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Michigan Irrevocable Life Insurance Trusts After the *Chawla* Decision: Satisfying the Insurable Interest Requirement

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Introduction

The irrevocable life insurance trust (ILIT) is a valuable and commonly used estate planning tool. An ILIT can be beneficial for clients having liquidity needs at death due to support obligations for dependants or transfer taxes imposed on assets held outside the ILIT.

Federal transfer tax issues with respect to an ILIT have been settled for years. Thus, with proper drafting, federal transfer taxation can be reduced or eliminated by (1) using Crummey withdrawal rights for federal gift tax purposes,[1] (2) preventing the settlor from having any "incidents of ownership" or "retained interests" in trust assets for federal estate tax purposes,[2] and (3) allocating the settlor's "GST exemption" to trust assets for federal generation-skipping transfer tax purposes.[3] However, a recent decision has startled estate planners by questioning whether the trustee of an ILIT has an insurable interest under state law when acquiring a life insurance policy on the settlor's life.

The *Chawla* Decision

In *Chawla v Transamerica Occidental Life Insurance Co*,[4] the decedent, Harald Geisinger, applied for a $1 million life insurance policy on May 4, 2000, and listed his close friend and business associate Vera Chawla as owner and beneficiary of the policy. The insurer refused to issue the policy because Chawla did not have an insurable interest in decedent's life. Decedent changed the owner and beneficiary of the policy to the Harald Geisinger Special Trust, a preexisting irrevocable trust. Decedent and Chawla were co-trustees of the trust and were also its income and remainder beneficiaries, respectively. Decedent died on September 23, 2001, at which point the insurer rescinded the policy, refunded the premiums, and alleged that material misrepresentations had been made in the life insurance application and that the trust lacked any insurable interest in decedent's life.[5]

The United States District Court ruled in favor of the insurer on both counts. The court noted that, under Maryland law, the trust, as beneficiary, had to have an insurable interest in decedent's life. An insurable interest exists under Maryland law if one is "related closely by blood or law" or has "a lawful and substantial economic interest in the continuation of the life, health, [or] bodily safety of the individual."[6] The trust, according to the court, could not satisfy the economic interest test because it stood to merely enhance its value by reason of decedent's death and suffered no detriment, pecuniary or otherwise, upon decedent's death.

The United States Court of Appeals for the Fourth Circuit affirmed the district court on the material misrepresentation count but vacated its decision on the insurable interest count. According to the Fourth Circuit, the lower court's reasoning could be interpreted to mean that a trust can never possess an insurable interest in a person's life under Maryland law, a ruling that could significantly impact how life insurance companies transact business in Maryland. The Fourth Circuit determined that the district court's alternative ruling on insurable interest was unnecessary, and that the court should have exercised judicial restraint when faced with a novel state law issue of vital concern.

However, as one commentator has noted with respect to *Chawla*, the Fourth Circuit's decision to vacate the district court's insurable interest ruling expresses no view on the substantive law and therefore leaves unresolved the issue of insurable interest.[7] Consequently, *Chawla* is causing estate planners to revisit the insurable interest requirement under applicable state law

and to press for clarifying or remedial legislation when necessary.[8] This article reviews Michigan insurable interest law and discusses why clarifying or remedial legislation should be enacted with respect to an ILIT.

Public Policy on Wagering Contracts

Life insurance policies that constitute wager policies are against public policy. A wager policy is a mere speculative contract upon the life of the insured where there is a direct interest in the policy's early termination. In other words, if the party taking the life insurance policy is directly interested in the early death of the insured, the policy has a tendency to create a desire for the event. That policy, independent of any statute on the subject, is condemned as being against public policy.[9]

The concept of insurable interest arose to curb the use of wager policies.[10] A life insurance policy issued to one who has no insurable interest in the life of the insured is void in Michigan as a wager policy.[11] Only the insurer, however, may assert the lack of an insurable interest,[12] and the insurer does not waive this defense by accepting premiums.[13]

Whether an insurable interest exists with respect to a life insurance policy is mitigated in two respects. First, life insurance polices are, by statute, incontestable after two years, except as to certain specified defenses that do not include lack of an insurable interest.[14] Thus, if the trustee of an ILIT acquires an insurance policy on the life of the settlor or any other person and the incontestability period is satisfied, an insurable interest is deemed to exist. Second, section 2207(2) of the Michigan Insurance Code of 1956 (the Insurance Code)[15] appears to allow a beneficiary or assignee of a life insurance policy to be any person, including one with no insurable interest in the life of the insured.[16] This statute seems to follow the holdings of the Michigan Supreme Court in *Dolan v Supreme Council Catholic Mutual Benefit Ass'n* and *Prudential Insurance Co v Liersch.*[17] Accordingly, it appears that a trustee of an ILIT may be a beneficiary or assignee of a life insurance policy on the settlor's life regardless of whether the trustee has an insurable interest in the settlor's life.

However, whether a trustee can purchase a life insurance policy on the settlor's life depends on whether the trustee has an insurable interest in the settlor's life.[18] Generally speaking, an insurable interest is based on (1) an expectation of an advantage or benefit that can be computed monetarily, or (2) natural affection that is considered more powerful at protecting the life of the insured than any other consideration.[19] In the words of Justice Field, "in all cases there must be a reasonable ground, founded upon the relations of the parties to each other, either *pecuniary* or of *blood* or *affinity*, to expect some benefit or advantage from the *continuance* of the life of the assured."[20]

Michigan Insurable Interest Law

In determining what an insurable interest is in Michigan, the Insurance Code must be consulted, particularly Chapter 22, "The Insurance Contract,"[21] which lists the following insurable interests:

1. A husband may insure his life for the benefit of his wife or any of his children;[22]
2. A married woman, individually or "in the name of any third person as her trustee," may insure the life of her husband or "any other person;"[23]
3. An employer may insure the lives of its officers, directors, management, non-management, and retired employees, subject to the employee's consent;[24] and
4. A 501(c)(3) organization may insure the life of an individual who gives written consent to the ownership or purchase of a policy on his or her life.[25]

This list of insurable interests is narrow. It fails to address, for instance, whether an unmarried

individual with no children may insure his or her own life for the benefit of his or her estate, or whether a husband can insure the life of his wife. One might conclude that common law should fill the gap regarding other possible insurable interests, but rules on statutory construction may not allow the expansion of insurable interests through common law.

A court might apply the legal maxim *expressio unius est exclusio alterius*—the expression of one thing is the exclusion of another—and prevent the expansion of insurable interests via common law. According to the Michigan Supreme Court, this maxim is a rule of construction that is a product of logic and common sense. No maxim is more uniformly used to properly construe statutes;[26] moreover, it is applied when statutes are deemed to regulate a matter of public interest or confer on a public body the power to perform acts that concern the public interest.[27] The Insurance Code appears to regulate an area of public interest and confers authority on the Commissioner of the Office of Financial and Insurance Services, including the power to determine the reasonableness of insurance contracts.[28]

For example, a court might apply this maxim to the Insurance Code because the Code provides a short list of insurable interests that is easily justified under public policy against wager contracts. A court might also apply this maxim to the Insurance Code because the Code expressly allows a wife, but not a husband, to use "any third person as her trustee" to procure insurance on the life of her husband or "any other person." This authorization arguably excludes similar authorization with respect to a husband. Consequently, a court could apply this maxim to prevent a husband from having a trustee procure insurance on his life or the life of another person. Similarly, the Insurance Code expressly provides that a trust established by an employer has an insurable interest in the lives of the employer's directors, officers, managers, nonmanagement employees, and retired employees.[29] Under the maxim, the authorization granted to an employer and a married woman to use a trust to obtain insurance arguably excludes similar authorization for any other person.

There are, however, compelling reasons why the maxim should *not* be applied to prevent common law expansion of the list of insurable interests. For instance, if the maxim were applied, it would prevent an unmarried individual with no children from insuring his or her own life for the benefit of his or her estate, and would also prevent a husband from insuring the life of his wife, because neither scenario is expressly authorized in the Insurance Code. The Michigan Legislature could not have intended that result. Rather, the Legislature must have intended for common law expansion of the list of insurable interests, which is arguably shown by (1) a wife's ability to procure life insurance on the life of "any other person," and (2) the ability of a person under section 2207(2) of the Insurance Code to effect insurance "on his own life *or on another life* in favor of a person other than himself."[30] In other words, the Insurance Code does no more than define what constitutes an insurable interest in certain circumstances. It neither attempts nor purports to list all forms of insurable interests.[31]

Assuming the Insurance Code allows common law to expand the list of insurable interests, the list of insurable interests in Michigan would likely expand as follows:

1. An individual would have an insurable interest in his or her life in favor of his or her estate.[32]

2. A husband would have an insurable interest in his wife.[33]

3. An individual who is dependent on another for his or her support has an insurable interest in the life of the person upon whom he or she is dependent.[34] This is particularly useful for many of today's families where a stepparent supports a stepchild, an aunt

or uncle supports a niece or nephew, or an in-law supports another in-law.

4. When one desires to purchase life insurance on another person's life but is neither related to nor supports the other person, an insurable interest exists if it can be shown that the person acquiring the insurance has a reasonable expectation of some benefit or advantage from the continuance of the insured's life. This does not need to be capable of pecuniary measurement.[35]

Based on the list above, a trustee of an ILIT would have to show, when purchasing a life insurance policy on the settlor's life, that the trustee has a reasonable expectation of some benefit or advantage from the *continuance* of the insured's life. However, as the United States District Court noted in *Chawla*, an ILIT has no interest that would be promoted by prolonging the settlor's life and stands to merely enhance the value of its assets at the settlor's death because it would suffer no economic detriment, pecuniary or otherwise, as a result of the settlor's death. That rationale views an ILIT as an entity for insurable interest purposes rather than as an aggregation of beneficial interests,[36] although there is no Michigan case law viewing a trust as an aggregation of beneficial interests for insurable interest purposes. If such law were to exist, a beneficiary, rather than a trustee, would need an insurable interest in the settlor's life when an ILIT purchases insurance on the settlor's life. That may be difficult to show in certain situations unless the beneficiary is being supported by the settlor. Consequently, remedial legislation appears to be appropriate to clarify the insurable interest issue in Michigan with respect to an ILIT. Other states have already addressed this issue by enacting remedial legislation.[37] Remedial legislation would preserve the ILIT as a viable estate planning tool and would prevent a trustee of a Michigan ILIT from having to purchase life insurance on the settlor's life in other states whose laws grant the trustee an insurable interest in the settlor's life.

Conclusion

The *Chawla* case raises an issue to which many estate planners have not given much consideration in the past. Before *Chawla*, estate planners generally assumed that an individual could establish an ILIT and then have the trustee acquire insurance on the individual's life. Amending the Insurance Code to expressly grant an insurable interest in this context would facilitate the future use of an ILIT in Michigan and obviate the need for Michigan courts to resolve this issue.

Notes

1. *Crummey v Commissioner*, 397 F2d 82 (9th Cir 1968). *See also Estate of Cristofani v Commissioner*, 97 TC 74 (1991).

2. *Headrick v Commissioner*, 918 F2d 1263 (6th Cir 1990).

3. IRC 2631, 2632.

4. No 03-1215, 2005 US Dist LEXIS 3473 (ED Va Feb 3, 2005), *aff'd in part and vacated in part,* 440 F3d 639 (4th Cir 2006).

5. Thus, the insurer, not the court, raised the issue regarding the lack of any insurable interest.

6. 2005 US Dist LEXIS 3473 at *17.

7. Sebastian V. Grassi, Jr., *A Practical Guide to Drafting Irrevocable Life Insurance Trusts* § 12.9 (2d ed 2003).

8. *Id*.

9. *Warnock v Davis*, 104 US 775, 779 (1882). *See also Crossman v American Ins Co*, 198 Mich 304, 308, 164 NW 428 (1917) ("Policies of insurance founded upon mere hope and expectation and without some interest in the property, or the life insured, are objectionable as a species of gambling, and so have been called wagering policies. All species of gambling policies were expressly prohibited in England by Stat. 19 Geo. II, chap. 37, and have been treated as illegal in this country upon the principles of that statute, without acknowledging it as authority. Here, such contracts of insurance are treated as contravening public policy, and are therefore void").

10. *Dow Chem Co v United States*, 250 F Supp 2d 748, 757 (ED Mich 2003), *modified,* 278 F Supp 2d 844, *rev'd on other grounds,* 435 F3d 594 (6th Cir 2006).

11. *Dolan v Supreme Council Catholic Mut Benefit Ass'n*, 152 Mich 266, 269, 116 NW 383 (1908) ("There is no doubt that Guerold had no insurable interest in the life of Dolan, and had he himself obtained the insurance under consideration, the contract would have been a wagering

one and void on the ground of public policy"); *Crossman*, 198 Mich at 304.

12. *Hicks v Cary*, 332 Mich 606, 612, 52 NW2d 351 (1952); *Secor v Pioneer Foundry Co*, 20 Mich App 30, 32–35, 173 NW2d 780 (1969).

13. *Sun Life Assurance Co v Allen*, 270 Mich 272, 284–286, 259 NW 281 (1935).

14. A group life policy is incontestable "after 2 years from its date of issue." MCL 500.4432. Any other life insurance policy is incontestable "after it shall have been in force during the lifetime of the insured for 2 years from its date." MCL 500.4014, .4208. Those incontestability periods are fundamentally different. Under a group term policy, death of the insured within the two-year period does not bar its operation. Under any other life insurance policy, death of the insured within the two-year period bars its completion because the policy must be in force for two years during the insured's life. *Sun Life* at 282–284. *See also* Michigan Civil Jurisprudence *Insurance* § 381, at 389.

15. MCL 500.100 et seq.

16. MCL 500.2207(2) provides in part, "If a policy of insurance, or contract of annuity (whether heretofore or hereafter issued) is effected by any person on his own life or on another life *in favor of a person other than himself*, or (except in cases of transfer with intent to defraud creditors) if a policy of life insurance is *assigned or in any way made payable to any such person*, *the lawful beneficiary or assignee thereof* (other than the insured or the person so effecting such insurance, or his executors or administrators) *shall be entitled to the proceeds and avails (including the cash value thereof)* against the creditors and representatives of the insured and of the person effecting the same, (whether or not the right to change the beneficiary is reserved or permitted and whether or not the policy is made payable in the event that the beneficiary or assignee shall predecease such person, to the person whose life is insured or the person effecting the insurance) …" (emphasis added).

However, it is possible that the statute might be construed, for example, as being primarily for the protection of creditors. In that event, the clause "lawful beneficiary or assignee" would have to be construed narrowly (i.e., a beneficiary or assignee is "lawful" if that person has an insurable interest). Nevertheless, the term "lawful" was probably inserted to pertain solely to assignments or beneficiary designations that were free from any intent to defraud creditors, which MCL 500.2207(2) expressly requires.

17. *Cf. Dolan*, 152 Mich at 269, 274–275 (adopting the prevailing rule that, in the absence of a statute to the contrary, a person may insure his or her life for the benefit of another who has no insurable interest), and *Liersch*, 122 Mich at 438 (upholding an assignment of a policy to a person having no insurable interest when there was no statute, insurer bylaw, or policy provision prohibiting the assignment and when the insurer assented to the assignment), with *Michigan Mut Benefit Ass'n v Rolfe,* 76 Mich 146, 151–152, 42 NW 1094 (1889) (a statute authorizing the issuance of a life insurance policy in favor of a specific class of beneficiaries was treated as requiring a beneficiary *and* an assignee of that policy to have an insurable interest as a member of the class). For authorities similar to *Dolan* and *Liersch*, see *Bristol v Mutual Benefit Health & Accident Ass'n*, 305 Mich 145, 151, 9 NW2d 38 (1943); 3 Lee R. Russ et al, Couch on Insurance 3d, § 41.19, at 41-37, 41-38; 44 Am Jur 2d *Insurance* § 978, at 242; 14 Michigan Civil Jurisprudence §§ 112, 267, at 119–120, 278. For authorities similar to *Rolfe*, see 3 Couch on Insurance 3d, § 41.20, at 41-38–41-40.

18. For example, MCL 500.3462, which deals with third-party ownership of a policy, provides in part that "a person other than the insured with a proper insurable interest" may apply for and own an insurance policy on the life of the insured.

19. *Warnock*, 104 US at 779.

20. *Id.* (emphasis added).

21. The application of Chapter 22 to life insurance policies issued or delivered in Michigan by any life insurer doing business within the state is shown by MCL 500.2226, which describes certain required provisions for such policies and further references the standard provisions required by chapters 40, 42, and 44 that deal, respectively, with life insurance generally, industrial life insurance, and group life insurance.

22. MCL 500.2207(1).

23. *Id. See also* MCL 500.2209. The "other person" would have to be one in whom a married woman has an insurable interest or else the public policy against wager contracts would be violated. This interpretation coincides with MCL 500.2211(1), which provides that "[a]ny individual *who has an insurable interest in the life of another human being* shall not insure that other human being's life for the individual's benefit unless the human being whose life is to be insured consents to be insured in writing" (emphasis added).

24. MCL 500.2210. See *Dow Chem Co*, 250 F Supp 2d at 782, where the deductibility of premiums paid for policies acquired pursuant to this statute was at issue for federal income tax purposes.

25. MCL 500.2212, *enacted by* 1996 PA 572.

26. *Hoerstman Gen Contracting, Inc v Hahn*, 474 Mich 66, 711 NW2d 340 (2006), which applied this maxim in holding that section 3311 of the Michigan Uniform Commercial Code (MCL 440.3311) preempted common law on accord and satisfaction involving negotiable instruments.

27. 29 Michigan Law & Practice *Statutes* §§ 94, 111.

28. In *Rory v Continental Insurance Co*, 473 Mich

457, 474–476, 491, 703 NW2d 23 (2005), the Michigan Supreme Court determined, among other things, that (1) the Commissioner is "charged with reviewing and approving insurance polices," (2) "the explicit 'public policy' of Michigan is that the reasonableness of insurance contracts is a matter for the executive, not judicial, branch of government," and (3) that a determination of reasonableness is subject to judicial review only with respect to abuse of discretion.

29. MCL 500.2210(2), (3).

30. MCL 500.2207(2) (emphasis added).

31. See *Buckner v Ridgely Protective Ass'n*, 131 Wash 174, 229 P 313 (1924), where the Washington Supreme Court applied the same reasoning when analyzing a statute that generally defined the term "insurable interest" in the context of a beneficiary. The court ruled that the statute did not require every beneficiary to have an insurable interest; rather, it provided guidance on the meaning of that interest. The court then applied the prevailing rule that an insured could designate any person as beneficiary, regardless of whether the person had an insurable interest in the insured's life. *Id.* at 182, 183.

32. 44 Am Jur 2d *Insurance* § 978, at 242 (citing *Smith v Coleman*, 184 Va 259, 267, 35 SE2d 107 [1945]). This scenario should be allowed because Michigan case and statutory law already appear to allow an individual to insure his or her life and designate any beneficiary, including one with no insurable interest.

33. 3 Couch on Insurance 3d § 43.1, at 43-2, 43-3, providing that most jurisdictions today recognize an insurable interest during marriage.

34. *Berdan v Milwaukee Mut Life Ins Co*, 136 Mich 396, 401, 99 NW 411 (1904). After setting forth the rule as described above, the Michigan Supreme Court applied it as follows: "In the case at bar, the beneficiary was generally known as the nephew of Miss Quick. He was dependent upon her. He had an insurable interest in her life. He was eligible to be named as a beneficiary in the defendant society. Whether he was named as a nephew, or as one having an insurable interest, would not affect the question of the desirability of Miss Quick as a subject of insurance." *Id.* at 404.

35. In *Indemnity Insurance Co v Dow*, 174 F2d 168, 170 (6th Cir 1949), the Federal Court of Appeals for the Sixth Circuit found, after reviewing *Sun Life Assurance*, 270 Mich at 272, and the cases cited there, that it is not necessary in Michigan to show that the death of the insured would result in a substantial loss to the insured; rather, "[i]t is sufficient that the beneficiary has a reasonable expectation of some benefit or advantage from the continuance of the life of the assured." The Sixth Circuit then affirmed the jury verdict in the lower court in favor of a man named Dow, who entered into a commercial airplane venture with a woman named Kruger and purchased insurance on Kruger's life. Dow supplied funds for the business and Kruger ran the business. The only return Dow was to receive was half of the profits from the business. The Sixth Circuit noted, when upholding the lower court jury verdict, that it was not necessary that Dow's expectation of benefit be capable of pecuniary measurement.

36. For further information regarding a trust as an entity or as an aggregation of beneficial interests for insurable interest purposes, see Grassi, n7 *supra*, and cases cited there from other states.

37. *See, e.g.*, Del Code Ann tit 18, § 2704(c)(5); Ga Code § 33-24-3(c); SD Codified Laws Ann § 58-10-4(6); Va Code § 38.2-301.B.5; and Wash Rev Code § 48.18.030(3)(c).