expiration of its contestability period.

## **Delaware's insurable interest statute permits an insured to procure a life insurance policy and immediately transfer it to a person without an insurable interest, even if the insured never intended for the policy to provide insurance protection to a person having an insurable interest, so long as the insured did not procure the policy as a mere cover for a wager.<sup>5</sup>**

In both of the complaints filed with the District Court, the challenging insurance company contends that the life insurance policy at issue was purchased for the ultimate benefit of a third party investor as part of a STOLI scheme which did not comply with Delaware's insurable interest laws. In furtherance thereof, one of the complaints specifically alleges that within three months of the policy having been issued to a trust, the entire beneficial ownership of that trust was sold on behalf of the insured (which was the sole indirect beneficial owner of the trust) to a third party investor. In this context, the District Court requested guidance from the DE Supreme Court regarding whether a

<sup>3</sup> Section 2908 of Delaware's Insurance Code states that "[t]here shall be a provision that the [life insurance] policy shall be incontestable after it has been in force during the lifetime of the insured for a period of not more than 2 years after its date of issue, except for (1) nonpayment of premiums, and (2) at the insurer's option, provisions relating to benefits in the event of total and permanent disability and provisions granting additional benefits specifically against death by accident or accidental means."

<sup>4</sup> The DE Supreme Court noted that its holding is consistent with most other states which have addressed the issue. New York and Michigan represent two exceptions. See *New England Mut. Life Ins. Co. v. Caruso*, 535 N.E.2d 270 (N.Y. 1989) and *Bogacki v. Great-West Life Assurance Co.*, 234 N.W. 865 (Mich. 1931).

<sup>5</sup> Following is the text of the full question addressed by the DE Supreme Court: "Does 18 *Del. C.* § 2704(a) and (c)(5) prohibit an insured from procuring or effecting a policy on his or her own life and immediately transferring the policy, or a beneficial interest in a trust that owns and is the beneficiary of the policy, to a person without an insurable interest in the insured's life, if the insured did not ever intend to provide insurance protection for a person with an insurable interest in his or her life?" The DE Supreme Court answered the question in the negative, provided the insured procured or effected the policy and the policy is not a mere cover for a wager.

provision of Delaware's insurable interest statute would be satisfied even if an insured did not intend at the outset for a policy to provide insurance protection to a person having an insurable interest in the life of the insured.

Section 2704(a) of Delaware's Insurance Code establishes the primary insurable interest rule for life insurance policies issued in Delaware. The first clause of Section 2704(a) addresses policies taken out by or for the insured, by providing that an individual may "procure or effect [the procurement of] an insurance contract upon his/her own life or body for the benefit of any person" (emphasis added). The second clause of Section 2704(a) sets forth the corollary by prohibiting a person from procuring a life insurance policy on a third party unless the benefits of the policy are payable to a person which has an insurable interest in the life of the insured when the policy is issued. In seeking to harmonize these two clauses, as well as applicable aspects of Delaware's Constitution<sup>6</sup> and Delaware's other insurance laws, the DE Supreme Court held the following:

- If an insured truly procures or effects the procurement of a life insurance policy on his/her own behalf, then the requisite insurable interest tenets of Section 2704(a) will be satisfied. Moreover, insurable interest is relevant under Section 2704(a) only at the time of the policy's issuance, and not thereafter. Accordingly, an insured may procure a life insurance policy in good faith and immediately transfer the policy following its issuance to a third party without an insurable interest (or immediately transfer the beneficial interest of a trust which owns the policy to such a third party), even if the insured intended to do so when the policy was issued.
- However, procurement by an insured under Section 2704(a) requires "more than just technical compliance at the time of issuance."

If an insured has an arrangement in place at or prior to a policy's issuance to transfer the policy to a third party lacking an insurable interest, then the insured will be considered to have procured the policy as a "cover for a wagering contract" and not in good faith.<sup>7</sup>

The DE Supreme Court's opinion furthermore notes that "procuring or effecting' a policy has to be something more than simply applying for a policy or providing written consent to the policy's issuance." A third party which lacks an insurable interest in an insured cannot use the insured "as an instrumentality to procure the policy," because by doing so the third party is actually causing the policy to be procured in contravention of the second clause of Section 2704(a).

- Consistent with longstanding case law in Delaware, a principal aspect of determining whether an insured procures a life insurance policy is whether the insured pays the premiums on the policy without financial means provided to the insured by a third party.

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<sup>6</sup> Delaware's Constitution prohibits all forms of gambling that are not otherwise expressly enumerated. The DE Supreme Court observed that a life insurance policy procured or effected without the requisite insurable interest constitutes a wager on the life of the insured in violation of Delaware's Constitution.

<sup>7</sup> Although the DE Supreme Court references last year's decision of the New York Court of Appeals in *Kramer v. Phoenix Life Ins. Co.*, 15 N.Y.3d 539 (N.Y. 2010) (holding that New York's former insurance laws permitted an insured to obtain a life insurance policy with the intent to immediately transfer it to a person without an insurable interest even if there was an arrangement to do so when the policy was issued), the DE Supreme Court distinguishes the *Kramer* opinion as applying to a narrow set of issues that were unique to New York's insurance statutes. The DE Supreme Court also noted that *Kramer's* precedential value has been limited by amendments to the New York Insurance Law, which now expressly prohibits STOLI transactions.

**If an individual actually establishes a Delaware trust, then the trustee of the trust has an insurable interest in the life of the individual even if the individual intends, at the time of the application for a life insurance policy to be owned by the trust, that the beneficial interest in the trust would be transferred to a third party without an insurable interest following the policy's issuance.<sup>8</sup>**

At the time when the two subject policies were issued, Section 2704(c)(5) of Delaware's Insurance Code stated that "[t]he trustee of a trust established by an individual has an insurable interest in the life of that individual . . ." (emphasis added). Section 2704(c)(5) was since amended this past July, and now provides that:

"[t]he trustee of a trust created and initially funded by an individual has an insurable interest in the life of that individual . . . without regard to:

- a. The identity of the trust beneficiaries;
- b. Whether the identity of the trust beneficiaries changes from time to time; and
- c. The means by which any trust beneficiary acquires a beneficial interest in the trust" (emphasis added).

Relying upon legislative history stating that the July amendment was intended to clarify the provisions of the then-current law, the DE Supreme Court treated the post-amendment version of Section 2704(c)(5) as merely a more detailed version of the statute which did not alter its pre-amendment meaning. On this basis, the DE Supreme Court concluded that, under both versions of Section 2704(c)(5) of the Insurance Code, a trustee has an insurable interest in the life of the person who creates and initially funds a trust, "without regard to whether the beneficial interest in the trust is subsequently sold or transferred."

In order to harmonize Section 2704(c)(5) with the insurable interest requirements of Section 2704(a) of Delaware's Insurance Code and the Delaware Constitution's prohibition on wagering on the lives of insureds (discussed above), the DE Supreme Court also concluded that the provisions of Section 2704(c)(5) are "not satisfied if the trust is created through nominal funding as a mere formality [or i]f the funding is provided by a third party as part of a pre-negotiated agreement." The DE Supreme Court reasoned that Section 2704(c)(5) would otherwise permit a third party to procure a life insurance policy in a manner that is contrary to the insurable interest requirements of Section 2704(a) by means of an insured merely undertaking the basic formalities of forming a trust.

The DE Supreme Court summarized its analysis of this portion of the opinion by stating that "[w]here the individual insured creates a trust to hold a life insurance policy on his life and funds the trust with that policy or with money to pay its premiums then the trustee has the same insurable interest that the settlor has in his own life. . . . If the individual insured creates and initially funds the trust, then the trustee has an insurable interest without regard to how the trust beneficiaries obtained their interest." However, a policy "fails at its inception for lack of an insurable interest . . . [i]n cases where a third party either directly or indirectly funds the premium payments as part of a pre-negotiated arrangement with the insured to immediately transfer ownership."

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<sup>8</sup> Following is the text of the full question addressed by the DE Supreme Court: "Does 18 *Del. C.* § 2704(a) and (c)(5) confer upon the trustee of a Delaware trust established by an individual insured an insurable interest in the life of that individual when, at the time of the application for life insurance, the insured intends that the beneficial interest in the Delaware trust would be transferred to a third-party investor with no insurable interest in that individual's life following the issuance of the life insurance policy?" The DE Supreme Court answered the question in the affirmative, as long as the insured actually establishes the trust by creating and funding it sufficiently.

## Conclusion

The DE Supreme Court's opinion has received a fair amount of attention in the mainstream media, including having been the subject of articles in both *The New York Times* and *The Wall Street Journal*.<sup>9</sup> Although the decision has been characterized generally as a considerable victory for opponents of the life settlement industry, we believe the result is actually more nuanced.

- Although the DE Supreme Court's opinion permitting an issuing insurance carrier to challenge a life insurance policy for lack of insurable interest following the expiration of the policy's contestability period is seemingly a victory for carriers, such a decision should not have been a surprise to the life settlement market given its consistency with the laws of most other states which have addressed the issue. In fact, this historical recognition by market participants is reflected in the importance that life settlement investors already generally place upon reviewing the manner by which a policy was originated (including Delaware policies), where a significant aspect of the review is usually geared toward confirming whether a policy was issued in accordance with applicable insurable interest requirements (regardless of whether the policy's contestability period has expired).
- Similarly, even though the life settlement market views favorably the DE Supreme Court's conclusion regarding an insured's intent to transfer a policy to a third party as not in and of itself negating the existence of an insurable interest under Section 2704(a) of Delaware's Insurance Code, the opinion does not appear to be as far reaching in this respect as one might assume in mere reliance upon the DE Supreme Court's statement that "the insured's subjective intent for procuring a life insurance policy is not the relevant inquiry." For example, the DE Supreme Court specifically observes elsewhere that intent is relevant (concurring with one of the challenging insurers that "ignoring intent would result in an illogical triumph of form over substance that would completely undermine the policy goals behind the insurable interest requirement") and that an "insured's right to take out a policy with the intent to immediately transfer the policy is not unqualified." As a whole, however, the DE Supreme Court's analysis of Section 2704(a) appears to emphasize objective factors, in lieu of the insured's intent, such as whether there is a pre-negotiated arrangement by the insured to transfer the policy (which is relevant to the good faith element described in the opinion) and whether policy premiums are paid by the insured with its own funds (which is relevant to determining whether the insured procured or effected the policy within the meaning of Section 2704(a)).
- Life settlement market participants, as well as other courts, seeking to interpret or apply Delaware law will likely encounter continued uncertainty with respect to certain aspects of the DE Supreme Court's opinion. A notable example relates to the opinion's emphasis upon linking the determination of whether an insured "procures" a policy under Section 2704(a) of Delaware's Insurance Code to the insured's payment of premiums on the policy through the insured's own financial means. In light of the diverse nature of various premium finance and other structured transactions (ranging from so-called "carrier approved" full recourse loans to opaque non-recourse financing structures), we believe that until certain bright-lines are established through further judicial determinations, courts and market participants could be required to scrutinize the structure and terms of individual financing transactions to determine whether an insured procured a policy within the meaning of Section 2704(a), as well as whether such a transaction could be construed to constitute a pre-negotiated arrangement by the insured to transfer the policy within the meaning of the DE Supreme Court's opinion. Accordingly, application of the DE Supreme Court's opinion will continue to require participants in the life settlement market to apply a fact-sensitive approach to individual investment opportunities.

Even though the opinion is limited exclusively to Delaware law, the DE Supreme Court's reasoning and analysis likely has broader application to other states as well (albeit as persuasive, non-binding authority), because the issues underlying the opinion are not unique to Delaware and they remain unresolved in many states.

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.

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<sup>9</sup> See Agnes T. Crane *et al.*, *Playing with Death*, N.Y. TIMES, Sept. 27, 2011, at B2; Leslie Scism, *Ruling is a Defeat for Death-Bet Investors*, WALL ST. J., Sept. 26, 2011, at C1.

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