CHAPTER 58

Who Has an Insurable Interest?

MARTY BURBANK (Fullerton, California)

In 2006, I came home to find my next door neighbor's house was, for the most part, lost in a fire. The same thing had happened to another friend of mine in 2003. They had insurance and rebuilt their homes. It would have been nice if I also had insurance policies on their homes. I could have called up the insurance company and had them send me my check too. Unlike my friends, I would not have to rebuild my home, so I could just take the money and go buy that new airplane I've been wanting.

Of course, I did not have insurance on their homes, and I would not have been able to buy any even if I wanted to.

The reason why is that I lacked any insurable interest in either friends' home. What is an insurable interest? Generally one has an insurable interest if he or she has a risk of economic peril. For example, merchants and shipowners in the 16th century experienced great risk that their ships would be lost to storms and pirates. Today, a business owner has a risk that his business will be sued by an injured customer. These are interests that are insurable.

So why do we care, and what does it matter whether I have any economic risk in my neighbor's house. One reason is that it would create a moral hazard. For example, assume that I am home on the day of my neighbor's fire and I smell smoke. My normal reaction would be to try to put out the fire or at least call 911. I might react differently if I owned an insurance policy on my neighbor's house. My mind might not work that same — "what was that number…119?"

With life insurance, however, some people have an insurable interest even if they do not have a risk of economic loss. For example, a sibling, parent, child, or spouse has an insurable interest without having a risk of economic loss. But quite often, life insurance is purchased by others and they generally need to show some economic interest in the life of the insured. Non-family members often have an insurable interest in the life of another. But the non-family member must have some economic dependency on the life of the insured.

One of the most common areas for non-family member owned life insurance is in partnerships and other small business arrangements. A business partner will often want to have an insurance policy on the life of his or her other partners. Life insurance is often used to fund a buy-sell agreement between partners. These types of arrangements can be very beneficial, not only to the surviving partner, but also to the decedent partner's family. If a partner dies and there is insurance payable to the surviving partner (or the entity) then those funds provide the liquidly for the survivor to buy the decedent's interest from the family. This will ensure the family has cash and the surviving partner can run the business without interference from his or her partner's family.

Other arrangements where non-family members have an insurable interest include key employees of an organization. Keyman insurance can save a business when a key employee dies. But it is important that there be some risk that if the employee dies the company would suffer an economic hardship. It is hard to argue that the death of a rank-and-file employee would have a significant economic impact. For several years, Wal-Mart had the practice of obtaining insurance on most, if not all, of their employees, allegedly without always letting the employees know. Most states have laws requiring companies to advise their employees and seek their consent before purchasing the policies, but six states; Delaware, Georgia, New Jersey, North Carolina, Pennsylvania, and Vermont, allow companies to take out life insurance policies on their employees without notice to the employee. Wal-Mart has paid some very large settlements to the families of employees who sued when they learned of the policies.

The world of sports and entertainment is another area where key people are often insured by non-family members. For example, a movie producer or investor planning to make a movie would have an insurable interest on the lives of their lead actors. Professional sports teams have taken out large policies for both life and disability on some of their key players. The St. Louis Cardinals had a $12 million policy on Mark McGwire. But while one team may have an insurable interest in its players, another may not. The Seattle Mariners insure none of their players, as their draw is more dependent on fan loyalty than on superstars.

From time to time, news headlines read of someone who purchased insurance on a person's life and then killed the person. It sounds like a movie pitch, but there is a famous case of the "Blue Eyed Six" who bought a life insurance policy on Joseph Raber and then drowned him in 1878. As recently as April 18, 2008, two women in their 70s were convicted in Los Angeles for taking two separate homeless men off the street, purchasing life insurance on their lives, and killing each of them in separate hit and run "accidents." Clearly, in these cases there was no insurable interest in the victims.

Unlike casualty insurance, for life insurance, an insurable interest need only exist at the time the life insurance is purchased. The Supreme Court has determined that people who own life insurance have a property right interest and are able to sell that property right. Currently, there is great debate on how this might be done. The controversy does not exist when there is a good faith purchase of life insurance which is later re-sold. This is what happens in viatical settlements (for the terminally ill) and life settlements (for those with no impending health issues).

It is common for people to buy insurance with the idea that if the insured dies while the policy is in place, the money will take care of those who are left behind. However, sometimes the need for the insurance is no longer a concern. For example, if a parent purchases life insurance to cover his or her child's educational costs in the event of the parent's premature death, and the child is now grown and educated, or when a spouse has been predeceased by the spouse for whom the insurance proceeds were intended. In these cases, the sale of the death benefit in the insurance can provide a much better outcome than cashing out with the insurance company for the cash value of the policy.

Several programs have evolved over the last few years which give people incentives to purchase unneeded life insurance and then immediately sell the policy to an investor. This seems to run afoul of the insurable interest rules. Currently, however, many people are participating in these types of investments. Many insurance companies would like to see a stop put to these investments and they have been somewhat successful in some states. But in many other states, these transactions are common and account for millions of dollars of insurance sales and commissions every year.

In the Navy Hospital, Marty Burbank cared for heroes of WWI, WWII, and Korea; today he is proud and blessed to serve that same generation, and their families.

Estate Liquidity Worksheet

LIQUID ASSETS AVAILABLE		
Life insurance proceeds		$________
Checking and savings accounts		$________
Money market accounts and funds		$________
Certificates of deposit		$________
IRC Section 303 redemption proceeds		$________
Other liquid assets		$________
Total Liquid Assets Available		$________
CASH REQUIREMENTS		
Living expenses for family members	$________	
Administration expenses	$________	
Funeral and cost of final illness	$________	
Debt retirement	$________	
Personal income and excise taxes (Federal and state)	$________	
State death and/or inheritance taxes	$________	
Federal estate and generation-skipping transfer taxes	$________	
Specific cash bequests	$________	
Expenses of family business	$________	
Educational costs for child or spouse	$________	
Other: ____	$________	
Other: ____	$________	
Other: ____	$________	
Total Cash Needs		($________)
Surplus (Deficit) of Cash Available		$________