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COLI, BOLI, TOLI and 'Insurable Interests'

There have been a number of very important life insurance cases involving large publicly-traded corporations that purchased literally tens of thousands of policies on the lives of their employees.[1] We've asked Michel Nelson,[2] Vice-President and senior Trust Officer of Iowa Savings Bank in Carroll, to join us in focusing on the concept of insurable interest. Insurable interest is an aspect of these cases which did not receive much attention, but which we think is critically important—not only in future COLI (corporate-owned life insurance) cases but also in BOLI (bank-owned life insurance) and TOLI (trust-owned life insurance) arrangements as well as in situations involving FLPs and LLCs and in charitable planning. Michel has also created an invaluable table, which accompanies this article.

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Discussion concerning the recent COLI cases, *American Electric Power*, *Winn-Dixie*, and *C.M. Holdings, Inc.*,[3] has largely been limited to the question of deductibility of policy *loan* interest charges. Rarely discussed is the receipt by the corporation of death benefits from policies covering non-key employees that generally bear no relationship to the "loss" suffered by the corporate owner as a result of the non-key employee's death.

Background and purpose of the insurable interest rule

Under English common law, there was no prohibition against wagering on someone else's life using a contract of insurance. The law changed in 1774 with the adoption of the English Life Assurance Act. This three-part act was intended to prevent what was perceived to be a social evil—i.e., betting on someone else's life for profit. The act provided that:

- No insurance may be purchased by persons or other entities on the life of any person if the purchaser has no interest in the life being insured.
- Insurance contracts were required to include the name of the person or entity on whose account the contract was made or underwritten.
- Recovery under a contract of insurance was limited to the value of the interest of the purchaser in the life being insured.

In 1845, the Gaming Act was passed which provided that, "..contracts or agreements, whether by parole or in writing, by way of gaming or wagering shall be null and void."

Based on these precedents, each of the states in this country adopted some form of "insurable interest" statute or developed case law incorporating these ideas.[4] By statutory provision or case law, "insurable interest" was generally interpreted to permit the purchase of insurance covering the life of a spouse, minor child, an object of natural affection, and debtors (to the extent of the debt).

Corporate (or business-related) life insurance also came to be accepted when it involved key personnel and bore a rational relationship to the costs or losses that might be expected to be incurred as a result of the death of the person being insured. In addition, it was acceptable to use life insurance

to fund a buy-out of a decedent's interest in a business. Many states did require that the person whose life was being insured consent to the contract of insurance, although this is not strictly an "insurable interest" issue. The requirement of an "insurable interest" in the life insurance context generally must be met only at the time of creation.

COLI, BOLI, and TOLI insurable interest issues

Some promoters of COLI, TOLI, and BOLI have pushed the envelope of the "insurable interest" definition in order to maximize tax arbitrage sales opportunities. The recent history of the COLI evolution is ably discussed by the court in *American Electric Power, Inc. et. al.*[5]:

> In the late 1970s, a new form of cash value life insurance, known as "universal life," was introduced to the market. In a universal life policy, all of the economic components of the policy are revealed. The introduction of universal life had a significant impact on the life insurance industry by providing a product that could be marketed with an emphasis on investment goals and returns. With the introduction of universal life, the flexibility of life insurance as an investment vehicle was enhanced and the variations in the kinds of policies multiplied.
>
> *The tax advantages of life insurance*
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> Historically, Congress has deferred taxation of the inside buildup that occurs within a cash value life insurance policy. Additionally, death benefits have been exempt from taxation. Congress has, however, regulated and limited these substantial tax benefits by imposing restrictions on the amount of the investment component which can be built into a life insurance policy and by regulating the extent to which policyholders are permitted to access cash values without incurring tax consequences. Prior to the enactment of the Health Insurance Portability and Accountability Act of 1996 ("HIPA"), Pub. L. No. 104-191, 110 Stat. 1936, 2090, corporate policyholders enjoyed another significant tax advantage, namely the full deductibility of interest on policy loans. The combination of deferral of taxation of inside buildup, the exemption of taxation of death benefits, and the deductibility of interest on policy loans created the opportunity for tax arbitrage by corporate policyholders. Whenever the after-tax cost of a policy loan is less than the amount being credited to inside buildup, it becomes profitable to purchase life insurance and pay for it with policy loans. Not surprisingly, insurance industry entrepreneurs developed products for the corporate market which exploited this opportunity. Similar, although less sophisticated, products had been developed and marketed to high income individuals before Congress eliminated the deductibility of ordinary interest expense for individuals in the 1986 Tax Reform Act.

The court in *American Electric Power* further stated:

> Corporations have, for many years, purchased life insurance on the lives of their most valuable employees in order to protect the corporation against economic losses which would occur as a result of the untimely death of such an employee. This form of COLI is commonly known as key person life insurance. After it became widely accepted that corporations had an insurable interest in key employees, insurance companies began to market COLI as a funding vehicle for nonqualified deferred compensation plans, where the lives of the beneficiaries of the deferred compensation plans, usually executive-level employees, were insured and the death benefits were used to fund the deferred compensation obligation.[6] When these kinds of insurance programs began to exploit the tax arbitrage opportunities inherent in COLI, through the use of large policy loans, and the interest deductions which they generated, Congress reined them in by eliminating the interest deduction on policies in excess of $50,000. See I.R.C. section 264(a)(4)(B) (1994). Insurance industry entrepreneurs soon found a way to circumvent

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[1] Extensive commentary on these cases can be found at *Tax Planning With Life Insurance*, by Zaritsky and Leimberg (800-950-3055) and at http://www.leimbergservices.com.

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[3] American Electric Power, Inc., et al., 87 AFTR2d 2001-917 (DC Ohio, 2001); Winn-Dixie Stores, Inc., 113 TC 254 (1999); and In re C.M. Holdings, Inc., 254 B.R. 578, 86 AFTR2d 2000-6470 (DC Del., 2000).

[4] See also Blattmacher, "Assigning Insurance Policies to Charities," CPA Journal (New York Society of Certified Public Accountants), 1997, where the author notes, "All states have a requirement that no one can acquire a policy on the life of another person unless the acquirer has an insurable interest in the life of the insured. Basically, that means that the person acquiring the property is closely related to and/or financially dependent upon the insured. See McKinney's N.Y. Insurance Law, 3205(a)(1). Generally, spouse, children and certain others, such as business partners, will meet this test. Some states have passed legislation expressly providing that a charity is deemed to have an insurable interest in the life of any donor. See West's Annot. Cal. Code. 10110.1(f). Indeed, it can be argued that even in a state without such an express provision, in fact, charities do have an insurable interest because they are dependent upon anticipated future donations."

[5] 87 AFTR2d 2001-917 (DC Ohio, 2001).

EXHIBIT 1
BOLI Programs

	2000	1999	1998	1997
BOLI premiums paid	None	None	$300,000,000	$400,000,000
12-31 BOLI value	$804,941,000	$765,399,000	727,837,000	400,000,000
BOLI value increase from prior year	39,542,000	37,562,000	327,837,000	400,000,000
BOLI Income	39,544,000	37,560,000	28,712,000	None
BOLI income as % of prior yr. bal.	5.2%	5.2%	7.2%	Not applicable

this limitation by designing programs in which a corporation could purchase insurance policies on a large number or even all of its employees. These "broad-based" COLI plans could include any employee regardless of the length of employment or the value of the employee's services to the corporation. Thus, by increasing the number of policies issued, the opportunity for policy loans and loan interest deductions could be multiplied while remaining within the $50,000 per policy loan limit. These efforts to continue the exploitation of the tax arbitrage opportunities of COLI caused Congress to consider additional legislation to limit or eliminate the deductibility of interest on policy loans.

Interested members of the insurance community have worked to change "insurable interest" statutes to permit COLI policies covering large numbers of employees in a company. One employee benefits company in particular boasts in its advertising that, "Our legal experts drafted the first comprehensive insurable interest laws for corporate benefit financing in Georgia and Connecticut. The Georgia law has become a model for numerous other states. Various clarifying modifications have been made in response to changing business conditions."

The statement of legislative intent that accompanied New York's insurable interest revision in 1996 stated that,

> The legislature hereby finds and declares that assisting employers in developing innovative means of financing employee health and other benefits is in the best interests of the working people of this state. This legislation is intended to achieve that goal by authorizing businesses to purchase insurance on the lives of their employees in order to fund employee benefit plans which provide retirement, health and life insurance and deferred compensation benefits, a product known as corporate or trust-owned life insurance.

Where the new statutes have been enacted, the "insurable interest" concept has moved far beyond the historical anti-wagering public policy. Instead, the adopting legislatures have just simply declared that employees benefit when employers are allowed to use COLI policies covering the employees' lives and these states permit use of the tax-advantaged COLI plans up to an amount that reasonably covers specified employee benefit obligations of the employer-company.

Consider, however, the argument that could be made to counter this rationale: A party seeking to question the existence of an entity's insurable interest could justifiably ask:

- Do the employees actually benefit?
- Aren't employee wage and benefit levels as well as perquisites more closely tied to general market factors than to the profitability of the employer?
- Aren't corporations with large COLI/BOLI plans

6 See OCC Interpretive Letter No. 848 and OCC Bulletin 96-51 (which supercedes a 1983 Letter to the contrary) regarding the OCC (Office of the Comptroller of the Currency) position on life insurance in connection with nonqualified deferred compensation for bank executives and directors. The OCC determined that insurance purchased on the lives of executives and directors of banks is an appropriate investment for banks when purchased as a funding mechanism for nonqualified deferred compensation plans. The OCC stated that there were two reasons for banks to purchase the insurance in this context: (1) to meet the bank's contractual obligations of payments upon early, normal, or late retirement as well as to pay families of covered employees at their deaths, and (2) to serve as an actuarial cost recovery vehicle.

The issue arose during a routine bank audit. Bank auditors requested guidance from Washington as to whether there was a requirement under banking law that payments of life insurance proceeds to individuals under a nonqualified retirement plan had to be made in a lump sum, or whether post-employment payments could be made in installments. Here, payments were to be made in equal monthly installments for 15 years. The OCC concluded that "having been purchased in connection with employee compensation and benefit plans," the life insurance was an appropriate investment for the bank.There are two key points: First, it is important here that the policies were owned by, and the insurance proceeds were payable directly to, the bank in question, and the policies would never pass into the hands of the covered bank employee. Second, the authors think it's essential to document that the bank's obligation to make payments under the nonqualified deferred compensation plan would have existed with or without the presence of the insurance, and that the policy proceeds served to reduce or eliminate that existing obligation.

responsible for the employee benefits in any event?

- Is it reasonable to assume that most of the insurance-generated tax savings go to shareholders and/or management?
- If a corporation benefits from the death of an employee to an extent much greater than the corporation's possible loss, isn't that striking at the heart of the original anti-wagering public policy? (Although it may be obvious, we note that the corporation's future income stream can be predicted with great accuracy when many thousands of lives are being insured. It becomes relatively easy to compare the anticipated returns of an ordinary taxable use of money with the tax-advantaged use of COLI. In this sense, it is not a wager, but an almost sure thing provided that the expected tax advantages and insurance proceeds are not lost.)
- If the same death benefit is used for each employee, doesn't this fact tend to indicate that the employer made no effort to determine what loss the company would suffer if any particular employee died?

Specifically, it appears difficult for corporate owners to claim an "insurable interest" when the amounts of insurance coverage bear absolutely no relationship to any loss or cost that might be incurred by the corporation with regard to a given employee's death. But if states have enacted generously broad insurable interest laws, and insurers are willing to sell insurance contracts (indicating by their willingness to accept the risk and issue coverage that they are unconcerned about the economic risk to their company, policyholders, or shareholders of "adverse selection"), where's the problem?

In at least one recent case, *Tamez*,[7] where the employer was the owner and beneficiary of an accidental death policy that paid it $250,000 each time one of its employee-convenience store clerks was killed while working, the court granted the employees' estates the right to raise the insurable interest issue, and permitted the estates to claim a right to the death benefit.

Is this anything to worry about? It could be rationalized that, in most states, only the insurer can raise the issue of lack of insurable interest.[8] It's also true that insurers issuing large COLI policies are not likely to raise an insurable interest question. But this may change because the world (and litigation attorneys) abhors a vacuum.

BOLI issues

The Comptroller of the Currency oversees the use of COLI programs by banks (BOLI) and issued guidelines last year in OCC Bulletin 2000-23 (7/20/00), replacing OCC 96-51 covering the purchase of BOLI plans. Among other things, the bulletin requires consideration of state insurable interest laws. Although this bulletin covers only national banks, as a practical matter, regulators of other banks will be using the same guidelines. Often, there is no specific statutory authority for banks to purchase life insurance, and they must rely on regulators to deem it a permissible investment. This fact makes it particularly important to comply with the regulator's pronouncements.

Banks have much in common with other corporate owners. But they also have the additional risk of dealing with banking regulators as well as the additional opportunity to purchase life insurance covering individual borrowers (normally with a decreasing balance and termination at loan payoff) and pools of mortgage clients (typically maintained until death or for a set term and not a decreasing balance). Some banks use the latter as an additional profit source because the income may exceed the amount due to the bank on the underlying obligation.

The dollar amounts involved in BOLI programs can be substantial—in some cases, almost astonishingly large. For example, Exhibit 1 shows an excerpt derived from the annual reports and SEC filings of Huntington Bancshares, Inc.

Bulletin OCC 2000-23 requires that the purchase of BOLI "...must address a legitimate need of the bank for insurance. Life insurance may not be purchased to generate funds for the bank's normal operating expenses, for speculation, or for the primary purpose of providing estate planning benefits for bank insiders unless it is part of a reasonable compensation package."

Having satisfied this requirement and the normal considerations of rate of return and financial soundness of the issuer, banks must also consider the risk that the estate of the covered employee will have a claim to the death benefit or that the governing state's public policy may prevent the bank, as beneficiary, from receiv-

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7 Tamez v. Certain Underwriters at Lloyd's, London, Int'l Accident Facilities, Inc., 999 S.W.2d 12 (Tex.App.-Houston, 1999). The Texas Supreme Court has denied a petition for review on Tamez and later denied a request for rehearing on the first petition.

8 See *Couch on Insurance* 3D § 41.5, n. 37 (1995).

EXHIBIT 2

Summary of Life Insurance 'Insurable Interest' State Statutes

State	Statutory Reference
Alabama	§27-14-3: Insurable interest in personal insurance; insurable interest of corporations and charitable institutions.
Alaska	21.42.020: Insurable interest: personal insurance.
Arizona	20-1104: Insurable interest with respect to personal insurance; definition.
Arkansas	23-79-103: Insurable interest; personal insurance.
California	§10110.1 Ins.
Delaware	18 Del. C. §2704: Insurable interest; personal insurance. 18 Del. C. §2708: Consent of insured; life, health insurance.
District of Columbia	§35-521: Rights of parties under life policies.
Florida	627.631: Third-party ownership. 627.404: Insurable interest; personal insurance.
Georgia	33-24-6: Consent of insured to insurance contract; exceptions; reliance by insurer on statements in application. 33-24-3: Insurable interest; personal insurance.
Hawaii	§431:10-202: Definitions.
Idaho	41-1804: Insurable interest; personal insurance.
Illinois	215 ILCS 5/224.1.
Indiana	IC 27-1-12-17.1 Sec. 17.
Iowa	See Reilly v. Penn Mut. Life Ins. Co. of Philadelphia, 207 N.W. 583 (1926).
Kansas	40-452: Life insurance; employer's insurable interest in employees; when.
Kentucky	304.14-040: Insurable interest.
Louisiana	22:613: Insurable interest required; personal insurance.
Maine	24-A M.R.S.A. §2404: Insurable interest; personal insurance.
Maryland	§12-201 INS: Requirements for procuring life insurance; definition of insurable interest; requirements for institutions, trusts to procure life insurance.
Massachusetts	G.L.C. 175, §123A: Insurable interests of corporations.
Michigan	500.2210: Definitions; insurable interest; employer; trust; exemption from claims.
Minnesota	61A.074: Insurable interests.
Mississippi	§83-5-251: Procurer of insurance must have insurable interest; insurable interest defined; insurer reliance on applicant's representations; insurable interest of charitable, etc. organization.
Missouri	376.531: Life insurance policies, consent of insured required; exceptions—employers have insurable interest in employees, when, effects.
Montana	33-15-201: Restrictions on contracting for personal insurance: insurable interests; violation.
Nebraska	44-103: Terms, defined.
Nevada	NRS 687B.040: Insurable interest; personal insurance.
New Hampshire	408:2: Third person.
New Jersey	17B:24-1.1: Insurable interests.
New Mexico	59A-18-4.
New York	§3205 Ins.: Insurable interest in the person; consent required; exceptions.
North Carolina	58-58-75: Insurable interest in life and physical ability of employee or agent.
North Dakota	26.1-29-09.1: Insurable interest in personal insurance.
Ohio	§3911.091.
Oklahoma	§36-3604: Insurable interest with respect to personal insurance.
Oregon	743.024: Insurable interest and beneficiaries; personal insurance.
Pennsylvania	40 P.S. §512: Application for insurance; insurable interest.
Rhode Island	§27-4-27: Insurable interest.
South Carolina	§38-71-640: Person with insurable interest may take out policy on insured. §38-37-760: Beneficiaries.
Tennessee	56-26-112: Third-party ownership.
Texas	Art. 3.49-1 INS. CODE: Life insurance; designated beneficiaries or owners; insurable interest.
Utah	31A-21-104: Insurable interest and consent.
Vermont	8 V.S.A. §4069: Third-party ownership. 8 V.S.A. §3802: Group contracts must meet group requirements.
Virginia	§38.2-301: Insurable interest required; life, accident and sickness insurance.
Washington	RCW 48.18.030: Insurable interest; personal insurance; nonprofit organizations.
West Virginia	§33-6-2: Insurable interest in one's own life or life of another; actions to recover benefits; insurable interests defined; requirements for charitable institutions.
Wisconsin	631.07: Insurable interest and consent.
Wyoming	26-15-102: Life insurance upon individual or person in whom he has insurable interest; insurable interest defined.

ing the death benefit because it lacks an insurable interest.[9]

Choice of law issues

Under the McCarran-Ferguson Act, state law will normally govern the insurable interest questions. At first glance, it appears that the question of which state's law applies is simple. But that appearance is true—only if all factors point to a single state.[10] For example, a corporation may have its headquarters in one state, a physical presence and employees in many other states, insurance policies contracted for in yet a different state, and delivery of the policies made to a trustee in a specially selected state from where the trustee pays the premiums.

It is not at all clear which insurable interest laws will apply and how aggressive any particular state will be in claiming an interest in governing policies issued on the lives of its residents. The laws of the states are wildly diverse and there is almost a total dearth of case law.

Nor is it sufficient to obtain a written assurance from the insurer that the insurer will not raise any insurable interest defenses, because there are other parties that may raise the issue (as was done in *Tamez*). The obvious solution would seem to be to secure written consents from the covered employees. But obtaining consents from all employees containing permission to obtain insurance and also designating the choice of forum may not be dispositive because—in a company-wide plan—litigation counsel could argue that there will always be an implied threat of retaliation for refusal to sign.

NYPD Blue warning

"Be Very Very Careful Out There!" is our main message. *Tamez* is a warning that insurable interest is a concept that must be very carefully investigated by all the parties in a COLI, BOLI, or TOLI situation, or if insurance is owned by an FLP/LLC or a charity. Planners, counsel, and clients must be satisfied that the plan falls well within the appropriate state's laws (and more conservatively, within the laws of all the possible states that may claim jurisdiction).

Resources

A comprehensive and useful discussion of "insurable interest" in the State of New York and the interaction with COLI has been published at the New York State Insurance Department website and may be found at www.ins.state.ny.us/acrobat/colitoc.pdf.

The chart in Exhibit 2 summarizes the "insurable interest" statutes of most, but not all, states. It should be used as a quick reference, but is not intended to be solely relied upon. The potential quirks of individual states are beyond the scope of this column. Specific statutes affecting charitable ownership are not included in the material in Exhibit 2. ■

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9 At least one major law firm has expressed public concern about the regulatory issues and insurable interest laws as they apply to COLI/BOLI. See Mayer, Brown & Platt, The Financial Services Regulatory Report, Vol. 8, No. 2 (Mar/Apr 2001).

10 In the soon-to-be published *Tools and Techniques of Charitable Planning*, National Underwriter Company (800-543-0874), the authors state with respect to charitable planning, "In order for an insurance policy to be considered valid, it must meet the insurable interest rules in the state in which it is issued. If the policy is found to have violated these rules when issued, the insurance company can later argue that the policy was void from the beginning and may refuse to pay the death benefit at the insured's death. While charity is assumed to have an insurable interest in the life of a donor in most states, there may be unusual quirks in the state code which must be followed to the letter in order to avoid having the contract nullified later. For example, if a charity located in New York purchases a policy on the life of a donor residing in California, the insurable interest rules for New York (the location of the policy owner) must be met."

If one party purchases a policy but the ownership is immediately transferred to another party, the insurance company may later attempt to void the contract if the insurable interest rules for either owner are in any way not met. In the example above, if a California donor purchases the policy on his own life and then immediately transfers the policy to the New York charity, the policy could be found void if New York's insurable interest laws are not closely followed. Technically, California's laws should apply since the policy was issued in California, but the insurance company can assert that New York's laws should apply since the policy was only temporarily owned by a California resident in anticipation of transferring it to New York.

Baskies and Samuels in "Aggressive Viatical Settlement Transactions: Gambling on Human Lives," 28 ETPL 76 (Feb 2001), present a sobering discussion of the issue. They point out that the viatical area is replete with so-called "wet-ink" transactions that may be invalid, fraudulent, and outright illegal. The issue is again the concept of "insurable interest," the absence of which makes what would have been a contract nothing more than "a mere wager, by which the party taking the policy is directly interested in the early death of the insured." Because such actions tend to precipitate or encourage the event, they are typically considered as being against public policy. The validity of the contract or subsequent assignment will depend both on the good faith of the parties and state law. The presumption of a wagering intent will typically nullify either the contract or the assignment (even if the policy may have been valid at inception). "Certainly, 'wet-ink' transactions," the authors point out, "raise serious suspicion as to their intent and validity."

In Ltr. Rul. 9110016, where the insurance purchase did not meet state insurable interest laws, the IRS denied income, gift, and estate tax charitable deductions. In response to Ltr. Rul. 9110016, New York State changed its law. The new law makes it clear that an insured's immediate assignment of a policy, whether to charity or otherwise, is valid. But that law does not expressly state that charities have an insurable interest in the lives of donors. This suggests that a donor should purchase the life insurance in his/her own name and later transfer it to the charity. It is essential that the laws of the state where the policy owner is domiciled be met. For example, if a California donor purchases a policy and immediately transfers it to the New York charity without meeting the specific terms of the New York insurable interest laws, he could lose his income tax deduction for the gift. Moreover, because the donor originally owned the contract, the death benefit will be in his taxable estate for three years following the date of the donation. If he should die within this time frame, the charity would receive the death benefit but, absent insurable interest, the donor's estate would have no offsetting estate tax charitable deduction. Furthermore, the decedent's personal representative could arguably have the right to be reimbursed by the charity for the estate taxes due on the death benefit.