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The Insurable Interest Rule: Who Kicked the Slumbering Bear-and Did it Wake Him Up?

Introduction

Estate planners and others have for years gone blissfully along in their planning for families and business owners, devising wonderfully helpful trusts and solving liquidity needs with the use of life insurance. Often these techniques are combined, especially in the context of irrevocable life insurance trusts (ILITs). Because these transactions almost always arise in the context of 'related' (by blood, marriage, or business) parties, one of whom is the insured in those situations involving the purchase of life insurance, nary a thought has been given to the requirement that the original owner of the life insurance have an insurable interest in the insured for the policy to be 'valid.' The owners of these policies have either been the insured, a person related to the insured, or the trustee of a trust for the benefit of some related person. The policies have been applied for, issued by the insurance companies, and problem solved-'no worries, mate.' No worries, that is, until the United States District Court for the Eastern District of Virginia handed down its decision in *Chawla v. Transamerica Occidental Life Insurance Company*. [\[FN1\]](#)

The Chawla Case

In 2000, Harald Geisinger applied to Transamerica for a ten-year term life insurance policy on his life. Mr. Geisinger was divorced, with no children. His application named Vera Chawla as the owner and beneficiary of the policy. Ms. Chawla was not related to Mr. Geisinger by blood or marriage. Mr. Geisinger apparently lived from time to time with Ms. Chawla and her husband, who was also Mr. Geisinger's doctor.

When Transamerica received Mr. Geisinger's initial application for the life insurance policy, it refused to issue the policy on the grounds that Ms. Chawla did not have an insurable interest in Mr. Geisinger. So Ms. Chawla and Mr. Geisinger resubmitted the application for the insurance policy, listing The Harald Geisinger Special Trust, an irrevocable inter vivos trust that Mr. Geisinger had previously created, and which then owned his personal residence, as the owner and beneficiary of the policy. As part of the application, Mr. Geisinger had to complete a medical history questionnaire, on which he undisputedly made numerous false statements and

failed to disclose significant negative material medical facts. [FN2]

Mr. Geisinger was the grantor of the trust and Mr. Geisinger and Ms. Chawla were the co-trustees. The trust agreement provided that, in the event that Mr. Geisinger was no longer able to serve as co-trustee, Ms. Chawla would become the sole trustee. The trust agreement did not specifically give the trustees the authority to procure life insurance on the life of Mr. Geisinger, although this was not a material fact in the court's decision. The trust provided that Mr. Geisinger had the right to all the income during his life and the right to occupy the residence. At his death, all property was to be distributed to Ms. Chawla.

In July 2000, Transamerica issued the life insurance policy. Several months later, Mr. Geisinger applied to increase the death benefit of the policy, and Transamerica issued a new policy. Ms. Chawla paid the premiums by check, drawn on a joint bank account that she shared with her husband.

Mr. Geisinger died approximately one year later, leaving Ms. Chawla as the sole trustee of The Harald Geisinger Special Trust. Upon application for the death benefits, which was within two years of the policy's issue date, Transamerica investigated the matter and informed Ms. Chawla that it was rescinding the policy because of Mr. Geisinger's material misstatements and omissions on the application, and it returned the premiums that Ms. Chawla had paid. Ms. Chawla sued Transamerica for breach of contract. Transamerica answered and asserted two main defenses: fraud in the application, and lack of insurable interest by the trustee in the life of Mr. Geisinger. It is this latter claim that sent up red flags throughout the estate planning community.

In awarding summary judgment in favor of Transamerica, the district court held that the omissions and misstatements in the application were material misrepresentations, allowing Transamerica to rescind the policy. However, the court did not stop there. The court further noted that Ms. Chawla's claim would necessarily fail as a matter of law because the trustee had no insurable interest in the life of Mr. Geisinger. After finding that Maryland common law required an insurable interest to validate a life insurance policy, the court applied the Maryland substantive law on insurable interests, which stated that:

a person may not procure or cause to be procured an insurance contract on the life of another individual unless the benefits under the insurance contract are payable to (i) the individual insured; (ii) the individual insured's personal representative; or (iii) a person with an insurable interest in the individual insured at the time the insurance contract was made. [FN3]

The court, in construing the Maryland statute, focused on the third permissible recipient of the death benefit ('a person with an insurable interest in the individual-insured at the time the insurance contract was made') and noted that Maryland law defines 'person' as 'an individual, receiver, trustee, guardian, personal representative, fiduciary, representative of any kind, partnership, firm, association, corporation, or entity.' [FN4] Thus, the court reasoned, the trustee of a trust, according to Maryland's definition of 'person,' is required to have an insurable interest in the insured. Whether the beneficiaries of the trust had an insurable interest was obviously not relevant in Maryland, because the insured was the primary beneficiary of the trust.

The court found that none of the permissible recipients of death benefits included trustees or trusts; that, *inter alia*, there was no economic interest between the trustee and the continued life of Mr. Geisinger; in fact, the trustee would only benefit by the death of Mr. Geisinger. [FN5] Thus, the court concluded that The Harald Geisinger Special Trust, with Ms. Chawla as its trustee, did not have an insurable interest in Mr. Geisinger's life.

Ms. Chawla appealed the decision to the Court of Appeals for the Fourth Circuit. Estate planners were hopeful that the appellate court would rule (read: overrule) on the question of insurable interest; however, to

everyone's dismay, the appellate court merely affirmed the lower court's holding without comment. [FN6]

General Response to *Chawla*

A great hue and cry has arisen across the country in response to the *Chawla* decision, especially considering the proliferation of ILITs and the disastrous effects that could occur if *Chawla* were the law in every jurisdiction. In states that view the trustee/trust as a legal entity, separate and distinct from its beneficiaries, seemingly the trustee itself must have an insurable interest in the insured. In these states, *Chawla* is very troubling absent a specific statute conferring an insurable interest on the trustee. In states that view the trust as a collection of its beneficiaries, seemingly only some or all of the trust beneficiaries must have an insurable interest in the insured. In these states, *Chawla* is perhaps less troubling. The problem is that most states without a specific statute do not have sufficiently clear common law to make it apparent which type they are.

As of this date, new state statutes have been adopted in Delaware, Virginia, Washington, and South Dakota, establishing (or codifying common law to affirm) an insurable interest on the part of a trustee of a trust created by the insured for the benefit of related parties. Studies are underway in several other states, including Ohio, with respect to proposing similar legislation. The insurance industry (which created this problem by raising the defense in *Chawla*) is at best neutral, and tending to unsupportive, of these legislative entreaties.

If *Chawla* were to be applicable in other states, there is some concern that the IRS might decide that a state would determine that there be no insurable interest, thus transforming 'insurance' proceeds into contract payments and disallowing the tax-free nature of life insurance proceeds. This seems fairly unlikely, but certainly the IRS is capable of deciding to make this sort of thing an issue.

What Does All This Mean in Ohio? Current Ohio Law

Common Law

A significant part of Ohio law regarding insurable interests is found in the common law. As an initial matter, it may be helpful to note that Ohio common law specifies that the insured always has an insurable interest in himself. Thus, if the insured is the original owner of the policy there will be no insurable interest problem, regardless of the choice of beneficiary. [FN7] The problem, however, arises when the insured and the original owner of the policy are not the same person, as in the *Chawla* case.

Ohio courts have long held that a person may not take out a life insurance policy on another when the policyholder does not have an 'insurable interest' in the life of the insured. [FN8] Ohio courts have used several different definitions of insurable interest when discussing the topic, but all include a mention of some relationship between the policyholder and the insured such that the effect of the insurable interest requirement is that someone may not take out a life insurance policy on a stranger's life. [FN9]

The question of whether there is an insurable interest only arises with respect to the original owner of the policy. Courts address the question of whether there was an insurable interest with a view to the relationships between the parties at the time that 'the insurance was effected.' [FN10] Once the insurance company issues the policy to the original owner, that original owner may transfer the ownership of the policy to anyone he or she sees fit, without regard to whether the new owner of the policy has an insurable interest in the insured.

If the original owner has no insurable interest in the insured, the policy has been held to be void as against public policy. [FN11] The holder of a void policy will not get back the premiums that he has paid. [FN12] This rule presumably exists because the original owner of the insurance policy would have had to perpetrate some type of fraud or misrepresentation on the insurance company with respect to the existence of an insurable interest in order for the insurance company to issue the policy in the first place. [FN13] Only the insurance company may assert the defense of a lack of insurable interest. Would-be beneficiaries and other claimants may not assert the defense, though many have tried unsuccessfully.

There may be, or at least should be, a different result if the insurance company knew, or should have known, of the lack of insurable interest when it issued the policy. Though the Ohio courts have never considered such a situation, it would seem likely that a court would have to award damages in quasi-contract to the original owners, such as return of premiums or payment of the death benefit as a contract claim rather than insurance proceeds (of course, significantly changing the income tax character to the recipient of the payment). Failing to do so would reward unscrupulous insurance practices.

Some have argued that the insurance companies and the purchasers of life insurance policies can simply agree that the insurance company, in exchange for the premium payments, will waive its defense of lack of insurable interest. In fact, some Ohio practitioners and life insurance companies are currently entering into such letter agreements. The problem with this argument may be that, if a lack of insurable interest makes the life insurance contract void as against public policy, it may not be possible to 'waive' such a requirement. Reliance on this practice seems tenuous.

Statutory Law

[Section 3911.09 of the Ohio Revised Code](#) is one of two Ohio statutes dealing with some aspects of the insurable interest requirement. [FN14] [R.C. § 3911.09\(A\)](#) states that:

[a]ny person may procure, authorize procurement of, or effect an insurance on the person's life, for any definite period of time or for the term of the person's natural life, to inure *to the benefit of* the person's spouse and children, or either, or other persons dependent upon such persons. [FN15]

[R.C. § 3911.09\(B\)](#) mainly creates an insurable interest for charitable organizations in their donors.

This statute is so specific in its application that there can be no question that it is not in derogation of the common law. For example, it does not even address the one thing we know about insurable interests with absolute certainty in Ohio: that an original owner/insured can take out a policy and name anyone he or she pleases as beneficiary. Therefore, one must conclude that [R.C. § 3911.09](#) simply stands for the proposition that one may purchase an insurance policy on one's own life for the benefit of certain other persons.

Does the statute recognize an insurable interest in a trustee/trust holding the proceeds for 'the benefit of the person's (i.e., insured's) spouse and children, or either, or other persons dependent upon such person'? Although not specifically using the word 'trust,' it seems difficult to imagine that the words 'for the benefit of' do not contemplate a trust.

Positive Vibes in Ohio

If the insured is the original owner of the insurance policy, then he or she can turn right around and immediately transfer ownership to a trust of any type for the benefit of any set of beneficiaries, avoiding any concern

about the insurable interest requirement.

If, as seems almost a certainty, [R.C. § 3911.09\(A\)](#) recognizes an insurable interest in a trustee/trust for the benefit of certain beneficiaries, then so long as we can comply with its provisions there should be little cause for concern. First, the trust must be for the benefit of the insured's spouse, children or other persons dependent upon the insured. For the run-of-the-mill ILIT, benefiting the insured's spouse and issue, this should present no problem. Second, the insurance must be procured, authorized, or effected by the insured. If the insured is the trustee of the trust, or if the insured is the grantor of the trust and the trust contains language authorizing the trustee to procure insurance on the life of the grantor, it would seem that the insurable interest requirement would be met. And even if neither applied, if the insured was aware of and/or participated in the issuance of the insurance policy (which would seem to almost always be the case), then it would seem that the insured 'effected' insurance within the protective language of the statute.

Because only the insurance company can raise the defense of lack of insurable interest, getting the waiver from the insurance company mentioned earlier certainly could not hurt. Even if it is not legally effective, at least perhaps the insurance company may feel morally bound to pay the claims, absent some third party action (which in most cases would be nonexistent.)

Presently, the Council of the Estate Planning, Trust and Probate Law Section of the Ohio State Bar Association is contemplating proposing legislation similar to other states to clarify the issue in Ohio. The Council is in discussion with various representatives of Ohio-based life insurance companies to consider whether this is practical or advisable from the insurance industry's perspective. In the interim, the companies are considering adopting some sort of 'statement of best practices' whereby they would acknowledge the issue and, upon issuance of a policy to a trustee/trust, would affirmatively state their opinion that an insurable interest exists.

There is no case in Ohio in which the lack of insurable interest in a trustee/trust has been raised in this context as a defense. Maybe the common law in Ohio makes this a moot issue, allowing the slumbering bear an extra forty winks.

Negative Vibes in Ohio

In the typical ILIT, the three-year rule generally precludes, or at least seriously impairs, the idea of having the insured initially acquire the policy and transfer it to the trust. [\[FN16\]](#) Nevertheless, the odds of most insureds dying in the first three years are relatively quite low, and some insurance companies offer a three year 'double death benefit' term rider at a fairly low cost to offset this problem.

Fitting into the protection of [R.C. § 3911.09\(A\)](#) is not always easy, as, for example, when the beneficiaries of the trust are only grandchildren or more remote descendants, or nonadopted children of a second spouse. However, these beneficiaries may fit within the general common law definition of a person who has an economic interest in the survival of the insured. [\[FN17\]](#)

So, What Do We Do?

When drafting a typical ILIT for the benefit of the insured's spouse and/or issue, wherein the insured is the grantor but not the trustee, the trust agreement should specifically authorize the trustee to procure life insurance on the grantor's life payable to the trust. This should fit squarely within the protection of [R.C. § 3911.09\(A\)](#). For

older ILITs without such specific authorization, a letter from the insured that he or she was aware of the application for the insurance and that he or she participated in 'effecting' such coverage should be sufficient.

If the trust beneficiaries do not fit the narrow definition in the statute, planners will just have to rely on the common law, which so far does not seem to be a problem. Extra-cautious practitioners might consider the waiver letter from the insurance company, if obtainable.

For the extra-extra-cautious, fail-safe approach, have the insured take out the policy initially and transfer it to the ILIT, dealing with the three-year rule as described above.

FN1. *Chawla v. Transamerica Occidental Life Ins. Co.*, 2005 WL 405405 (E.D. Va. 2-3-05); see also, generally, Mary Ann Mancini, *The Chawla Case, Insurance Trusts and the Insurable Interest Rule: 'Houston, We Have a Problem'*, 31 ACTEC Journal 125 (2005).

FN2. In response to questions regarding (1) his past treatment at a clinic, hospital, or sanitarium, (2) any past surgeries, and (3) whether he had been treated for alcoholism or drug addiction, Mr. Geisinger answered in the negative. Mr. Geisinger did not disclose that he had visited Dr. Chawla for a physical in February of 2000. Dr. Chawla later confirmed the visit and attested to Mr. Geisinger's good health. Nor did Mr. Geisinger disclose that he had undergone brain tumor surgery, spinal taps, and at least one collection of cerebrospinal fluid in his head in Austria in 1999. The Austrian doctors treating him at the time also diagnosed Mr. Geisinger with chronic alcohol abuse, which he did not disclose. Then, when he returned to the United States, Mr. Geisinger underwent additional surgery in Washington, D.C. to insert a shunt into his head to drain the fluid that had accumulated after his brain tumor surgery. He did not disclose this event on his application for life insurance either. In 2000, Mr. Geisinger was hospitalized for alcohol abuse. Later in that same year, Mr. Geisinger was again hospitalized for complications associated with alcohol abuse, namely episodes of unconsciousness. He reported neither of these hospital visits on his application for life insurance.

FN3. Md. Code Ann., Ins. § 12-201 (2006).

FN4. Md. Code Ann., Ins. § 12-101(dd) (2006).

FN5. The 'economic interest' test is a frequent bellwether of insurable interests. See, e.g., *Rakestraw v. Cincinnati*, 69 Ohio App. 504, 511 (Hamilton County Ct. App. 1942), citing 29 Am. Jur. §§ 309, 353.

FN6. *Chawla v. Transamerica Occidental Life Ins. Co.*, 440 F.3d 639 (4th Cir. 2006).

FN7. *Pierce v. The Metropolitan Life Ins. Co.*, 46 Ohio App. 36, 37 (1933), quoting *Schmidt v. Prudential Ins. Co.*, 37 Ohio App. 258, 261 (1928) ('Under the laws of Ohio a person may, in good faith, insure his own life for the benefit of any one whom he may choose, though not related to him by blood or marriage, and that such insurance so procured is not invalid as being against public policy'). The most common way of phrasing this comes from May's treatise on insurance: 'When one causes his own life to be insured for the benefit of a stranger, the want of an insurable interest in the stranger will not invalidate the policy.' *Northwestern Mutual Life Ins. Co. v. The Coshocton Glass Co.*, 21 Ohio C.D. 665, 667, 1910 WL 1166 (Ohio Cir. 1910), citing *Ryan v. Rothweiler*, 50 Ohio St. 595, 601 (1983); May on Insurance § 75b.

FN8. See, e.g., *Rakestraw v. Cincinnati*, 69 Ohio App. 504 (1942).

FN9. See, e.g., *Northwestern Mutual Life Ins. Co. v. Coshocton Glass Co.*, 21 Ohio C.D. 665, 667, 1910 WL 1166 (Ohio Cir. 1910) ('We are conscious of the difficulty of defining with absolute precision what will in all cases constitute an insurable interest in the life of a person, so as to take a contract of insurance out of the class of wager policies. But we believe the test to be that where there is a reasonable ground, founded upon the relations of the parties to each other contractual, or by blood or affinity, whereby any pecuniary interest arises in the continuance of the life or expected benefit, or advantage from the continuance of the life of such person, there is an insurable interest in his or her life.');

Shaddinger v. Metropolitan Life Ins. Co., 2 Ohio Dec. 200, 201 (Hamilton County Ct. Com. Pleas Nov. 1893) ('The American law is drifting in the direction that [the insurable interest] need not be pecuniary, but that a relationship of natural affection, accompanied by expectation of pecuniary advantage from continuance of life, or of loss from death, is sufficient.').

FN10. *Union Cent. Life Ins. Co. v. Hilliard*, 8 Ohio C.D. 437, 1898 WL 1629 (Ohio Cir. 1898) ('In life insurance as in other kind of insurance the assured must have an interest in the life insured; and where insurance be effected by one person on the life of another the assured must show himself to have possessed an interest in the life of that other at the time the insurance was effected.').

FN11. See, e.g., *Septer v. Septer*, No. 73422 (Franklin County Prob. Ct. July 12, 1935); *Union Cent. Life Ins. Co. v. Hilliard*, 8 Ohio C.D. 437, 1898 WL 1629 (Ohio Cir. 1898) ('It is undoubtedly the rule that the insured must have an interest in the subject matter in the insurance. A policy of insurance obtained upon the subject in which the insured has no interest is void, whether or not it be so stipulated therein. No action can be maintained upon it; the notes given for the premiums upon such insurance are void for want of consideration.');

Ryan v. Rothweiler, 50 Ohio St. 595, 601 (1893) ('While a man may cause his own life to be insured for the benefit of a stranger, and the want of insurable interest in the stranger will not invalidate the policy, a policy taken out by a man for his own benefit on the life of a stranger, would be void for want of insurable interest.');

Milano v. Cincinnati Equitable Ins. Co., 1992 WL 74293, at *1 (8th Dist. Ct. App. 4-9-92) ('Where an insured does not have an insurable interest in the subject matter of the policy, the policy is void.');

Western & Southern Life Ins. Co. v. Forrey, 8 Ohio L. Abs. 705, at *6 (1930).

FNInsurance contracts which lack an insurable interest are void as against public policy because courts view them as contracts that 'wager' on someone else's life. *Evans v. Moore*, 18 Ohio C.D. 1, 1905 WL 1170 (Ohio Cir. 10-1-1905). See also *Union Cent. Life Ins. Co. v. Hilliard*, 8 Ohio C.D. 437, 1898 WL 1629 (Ohio Cir. 1898) ('Where a third party, without any insurable interest in the life of another, procures a policy of insurance on the life of such person...the transaction is a mere speculation on the life of another, and, as such, contrary to public policy and void.').

FN12. *Endress v. Ins. Co.*, 1923 WL 2676 (2d Dist. Ct. App. Montgomery County 6-27-23) (explaining that 'in an action to recover premiums paid under a void insurance policy...[because] plaintiff became a party to an insurance contract illegal upon its face and contrary to public policy [and because] he must have known at the time he made the payments sought to be recovered that he had no insurable interest in the life of the insured,' the plaintiff was not entitled to recover the premiums paid).

FN13. See *Sudvary v. Ohio Farmers Ins. Co.*, 1984 WL 6351 (8th Dist. Ct. App. Cuyahoga County 12-6-84), quoting *Insurance Co. v. Pyle*, 44 Ohio St. 19, syllabus (1886) ('It has long been accepted that a material misrepresentation may void a policy of insurance: 'When a life policy is issued and accepted upon the expressed condition that the answers and statements of the application are warranted true in all respected, and that if the policy be obtained[] by any untrue answer or statement or by any fraud, misrepresentation, or concealment,' the

policy shall be absolutely null and void.').

FN14. The other is [R.C. § 3911.091](#), which mainly creates an insurable interest in participants of qualified employee pension plans. [R.C. § 3911.091](#).

FN15. [R.C. § 3911.09](#) (emphasis added).

FN16. [Section 2035 of the Internal Revenue Code](#) provides that, for estate tax purposes, the decedent's gross estate will include the proceeds of any life insurance policies, the ownership of which were transferred for less than adequate and full consideration by the decedent/insured within three years prior to death. [I.R.C. § 2035](#).

FN17. That is, an insurable interest.

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