Whose Life Insurance Is It, Anyway?

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Suppose a promoter came to your client with a great deal—something like this:

“You’re a high-net-worth individual, and you have a valuable asset—your insurability. Have I got a deal for you! It’s a no-brainer! Here’s how you can cash in on it. You’ve got a net worth of about $5 million. You are covered by only $2 million of life insurance. An insurance company would probably agree to cover you for around $3 million. I know a bank that will loan you—a nonrecourse loan, so you can’t lose a thing—enough money to purchase the insurance based on your ‘excess insurance capacity.’ You’ll get a nonrecourse loan to take out a policy for about $3 million for only two years. At the end of the two years, you can keep it if you want. Or you can sell the policy to a life settlement company, pay off the loan and interest, and keep the balance as pure profit. Or you can just walk away from the deal, and let the lender take the policy in satisfaction of the debt.”

“Wait,” your client says, “I have enough life insurance.”

“You’re just talking about $3 million of free insurance for two years, then selling it and keeping the profit. Follow me on this. You borrow the money from the bank to pay the premiums, and you can sell the policy to the life settlement company two years after you purchase it. Because the loan is a full nonrecourse loan, you’re not liable for payment. The loan is fully secured by the policy. Loan payments accrue so you have no out-of-pocket outlay. If you die before the maturity date, the loan gets repaid out of the policy’s death benefit, and the remainder goes to the beneficiary of your choice or your estate. In effect, you get two years of free insurance, plus a share of the profits if you elect to sell.

“The only thing is that, if you elect to keep the insurance at the end of two years, you will be fully liable for repayment of the loan (and all the accrued interest), and you’ll continue to be the owner of the policy (and responsible for future premiums to keep it in force). You’ll have the extra insurance if you keep the policy. But if you do choose to sell, you’ll make what might amount to a couple of hundred thousand dollars after taxes for doing next to nothing. Good deal, huh?”

Should you recommend your client take such a deal? Is it in the best interest of your client? Is it a legitimate transaction? What are the ethical implications?

The deal is based on a real-life concept that adds a product with a new wrinkle to the rapidly expanding “secondary market” in life insurance—one that began to grow with the development of viaticals in response to AIDS victims and has since spread to life settlements that include charity-owned, company-owned, and investor-initiated and -owned life insurance policies. All these products are financial instruments with one thing in common: ownership of the policy belongs to a new third party who does not necessarily have an insurable interest in the life of the person on whose life the policy is written. Serious debate is raging in the industry concerning both the acceptability of these products and the role of financial service professionals and companies in promoting them. Are these products really in the best interest of clients?

Why is there so much negative reaction to the concept of stranger-owned life insurance and to its promotion by the secondary market? The chief objection seems to be the claim that life insurance policies owned by strangers, and in some cases speculators, are fundamentally in conflict with the very nature and primary purpose of a life insurance policy. Call this “the purist argument.”

Life insurance is often (and rightly) presented as a purely altruistic product, meaning one person, at his or her own expense with no gain for himself or herself in mind, helps to assure the financial well-being of another—often a dependent—in case of the first person’s death. This was the original, noble use of life insurance—to protect the financial well-being of widows and orphans. Thus, to turn a contract dealing with a person’s life into a mere investment vehicle, bought or sold for a profit like a fungible commodity on the open market, vitiates that noble purpose.

One could retort that insurance is often viewed as a gamble, and therefore, one can, if it is legal, gamble on anything. Why not, then, gamble that a certain person will live only for a certain amount of time? The rationale against such a gamble is that, if a per-
son bets a substantial amount of money that you will live only so long, that person has created a financial incentive to see your life shortened. History shows that a great deal of ethical mischief occurs in business when purely commercial concerns inhibit the pursuit of the real purpose of a business entity or a product. With life insurance, it is a good idea for the beneficiary of a policy to have an interest that the insured person remains alive. In order to inhibit the perverse pursuit of self-interest at the expense of another's life, governments have historically prohibited the sale of life insurance where the applicant does not have an insurable interest. Joseph Belth reminds us that, as far back as 1774, the British Parliament prohibited issuing life insurance without an insurable interest. In 1844, in the United States, Elizur Wright crusaded for life insurance reform when he saw life insurance policies auctioned in public to speculators. In 1905, the Kansas Supreme Court held that the lack of insurable interest was "contrary to good morals and a sound public policy."

Since a person's life has been turned into a commodity and strangers are able to take out options on other people's lives, critics of these "free insurance" schemes condemn them as a futures market in death. Rather than protecting loved ones against the financial hardships that result from premature death, the life insurance contract becomes a wager. Is it socially desirable to market and support a concept that generates a profit on the early demise of a human being, a product that makes a person's long and continued life economically undesirable for an investor group?

The Supreme Court case of Warmack v. Davis clearly forbids turning life insurance into a wager or a gamble. In the May 2006 issue of this journal, Thomas Connoito, in his excellent piece, cited the case that gave the Court's view of the nature and importance of insurable interest:

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 (a relation, such as)... the ties of blood or marriage to (a person) as will justify a reasonable expectation of advantage or benefit from the continuance of his life.

Policies (which violate the insurable interest rule) have a tendency to create a desire for the event. They are, therefore, independently of any statute on the subject, condemned as being against public policy.

On the other hand, there is a powerful argument made about the benefits of life settlements and a secondary market in life insurance. The argument rests on the basic ethical principle of the free market—a person should be free to do with his or her property what he or she wishes. Like it or not, a life insurance policy, with its promise of future payment and its current cash value, has two different values: the cash value and what the life settlement advocates call a "fair market value." If there is a gap between the cash value and the market value, the owner should have a right to sell that asset. Further, insurability is an asset that has a market value, and one is thought to have a right to cash in on one's value.

With the rise of AIDS and the demographics of a longer life and changing needs and circumstances, there are times when a need to liquidate one's assets arises. It would seem unconscionable not to allow people who are terminally ill to sell such assets to make their lives easier. Furthermore, the offer of a fair market value over the policy's cash value to elderly people whose life expectancy is shortened and whose beneficiaries' needs have become minimal would seem a boon. It is argued that life settlements, like reverse mortgages, are innovative financial tools developed to meet the growing needs of the changing market.

Some companies have responded to those needs in two ways. For those facing imminent death, companies have developed accelerated death benefits (ADBs), which have the advantage of allowing the insured to remain the owner of the policy. To meet the needs of longer life spans, companies have developed the vehicle of the annuity wrapped in a term policy, which has begun to replace whole life insurance as the product of choice. Products that would allow favorable market conversions of life insurance to annuities would introduce a new concept.

Life settlement vehicles—from viaticals, to life settlements for the elderly, to COLI (company-owned life insurance), to CHOLI (charity-owned life insurance), to SOLI (stranger-owned life insurance), to IILI...
(investor-initiated life insurance)—can be viewed as a continuum of products. Some exist for good reasons, but an argument is made that, by the time we reach IIIIs, such products have long lost their primary altruistic reason for existence. They have morphed into a financial instrument whose raison d’etre is simply to make a profit from speculation, a goal quite different from life insurance’s goal of providing security in the face of premature death. Whether this reflects a tendency in our culture to reduce all things to their economic or market value is an open question, but it calls to mind the warning of Solomon Huebner, founder of The American College, against the danger of the professional insurance agent adopting the strictly commercial point of view. At any rate, whereas it is debatable whether and to what extent companies and charities have an insurable interest in the insured, there are strong arguments against IIIIs—SOLIs in which investment groups’ and strangers’ only interest is served best by the insured’s early death.

Thus, although there are good reasons to support and recommend some forms of life settlements, the IIII in the opening example seems to be ethically undesirable. As ACLI President Frank Keating said at a recent NAIC meeting, “Clearly, these types of transactions abuse the social purpose of life insurance, circumvent the letter and spirit of insurable interest laws, and threaten the viability of a product that has provided essential financial security to generations of Americans.”

These transactions are disturbingly reminiscent of tax-dodging schemes and accounting tricks where there is no legitimate (business) purpose other than to take advantage of loopholes in the system. Promoters have found they can “game the system” and make a quick buck, but it is at the expense of those who appreciate insurance for the protection it offers others and not as a quick return on investment. Gaming the system not only jeopardizes the tax benefits that are meant as incentives to purchase life insurance as protection and not as a speculative investment, it also ultimately raises the cost of life insurance for everyone. Such speculation is free riding at its worst, for, as the practice expands, the margins for profits will shrink, and the companies or promoters will have less ability to meet their presumed obligations.

For a financial services professional, engaging in this might look like something that is too good to be true. If it looks too good to be true, it probably is. Steve Leimberg warns about some of the issues practitioners should recognize if they get involved in promoting IIIIs. Is the IIII a security? Will it involve falsifying an application? Is it an illegal rebate? What are the tax implications? Who is the third-party investor? Is the investor reputable? Do IIIIs pass the “smell test”? Or is there something fishy here? Whatever one thinks of the merits of these products, one thing is clear: the moral obligation of the financial services professional is to look very carefully at the benefits, costs, and the legal ramifications of such products before recommending them to clients. The arguments about the merits of life settlements will continue. Stay tuned.

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(1) This scenario is based on a similar situation described in the New York State Life Insurance Department, Opinion RE: Life Insurance Transactions, December 19, 2005. In fact, that situation gave the insured a “put” that would, at the insured’s election, force the purchase of the coverage.


(4) 104 US 775 (1881).

(5) At the suggestion of Steve Leimberg, I used the term “investor-initiated” rather than “investor-owned” to distinguish between those life settlements initiated by the person whose life is insured and those initiated by investors with no insurable interest in the insured. Belth uses the word “spinline.”

(6) ACLI President Frank Keating in testimony at the May 3, 2006, NAIC meeting.

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