Insurable Interest after Price Dawe, Schlanger and Brasner

Introduction

Recent decisions from courts in Florida and Delaware have garnered significant attention and refocused the life settlement industry on the issue of insurable interest and policy origination practices. In September 2011, the Delaware Supreme Court issued decisions in two related cases, *PHL Variable Ins. Co. v. Price Dawe 2006 Ins. Trust* and *Lincoln Nat’l Life Ins. Co. v. Joseph Schlanger 2006 Ins. Trust*, addressing Delaware’s insurable interest statute. On November 14, 2011, the U.S. District Court for the Southern District of Florida opined on Florida’s insurable interest law in a case entitled *Pruco Life Insurance Company v. Steven M. Brasner et al.* While these decisions have generated much discussion, it is necessary to understand these decisions in context and properly analyze their true importance.

*Price Dawe and Schlanger*

One of the key questions addressed by the Delaware Supreme Court in the *Price Dawe* and *Schlanger* decisions is whether an insured may procure a policy on his own life and immediately transfer it to a third party who has no insurable interest in the insured’s life. This question arose in connection with the use of beneficial interest transfer programs. In a beneficial interest transfer program, an insured formed a trust, which applied for a policy insuring the life of the insured. Shortly after the policy was issued, the beneficial interests in the trust were sold to a third party who had no insurable interest in the life of the insured.

The Delaware Supreme Court affirmed that an insured may procure a life insurance policy and immediately transfer it to a third party, but if the insured takes out the policy as mere cover for a wagering contract, the insurable interest requirements are not met. The key question, according to the Delaware Supreme Court, is who, in fact, procured the policy. This, according to the Delaware Supreme Court, can be determined by looking at who paid the premiums.

In addressing a related question as to the insurable interest of trusts, here too the Delaware Supreme Court affirmed that a trustee of a trust formed by an insured has an insurable interest in the life of the insured, even if the insured intended that the beneficial interests in such trusts would be transferred to a third party. The insured, however, must have formed and funded the trust, and nominal funding would not be sufficient to meet the insurable interest test. The Delaware Supreme Court further explained that “if funding is provided by a third party as part of a pre-negotiated agreement – then the substantive requirements of [Delaware insurable interest law] are not met.”

Focusing on the issue of who procured the policy, the Delaware Supreme Court specifically noted that subjective intent is not the issue. While the Delaware Supreme Court noted that we must look to who pays the premiums, the Delaware
Supreme Court failed to indicate how much premium needs to be paid and for how long. In Price Dawe, it appears that the insured may have funded the initial premium as the beneficial interest in the trust was acquired two months after the policy was issued. Does this mean that, when the case is remanded to the District Court where it was originally filed, will the District Court find that the policy in question was issued to a party with the requisite insurable interest? Furthermore, it would appear difficult to discern whether a transaction was undertaken for a legitimate purpose and not as a cover for a wagering contract without making some attempt to divine the intent of the parties. The Delaware Supreme Court, in fact, highlights the need to understand intent when, in the conclusion of the Price Dawe opinion, the Court states, “In both scenarios, however, the individual insured or the trustee must intend to purchase the policy for lawful purposes, and not as a cover for a wagering contract.”

**Brasner**

The US District Court for the Southern District of Florida delivered an opinion in connection with an insurable interest challenge brought by Pruco Life Insurance Company (“Pruco”) in connection with a policy that it had issued several years prior to Arlene Berger with a death benefit of $10 million, with respect to which policy Steven Brasner was the insurance agent. In April 2010, authorities in Florida arrested Mr. Brasner on 22 counts of alleged grand theft, fraud and other offenses in connection with the sale of policies with an aggregate of $78 million in death benefits. Mr. Brasner allegedly misled the issuing insurance companies about the applicants’ financial status, in particular, their net worth, and their reasons for seeking insurance coverage.

The Berger policy appears to have been originated in a manner similar to the practices that led to Mr. Berger’s arrest. In particular, the Florida District Court noted that: at the time of issuance, the insured did not need or want any life insurance; her actual net worth was less than $1 million, far lower than the figures supplied to Pruco; the insured never paid any of the premiums, nor did she have the financial wherewithal to do so, and the premiums were financed utilizing a structure designed to hide that fact from the carrier; and the insured knowingly participated in a free insurance program with the intent that the policy would be transferred to a third party. Given these facts, the Florida District Court was asked to rule whether the Berger policy was void *ab initio* for lack of insurable interest.

The court held that a policy is void *ab initio* for lack of insurable interest if it is procured in bad faith – i.e., whether it was “procured with the intention that it will be assigned or transferred to a person or entity with no insurable interest in the life of the insured.” Evidence of such bad faith and an intent to transfer, includes: (1) a pre-existing agreement or understanding that the policy is to be assigned to a third party with no insurable interest, (2) “the payment of some or all of the premiums by someone other than the insured, and in particular, the assignee”, and (3) no risk of loss on the part of the insured.

The court also held that it is not necessary to identify the existence of a pre-existing agreement between an insured and a third party in order to hold that a policy was an illegal wagering contract. The court stated that, “the fact that there was a pre-existing understanding that the Berger policy would be assigned to someone with no insurable interest, regardless of whether Mrs. Berger or anyone else had selected the eventual third party purchaser, goes to show that there was an intent to assign or otherwise transfer the policy to a person or entity with no insurable interest in the life of the insured, and that the policy was therefore procured in bad faith.”
The Florida District Court also held that if a policy is void ab initio, a court will leave the parties as the court found them. Meaning, the insurer is not required to refund any premiums paid in respect of the policy. The Florida District Court further noted that the fact that the current owner of the policy did not participate in the fraudulent issuance does not change the fact that premiums need not be returned. Citing another Florida decision, the court distinguished policies that are void ab initio form policies that are voidable. If a carrier elects to rescind a voidable policy (e.g., where the insured makes material misstatements in the application), then the carrier must return the premiums.

**The State of the Insurable Interest Analysis**

Both the Delaware Supreme Court and the Florida District Court expressly declined to follow precedent set in other states. In a leading case, *Alice Kramer v. Phoenix Life Ins. Co.*, the New York Court of Appeals reviewed a transaction substantially similar to the one at issue in Price Dawe and Schlanger. The New York Court of Appeals noted that insurable interest existed at the time the policy was issued because the children of the insured were the beneficiaries of the trust. Under New York law, an insured may take out a policy and immediately transfer it to a party who has no insurable interest. Thus, the subsequent transfer of the beneficial interest in the trusts did not violate New York’s insurable interest law. The New York Court of Appeals rejected an attempt to read a good faith requirement into the law. The Delaware Supreme Court noted the *Kramer* decision, but determined that the ruling of the New York Court of Appeals turned on language unique to New York’s insurable interest statute. In reaching its decision, the Florida District Court discussed, but ultimately rejected the holding in *Sun Life Ins. Co. v. Paulson*. In *Paulson*, the U.S. District Court in Minnesota held that a mere naked intent to sell a policy does not violate Minnesota’s insurable interest law. Rather, the insured must have entered into an arrangement with an identified third party prior to the issuance of the policy. The Florida District Court found this reading to be too restrictive and, as noted above, determined that acquiring the policy with the understanding that a third party would acquire it is sufficient to violate insurable interest laws.

While the Delaware Supreme Court and the Florida District Court were willing to take a broader view of the insurance transaction than courts in Minnesota, New York and other jurisdictions, it is worth noting that the facts in *Price Dawe, Schlanger* and *Brasner* point to a pre-arranged understanding that a third party lacking insurable interest would fund and ultimately acquire the policies. Pre-arranged transactions have been deemed wagering contracts long before the advent of the life settlement industry.

The challenge posed to investors, however, is the focus on the intent of the insured at the time of issuance. Intent is exceedingly hard to define long after the fact, especially by a party that was not involved with the issuance of the policy. The decisions point to certain concrete factors that should be considered, such as looking at who paid the premiums and the insured’s actual need for a policy and the ability to pay the premiums. The most recent decisions highlight the need for thorough diligence and proper vetting of counterparties. These additional diligence standards, however, are manageable and will prove beneficial to those investors prepared to undertake the time to better understand the origination of policies entering the life settlement market.
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