



The Awe of *Dawe*?

By: Brian T. Casey

In September 2011, the Delaware Supreme Court answered several certified questions put to it by the federal district court in Delaware in the pending cases of *PHL Variable Ins. Co. v. Price Dawe 2006 Ins. Trust* and *Lincoln Nat'l Life Ins. Co. v. Joseph Schlanger 2006 Ins. Trust*. Both cases involve actions by life insurers seeking to have the federal district court to declare that the life insurance policies they have issued to trusts formed by the insureds are void based primarily on lack of insurable interest involving the same investor's purchase of the beneficial interests of the trusts shortly after issuance of the policies. In both cases, the insureds died almost three years after issuance of their respective policies and well after the end of their two-year contestability periods.¹ In each case, the defendants moved to dismiss the insurer's complaint, asserting that the policy's two-year contestability period barred the insurer's claim. The federal court denied the motions and asked the Delaware Supreme Court for its opinion.

A wide variety of observations about the effects of these decisions has already surfaced, ranging from statements that the decisions are very favorable to the insurers on the one hand to claims that the decisions are advantageous to the secondary life insurance market on the other hand.

The three certified questions to the Delaware Supreme Court were as follows:

1. Does Delaware law permit an insurer to challenge the validity of a life insurance policy based on a lack of insurable interest after the expiration of the two-year contestability period required by 18 Del. C. § 2908?
2. Does 18 Del. C. § 2704(a) and (c)(5) prohibit an insured from procuring or effecting a policy on his or her own life and immediately transferring the policy, or a beneficial interest in a trust that owns and is the beneficiary of the policy, to a person without an insurable interest in the insured's life, if the insured did not ever intend to provide insurance protection for a person with an insurable interest in his or her life?
3. Does 18 Del. C. § 2704(a) and (c)(5) confer upon the trustee of a Delaware trust established by an individual insured an insurable interest in the life of that individual when, at the time of the application for life insurance, the insured intends that the beneficial interest in the Delaware trust would be transferred to a third-party investor with no insurable interest in that individual's life following the issuance of the life insurance policy?



Delaware's two statutes governing incontestability clauses state:

There shall be a provision that the [life insurance] policy shall be incontestable after it has been in force during the lifetime of the insured for a period of not more than two years after its date of issue, except for (1) nonpayment of premiums, and (2) at the insurer's option, provisions relating to benefits in the event of total and permanent disability and provisions granting additional benefits specifically against death by accident or accidental means.

A clause in any policy of life insurance providing that such policy shall be incontestable after a specified period shall preclude only a contest of the validity of the policy and shall not preclude the assertion of any defenses based upon provisions in the policy which exclude or restrict coverage, whether or not such restrictions or exclusions are excepted in such clause. 18 Del. C. § 2908 (2011) and 18 Del. C. 2917.

With respect to the first certified question, whether the expiration of the contestability period of a life insurance policy prevents a life insurer from rescinding a policy for lack of insurable interest, the Court concurred with the majority view of the courts of many other states having ruled on this issue that lack of insurable interest creates an illegal wagering contract that is not time barred to its challenge by an incontestability clause required to be contained in the contract. Because an illegal wagering contract is a contract that never came into existence, the Court stated that the incontestability clause does not operate. This result should not be a surprise to either the primary or secondary life insurance industry, although it is important to note that the Court rejected the reasoning of the New York case of *Caruso*, which held that under New York law an insurer cannot rescind a life insurance policy for lack of insurable interest by the policyholder in the insured's life after the end of the policy's contestability period, and distinguished the recent New York *Alice Kramer v. Phoenix Life Ins. Co.* case, which was based on a somewhat unique New York insurable interest statute and thus has limited impact outside of New York. In *Kramer*, the New York Court of Appeals concluded that Mr. Kramer had procured on his own the policies on his life and that the assignment of the policies to an investor immediately after their issuance was not a violation of New York's insurable interest law, even though neither Mr. Kramer nor his trusts paid any premiums for the policies at issue.

Interestingly, however, is the road by which the Court found its way to the answer of this question. The Court found that the phrase "the validity of the policy" as used in one of the Delaware incontestability statutes was ambiguous, leading the Court to apply Delaware common law and conclude that an incontestability clause is subservient to the formation of a valid contract, which does not exist for a life insurance policy devoid of insurable interest and thus an illegal wagering contract. This appears to be the first case in which a court had found an incontestability statute to be ambiguous.

Given that the inapplicability of an incontestability clause to an insurable interest challenge has been the law for many years in most other jurisdictions, one might ask why is this issue being litigated in 2011? The reasons are simple: not all states have judicially adjudicated the issue, and the policyholders attempting to thwart the insurable interest challenge had no downside in trying to throw a "Hail Mary" pass on the question, particularly given the wide attention which the *Kramer* case had seemed to engender, possibly because the *Kramer* decision was, in many respects, somewhat of a surprise to the industry. The bottom line, however, is that the *Dawe* ruling on this question is not anything new.



Nevertheless, in answering the second certified question, the Delaware Supreme Court went on to hold that the intent of a policyholder immediately to transfer a newly purchased life insurance policy (or a beneficial interest in a trust that owns and is the beneficiary of the policy) to a person without an insurable interest in the insured's life is **not** a violation of insurable interest as long as (1) the insured procured or effected the policy and (2) the policy is not a mere cover for a wager, which arguably is a setback for the life insurers which sought to establish this as the basis for testing insurable interest.²

It is arguable that the Delaware Supreme Court's examination of an insured's intent was resolved similarly to the resolution of that issue in the *Kramer* case. Both cases stand for the proposition that the insured's subjective intent is not relevant. Where the *Kramer* and *Dawe* analyses differ is the next step. In *Kramer*, that was the end of any inquiry; in *Dawe*, the Court determined that it was still necessary to determine whether a third party with no insurable interest in the life of the insured used the insured as a means to procure a life insurance policy.

The Delaware law recognizes that an insured may take out an insurance policy on his or her own life. However, the statutes go on to provide that if someone else takes out the policy, then the beneficiary under the policy must have insurable interest. In *Kramer*, the New York court didn't reach the second part. In *Dawe*, however, the Delaware court said if we determine that someone other than the insured caused the insured to take out the policy, then we are into the second element and require that the beneficiary have an insurable interest. The discussion by the Delaware court of *Kramer* and the New York insurance code as contrasted to the Delaware insurance code is, to be frank, not exactly correct.

In determining whether an insured, or rather another person without an insurable interest, really procured a life insurance policy, the Court established a somewhat black and white primary litmus test for determining whether a valid insurable interest exists, stating that examining who paid the premiums for the policy is strong evidence of who in fact procured the policy and whether the policy is a cover for a wagering contract. The Court reiterated that the insured's subjective intent to transfer the policy is not the relevant inquiry. The Court indeed stated that the insured has a right to take out a policy with the intent to immediately transfer the policy, but emphasized that such right is not unqualified. "That right is limited to bona fide sales of that policy taken out in good faith." The Delaware statute requires that the insured procure and effect a policy on his own life and went on to state that "an insured cannot 'procure or effect a policy without actually paying the premiums.'" Here again, though, the Court found for a second time that the Delaware incontestability statute was ambiguous and had to resort to the Delaware Constitution to reach its conclusion. In the *Dawe* and *Schlanger* cases, the investor paid the premiums, which is a key fact supporting lack of insurable interest. The flip side, however, to this holding is that the Court may have actually narrowed the focus and test for assessing whether an investor procured a policy as it leaves open the result that an insured with clear financial capacity to pay premiums could fund his own premiums, yet buy a policy for the specific purpose of reselling it to an investor, making it more difficult for an insurer to prove another theory for voiding a policy for lack of insurable interest in some states, which is the existence of a prearrangement between the policy purchaser and an investor for the policy to be sold to the investor after the policyholder has used his own funds to buy the policy.

In other words, under the analysis in the *Dawe* case, such a prearrangement arguably might not violate the Delaware insurable interest requirements.



The *Dawe* and *Schlanger* cases do not address the financing of premiums by a premium finance loan, and thus do not stand for the proposition that a premium finance loan made to an insured *per se* means that the insured did not fund policy premiums and not procure the policy himself or herself. Indeed, such a result would be questionable given that insurance premium financing is authorized and regulated in the majority of states, including Delaware.

Finally, with respect to the third certified question, the Court held that a trust has same insurable interest as the grantor insured has if the insured funded his or her own trust to purchase the policy, regardless of whether the trust's beneficiaries had planned from the get-go to sell their beneficial interests in the trust to an investor. Moreover, the Delaware insurable interest statute governing the insurable interest of a trust which existed when the policies were issued, as well as the current statute, does not require that the beneficiaries of a life insurance trust have their own independent insurable interest in the insured. Therefore, potentially an insured with financial capacity to pay premiums could form his or her own trust, fund the trust to pay some premiums, name an investor as the beneficiary of the trust, yet cause the trust to buy a policy for the specific purpose of allowing the investor to make a loan to the trust to pay the balance of the policy's premiums and effectively acquire all the policy's death benefits to repay the loan.

So, for all the hullabaloo about the *Dawe* and *Schlanger* cases, upon a close reading of the Delaware court's opinion, these cases really are equally victories for both the primary and secondary life insurance markets. The Delaware Supreme Court spoke very highly about the secondary market for life insurance policies. "The market provides a favorable alternative to allowing a policy to lapse, or receiving only the cash surrender value. The secondary market for life insurance is perfectly legal. Indeed today, it is highly regulated,...and all states permit the transfer or sale of legitimately procured life insurance policies."

Endnotes

- 1 The incontestability clause of the Dawe trust's policy expressly permits the insurer to contest the policy for fraud, while the Schlanger trust's policy does not.*
- 2 This holding begs the question of whether a question in a life insurance application regarding the intent of an applicant for life insurance later to resell the policy applied for is now appropriate. However, it is more likely than not that a 'fraudulent' answer to this question on a life insurance application could not serve as a basis for a carrier to deny payment of the death benefit post contestability period.*

For more information, please contact the author:

Brian T. Casey | T: 404-870-4638 | bcasey@lockelord.com