First Report to the ABA of the Proceedings of the NCCUSL Drafting Committee on the "Insurable Interests Relating to Trusts" Uniform Act

Reported by David Neufeld, ABA Advisor to the Committee

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On March 1, 2008, the NCCUSL Drafting Committee on the "Insurable Interests Relating to Trusts" Uniform Act (the "Committee") convened its first meeting, after two months of preliminary exchanges of emails among committee members, the ABA Advisor and observers. The scope of the Committee's task is narrow: to address the issues that came to light with the *Chawla*[i] case in a uniform manner among the several states, presumably as an amendment to the Uniform Trust Act, with the alternative possibility that it might be enacted in any given state as an amendment to a state's insurance code.

Background

It might be safe to say that until the District Court for the Eastern District of Virginia weighed in on the interpretation of the Maryland insurable interest law as it applied to insurance trusts ("ILITs") in 2005 most estate planning practitioners gave little thought about whether an ILIT could acquire a life insurance policy. In fact it was assumed that this just was the case. Whether such blissful ignorance across the industry was merited or not, that case opened a can of worms with its secondary ruling that the trustee possessed no insurable interest in the life of the insured and the policy was *void ab initio*. The world of estate planners was rocked. When the Court of Appeals for the 4th Circuit had a chance to address this issue and bring us back to bliss they went only part of the way. In affirming the decision on the basis of the primary ruling, it vacated the District Court's secondary ruling on insurable interest as unnecessary dicta. This helped the litigants but still left this gaping hole in ILIT related planning for everyone else. The fix then became legislative.

As of this writing six states have enacted legislation in an attempt to restore order. While some seem to share similarities and others are completely distinct, in fact each has its own unique characteristic. In essence we have six different approaches developing. In an article published in the ACTEC Journal by Mary Ann Mancini and Howard Zaritsky,[ii] the authors thoroughly analyze the history of insurable interest law, both generally and as it relates to trusts, discuss the *Chawla* case and dissect the legislative responses to *Chawla* thusfar, concluding with a call for a uniform and better approach than is already out there for providing for an insurable interest law relating to a trust as purchaser of life insurance. This article precipitated the current effort by NCCUSL.

The Scope of the Drafting Project

The "Project Proposal Form" from the NCCUSL Committee on Scope and Program states:

> . . . [T]he study committee has concluded that a drafting committee should be created to amend the Uniform Trust Code by developing a bracketed provision that addresses the use of life insurance trusts in estate planning in a manner to eliminate any issues about the validity of the life insurance policy because of the possibility the trustee or trust has no insurable interest in the life of the person who is the subject of the insurance.

Thus, the drafting committee will attempt to draft a provision that would provide ILITs with insurable interest as otherwise defined in the relevant state's laws. The scope does not extend to revising what is and is not an insurable interest generally, but rather to adapt ILITs to the existing law.

The drafting committee is composed of several commissioners and myself as ABA Advisor. In addition the Chairman has invited interested individuals and representatives from interested organizations as observers to provide their views during preliminary consideration of the project.

Results of the first meeting

The Committee defined two issues that might be addressed within the scope of its charge, defined in shorthand as "the *Chawla* issue" and "the STOLI issue."

The first issue easily fits within the Scope, with the most complicated issue being how to provide a trustee with insurable interest in situations where one might intuitively expect there to be insurable interest but closer scrutiny creates some doubt. For instance there seems to be uniform acceptance among practitioners that if, as is the case, spouses and children have an insurable interest in a spouse/parent so too does a trustee of a trust benefitting these same individuals. Also, of course, the insured always has an insurable interest in himself and therefore practitioners might expect that a trust created by the insured as grantor has an insurable interest in the grantor. But, the question was raised, what about the following situations, among others:

1. some, most or all of the trust beneficiaries might be individuals themselves without insurable interest, such as cousins, grandchildren and spouses of grandchildren;
2. the trust contains spray and other discretionary provisions that might result in trust beneficiaries not on the list of those with insurable interests receiving all of the trust assets; or
3. the trust grantor is not the insured and in fact the trust is an ancient trust created generations ago by a grantor no longer living.

The second issue, referred to in shorthand as the STOLI issue (STOLI being the acronym for "stranger owned life insurance," also referred to as "investor owned life insurance" or IOLI, among other names), deals with those insurance sales that on its face satisfy all legal requirements but whose underlying facts might support a finding that an investor arranged with an insured (or someone else with an insurable interest in the insured) to acquire a policy pursuant to a pre-existing plan to purchase the policy from the policy owner sometime after the policy is issued. This might be susceptible to attack on a form-over-substance argument or similar judicial tool, leading to a conclusion that the policy is void, as the true owner might be held to be the investor without an insurable interest. In the context of ILITs, a STOLI transaction might also arise in a situation where a trust beneficiary is obligated from the inception of the transaction to sell his beneficial interest in the trust to an investor. In this case the trust might have the requisite insurable interest in the insured but a thorough review of the trust beneficiaries and their legal obligations might indicate an arrangement intended to side-step the insurable interest law. Thus one concern of the Committee is whether the trust's insurable interest depends on who are the trust's beneficiaries, both nominally and in reality. If so then the bona fide nature of those beneficiaries may be considered as within the Scope. If not, or if the general application of the insurable interest law as in existence would handle this problem, then it would seem to be an external issue.

Among the working assumptions to come out of the first meeting are:

1. The Committee's efforts will focus on the trust grantor as analogous to the acquirer of the policy, such that if the individual who is grantor would have an insurable interest in the insured had he acquired the policy directly, then the trust/trustee has insurable interest, notwithstanding who are the beneficiaries (with a possible fix for the ancient trust issue).
2. Understanding that STOLI in the context of trusts concern two possible types of transactions (one being the acquisition of the policy by the trust with the intent of <u>selling the policy</u> to an investor, and the other being the acquisition of the policy by the trust with the intent of a trust beneficiary selling <u>the beneficial interest in the trust</u> to an investor) the Committee's effort will not concentrate

on those situations which concern whether the trust bought a policy with the intent of selling it but instead will, at most, consider issues arising from the sale of beneficial interests. This may prove to be an issue better handled in the context of general insurable interest law and not necessarily in the context of trusts, i.e. if the insurable interest law of a given state looks to, inter alia, who receives the insurance proceeds, then perhaps this already includes an examination of who receives trust distributions composed of those insurance proceeds. Whether the Committee covers sales of beneficial interests or considers it also to be better folded into general insurable interest law will continue to be reviewed.

The Chair parceled out responsibilities to three meeting participants to draft versions of legislation with alternative approaches, inviting others to contribute if they wish.

Request for input and suggestions

The role of the ABA Advisor is to be a resource to the Drafting Committee as well as a conduit of information between interested parties within the ABA and the Chairman of the Drafting Committee. In that regard I am soliciting input from interested Sections and Committees concerning the issues outlined herein. Our next meeting is scheduled for October/November 2008 although progress is expected to be made with interim correspondence.

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[i] *Chawla, ex rel Geisinger v. Transamerica Occidental Life Insurance Co.*, 2005 WL 405405 (E.D. Va. 2005), *aff'd in part, vac'd in part*, 440 F.3d 639 (4th Cir, 2006)
[ii] "Insurable Interests: Apres *Chawla*, le Deluge?" 32 ACTEC Journal 194 (2006).