# Demystifying the Insurable Interest Rule for life insurance

The laws of most states require that, at the time a life insurance policy is issued, the owner of the policy must have an insurable interest in the life of the individual insured under the policy. This is known as the Insurable Interest Rule, and it's an essential concept related to life insurance contracts.

Generally, a life insurance company will not allow the purchase of a policy unless the applicant can demonstrate that, as the proposed policy owner, they have an insurable interest in the life of the proposed insured.

But establishing whether the policy owner has or will have – or perhaps, no longer has – an insurable interest is not as simple as it may seem. In fact, proving the existence of an insurable interest is often not a bright-line test. Determining whether an insurable interest exists requires

1. an examination of the specific facts regarding the relationship between the owner and the insured; and
2. a review of the insurable interest statute in the state in which the policy will be sold.

Here, we'll cover the Insurable Interest Rule generally, as well as explain the reasons for the Rule. We'll also provide specific examples of situations where an insurable interest clearly exists, as well as examples of situations where an insurable interest does not exist or may no longer exist.

## WHAT IS AN "INSURABLE INTEREST" FOR LIFE INSURANCE PURPOSES?

As a general matter, an insurable interest is present where the person buying a life insurance policy has more to lose than to gain, either emotionally or financially, by the insured's death.[1]

Underlying the concept of insurable interest is a general principal that the owner of a life insurance policy should have a legitimate interest in the insured living a normal life expectancy. If someone has an insurable interest in the insured, then it generally means that they would experience a potential financial loss or economic hardship if the insured were to die.

To put it another way: If the insured dies, then the loss the applicant would potentially suffer must be sufficient to warrant compensation (i.e., the policy death benefit).

## WHAT IS THE REASON FOR THE INSURABLE INTEREST RULE?

There are several reasons states have implemented an Insurable Interest Rule. A primary reason for the Rule is to discourage speculating, gambling, or wagering based upon a person's life.

Requiring an insurable interest prevents potential speculators from buying insurance on a person's life in the hope that the insured will die before the amount paid as premiums exceeds the death benefit amount. The rule effectively decreases the financial incentive, particularly by a speculator, to hasten the insured's death in order to collect a death benefit.

## WHEN MUST AN INSURABLE INTEREST EXIST?

Most states and insurance companies require the existence of an insurable interest only when the contract is issued. There is generally no requirement that a beneficiary have an insurable interest. Likewise, if the policy were later assigned to a subsequent owner, there is typically no requirement that the assignee of the policy must have an insurable interest.

[1] See Howard M. Zaritsky & Stephan R. Leimberg, *Tax Planning With Life Insurance* Section 1.15 (2nd ed. 2012).

## EXAMPLES OF WHEN AN INSURABLE INTEREST GENERALLY EXISTS

As already mentioned, the existence of an insurable interest is a factual question. Life insurance companies will generally find an insurable interest exists where there is a bloodline relationship (e.g., parent-child); a relationship based on personal love and affection (e.g., spousal relationship); or a legitimate economic relationship (e.g., a business and its owners, key employes, officers, and/or directors).

Generally, if the applicant and insured are the same person, an insurable interest will certainly exist. In fact, an individual has an unlimited insurable interest in his or her own life. Family members are also often found to have insurable interests in each other. Although not intended as an exhaustive list, here are a few other common examples of relationships with insurable interests, in which the insured is also the applicant:

- Spouse or former spouse
- Parent or grandparent
- Child or grandchild
- Sibling
- A dependent who does not have legal capacity (e.g., an adult child with special needs)
- Employee (depending upon specific circumstances)

Some states allow a creditor, at the creditor's own expense, to obtain life insurance on a debtor (so long as the debtor consents and the amount of insurance is reasonably related to the amount of the debt). Common examples include life insurance to pay off a mortgage (sometimes referred to as credit life insurance).

Some states also consider individuals who are engaged to be married to have an insurable interest in each other.

In some situations, a guardian, trustee, or other fiduciary, acting in a fiduciary capacity, may also have an insurable interest in the life of any person for whose benefit the fiduciary holds property.

## EXAMPLES OF WHEN AN INSURABLE INTEREST MAY NOT EXIST

The following are a few examples where an insurable interest will not be found to exist between the applicant and the proposed insured:

- The applicant and proposed insured are distant relatives, such as cousins, aunts, uncles, nieces, or nephews.
- Situations where premiums for a life insurance policy are funded by investors who do not personally have any relationship to the insured. This arrangement, and similar arrangements, are sometimes referred to as "stranger-owned life insurance," or by the acronym, "STOLI."

## EXAMPLES OF WHEN AN INSURABLE INTEREST MAY NO LONGER EXIST

Even though insurable interest is mandatory at the time a life insurance policy is issued, an insurable interest does not have to exist at the time of the insured's death.

For example, assume a company purchases life insurance on a key employee who is notified of and consents to being insured. Undoubtedly, an insurable interest existed between the employer and the employee when the policy was issued. However, if the employee retires or employment is otherwise terminated, then an insurable interest will likely not continue to exist.

This does not mean that the employer cannot continue to own the policy after the individual is no longer employed. However, the employer may be unable to exchange the policy under IRC Section 1035.

## WHAT HAPPENS IF THE INSURABLE INTEREST RULE IS VIOLATED?

Let's assume, for this example, that a stranger convinces an individual to let the stranger purchase a policy insuring the individual's life. Further, assume that as an incentive for the individual's participation in the application for insurance, the stranger offers to pay the individual.[1]

Even if the policy were to be issued, the policy may be void (i.e., it is treated as though it never came into existence) or voidable for lack of an insurable interest. Some states may allow a court to order the death benefit be paid to someone who is equitably entitled to the proceeds, rather than the named beneficiary.

In some cases, where no insurable interest existed, the insurance company may be required only to return the premiums paid (possibly with some amount of interest, depending on the state where the policy was issued).

## CONCLUSION

Establishing an insurable interest between the policy applicant (or proposed owner) and the proposed insured is required for life insurance.

There are, of course, situations in which someone may have valid reasons for wanting to establish insurable interest in someone who is not a close relative or a key business associate, and the insurable interest may be less obvious.

A threshold step before applying for life insurance is to review and become familiar with the insurable interest statutes in the state where the policy will be issued. The statute will identify situations where an insurable interest is presumed to exist, as well as any specific requirements that must be followed (e.g., some states require the insured's consent). If the relationship between the applicant and the insured falls outside of state law, it may be difficult to purchase life insurance.

As an alternative, the applicant wanting the insurance could ask the proposed insured to apply for the policy and name the former proposed applicant as a beneficiary. As already explained, because state law and life insurance companies generally assume an individual has an insurable interest in their own life, this alternative should satisfy insurable interest requirements.

[1] Generally, the consent of the proposed insured is required as part of the application before a policy would be issued (subject to certain exceptions, such as a parent purchasing life insurance on a minor child).