INSURABLE INTEREST AMENDMENTS TO THE UNIFORM TRUST CODE

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INSURABLE INTEREST AMENDMENTS TO THE UNIFORM TRUST CODE

[SECTION 113. INSURABLE INTEREST OF TRUSTEE.

(a) In this section, "settlor" means a person that executes a trust instrument. The term includes a person for which a fiduciary or agent is acting.

(b) A trustee of a trust has an insurable interest in the life of an individual insured under a life insurance policy that is owned by the trustee of the trust acting in a fiduciary capacity or that designates the trust itself as the owner if, on the date the policy is issued:

(1) the insured is:

(A) a settlor of the trust; or

(B) an individual in whom a settlor of the trust has, or would have had if living at the time the policy was issued, an insurable interest; and

(2) the life insurance proceeds are primarily for the benefit of one or more trust beneficiaries that have[:

(A)] an insurable interest in the life of the insured [; or

(B) a substantial interest engendered by love and affection in the continuation of the life of the insured and, if not already included under subparagraph (A), who are:

(i) related within the third degree or closer, as measured by the civil law system of determining degrees of relation, either by blood or law, to the insured; or

(ii) stepchildren of the insured].]

Comment

Every state requires, either as a matter of statutory or common law, that a purchaser of life insurance on another individual have an insurable interest in the life of the insured. See

generally Robert H. Jerry, II & Douglas R. Richmond, Understanding Insurance Law, §§ 40, 43 (LexisNexis Publishing, 4 ed., 2007), at 273-77, 293-98. The definition of insurable interest became a matter of widespread concern among trust and estate planners after *Chawla ex rel Giesinger 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), where a Virginia federal district court applying Maryland law held that a trust did not have an insurable interest in the life of the insured who was the settlor and the creator of the trust. This portion of the district court's decision was subsequently vacated by the Fourth Circuit when holding that the district court's decision should be affirmed on other grounds, but the appellate decision did not question or criticize the district court's insurable interest analysis. The Maryland legislature subsequently enacted a statute in the state's insurance code clarifying the circumstances when a trustee or trust has an insurable interest in another's life, and several other states have enacted various forms of statutory clarification designed to address the "*Chawla* problem." During this process, the American College of Trust and Estate Counsel, among others, expressed the opinion that it would be best if a uniform approach could be fashioned in resolving the matter.

Consequently, the Uniform Law Commission, after studying the issue, decided to clarify the issue with respect to the Uniform Trust Code (UTC) and established a drafting committee for that purpose. The drafting committee, consisting of knowledgeable Conference members, was assisted by representatives from the American Bar Association, the American College of Trust and Estate Counsel, and the American Council of Life Insurers, consumer advocates, and other interested parties. This amendment resulted from their efforts and is designed to be inserted at the end of Article 1 of the UTC as Section 113. In keeping with the charge to the committee, the purpose of the amendment is to clarify when, for purposes of the Code, a trustee has an insurable interest in an individual whose life is to be the subject of an insurance policy to fund the trust. Clarification of this area of law that was subjected to uncertainty by the *Chawla* decision will provide a reliable basis upon which trust and estate planning practitioners may draft trust instruments that involve the eventual payment of expected death benefits.

It should be noted that the entire amendment is placed in brackets to indicate that each state should consider whether it is needed or its adoption would be appropriate. In some states *Chawla* may not present serious problems under pre-existing insurable interest law because it may be clear that a trustee already has an appropriate insurable interest for estate planning purposes. In other states, *Chawla* would present problems but, as indicated above, the state may have already addressed the issue so that the amendment may not be needed. Currently there are at least ten states that have enacted legislation on the subject (Delaware, Florida, Illinois, Georgia, Maine, Maryland, Minnesota, South Dakota, Virginia, and Washington). In those states that do need to respond to *Chawla* (plus those that may want to revisit the matter) the amendment offers a reasonable solution that has the support of many in the estate planning field, as well as the life insurance industry.

With regard to language of the amendment, subsection (a) provides that the term "settlor" is limited to a person who *executes* the trust instrument. This is narrower than the UTC definition of "settlor," which, in addition to the person who executes the trust instrument, would include a person who merely contributes property to the trust. See UTC Section 103(15). As explained in the comment to Section 103(15), the broader definition serves a useful purpose in connection

with the UTC generally; however, none of those situations relates to the issue of whose life should properly be the subject of a life insurance policy that is used to fund a trust. Moreover, to use the broader definition would needlessly complicate the issue of whose life should be the subject of insurance because it would be rare, if ever, that a life insurance policy used to fund a trust for estate planning purposes would be on the life of someone other than the settlor signing the trust or someone in whose life that settlor would have an insurable interest.
Because there are situations in which a trust instrument will be executed by a fiduciary or agent for the creator of the trust, subsection (a) also makes clear that in such circumstances the fiduciary or agent is deemed to be the equivalent of the settlor.

Subsection (b) carries forward the widely approved rule that the time at which insurable interest in a life insurance policy is determined is the date the policy is issued, otherwise understood as the inception of the policy. Thus, if on the date the policy is issued the trustee has an insurable interest in the individual whose life is insured, the policy is not subject to being declared void for lack of such an interest. Under the reasoning that an individual has an unlimited insurable interest in his or her own life, subsection (b) provides that a trustee has an insurable interest in the settlor's own life. If an individual, as settlor, has created a trust to hold a life insurance policy on his or her own life, has funded that trust with the policy or with money to pay its premiums, and has selected the trustee of the trust, it follows that the trustee should have the same insurable interest that the settlor has in his or her own life. Similarly, recognizing that an individual may purchase insurance on the life of anyone in whom that individual has an insurable interest up to, generally speaking, the amount of that interest, subsection (b) provides that the trustee has an insurable interest in an individual in whom the settlor has, or would have had if living at the time the policy was issued, an insurable interest.

Moreover, paragraph (1) of subsection (b) addresses the *Chawla* issue by referring to the jurisdiction's insurance code or other law regarding insurable interest as a separate, independent source of law for determining whether a trustee has an insurable interest in the life of an individual on whose life the trust has purchased insurance. This means that the trustee would be entitled to apply for and purchase an insurance policy not only on the life of a settlor but also on the life of any other individual in whom the settlor has an insurable interest, e.g., the spouse or children of the settlor, in the enacting jurisdiction. Exactly whose lives may be insured depends on the law of the enacting jurisdiction. In short, the amendment does not change the enacting jurisdiction's pre-existing law of insurable interest.

Paragraph (2) of subsection (b) addresses a somewhat different issue, although it also references the insurable interest law of the enacting jurisdiction. It is designed to ensure that irrevocable life insurance trusts (ILITs) are created to serve *bona fide* estate planning purposes by restricting who may be a beneficiary of insurance proceeds from a policy purchased to fund an ILIT. It establishes the requirement that the proceeds of such a life insurance policy used to fund the trust be payable primarily to certain types of trust beneficiaries. As to the latter, paragraph (2) contains bracketed language designed to provide states with a choice with regard to who those beneficiaries might be.

One choice may be exercised by deleting all the brackets, and all the language contained within the brackets, in paragraph (2) of subsection (b). By doing so, the class of beneficiaries for

whom the insurance proceeds must primarily benefit is limited to those who, in the enacting state, have an insurable interest in the life of the settlor. Depending on the law of the jurisdiction, this could mean that only those individuals traditionally recognized as having an insurable interest, such as spouses and their children, would qualify, or it could mean that additional family members, such as siblings, grandchildren, grandparents, and perhaps others, have an insurable interest in the life of the settlor. In some other jurisdictions, the law may not be clear on this point. In these jurisdictions, estate planners generally may be concerned that strictly tying the class of beneficiaries to the state's insurable interest law might unduly restrict their ability to provide appropriate legal services to their clients. To help alleviate this concern, an alternative is offered to clarify the law in these jurisdictions. To exercise this choice, the enacting jurisdiction need only remove the brackets while retaining the language contained therein, thereby adopting the language as part of the amendment.

Removing the brackets and retaining the bracketed language in paragraph (2) of subsection (b) clarifies and broadens to a limited extent the class of individuals for whom the insurance must primarily benefit. By including anyone who is related to the settlor or other insured by blood or law within the third degree, the amendment makes clear that not only parents and their children would fall in the required beneficiary category, but also that siblings, grandparents, grandchildren, great-grandparents, great-grandchildren, aunts, uncles, nephews, and nieces would also qualify. Lineal consanguinity, to use the more technical term for relation by blood, is the relationship between individuals when one directly descends from the other. Each generation in this direct line constitutes a degree. Collateral consanguinity refers to the relationship between individuals who descend from a common ancestor but not from each other. The civil law method of calculating degree of collateral consanguinity, which is used in most states, counts the number of generations from one individual, e.g., the insured, up to the common ancestor and then down to the other individual. See 1 RESTATEMENT (THIRD) OF PROPERTY (Wills and Other Donative Transfers) § 2.4 cmt. *k* (1999).

The following table identifies the relatives of an insured within three degrees of lineal and collateral consanguinity using the civil law method, with each row representing a generation.

			Great-Grandparents (3)
		Grandparents (2)	
	Parents (1)	Aunts and Uncles (3)	
INSURED	Sisters and Brothers (2)		
Children (1)	Nieces and Nephews (3)		
Grandchildren (2)			
Great-Grandchildren (3)			

The reference in subparagraph (B)(i) to relation by "law"–if that term is interpreted to have the same legal meaning as the term "affinity"–may extend the category of beneficiaries that must be primarily benefited to in-laws. If that is the case, degrees of relationship by law or affinity should be computed in the same manner as degrees of relationship by consanguinity. See State v. Hooper, 140 Kan. 481, 37 P.2d 52 (1934)(explaining, for example, that a husband has the same relation, by affinity, to his wife's blood relatives as she has to them by consanguinity, and vice versa). This would mean that a son- or daughter-in-law of the insured would be related in the first degree and a brother- or sister-in-law of the insured would be related in the second degree. A father- or mother-in-law would be related to the insured in the first degree, whereas an aunt- or uncle-in-law would be related to the insured in the third degree. See State v. Allen, 304 N.W.2d 203, at 207 (Iowa 1981)(listing authorities on how to compute degrees of relation).

At the very least, the term "law" should be interpreted to include the relation between spouses and the relation between an adoptive parent and adopted child, if they were not already included under subparagraph (A). Additionally, in case there is any doubt as to whether an adopted grandchild, i.e., a child adopted by an insured's child, is sufficiently related to the insured, as a biological grandchild might be, to have an insurable interest under subparagraph (A), the reference in (B)(i) may ensure that the adopted grandchild falls within the required category of beneficiaries. This is because the adopted grandchild arguably would, at the very

least, be related by affinity to the insured in the second degree, just as a biological child of the insured's child would be related by blood in the second degree to the insured. In other words, the adopted grandchild would be treated in the same manner as a biological grandchild for purposes of the amendment.

Stepchildren, who may not otherwise have an insurable interest in the life of the settlor or other insured under subparagraph (A) or who may not be included under subparagraph (B)(i), depending on the interpretation given to the term "law," are specifically included in subparagraph (B)(ii) to ensure that they occupy the same status as any other child of the settlor, biological or adopted.

The reason for the modifying language "if not already included under subparagraph (A)" found in subparagraph (B) of paragraph (2) of subsection (b) is to make it clear that there is no negative implication with regard to anyone related within the third degree to the insured and who would be included by virtue of the adopting jurisdiction's insurable interest law referred to in subparagraph (A). In other words, some of the people, but not all, included under subparagraph (A) will be related to the person whose life is insured within the third degree and the modifying language is designed to make it clear that subparagraph (B)(i) merely adds any others so related. The same reasoning applies to stepchildren. The adopting jurisdiction may already include them under its insurable interest law referred to in subparagraph (A). If not, however, subparagraph (B)(ii) makes sure they are included in the category of people for whom the insurance policy proceeds must primarily benefit.

Although estate planners expressed concern were a jurisdiction to delete subparagraph (B) because they felt doing so would unduly limit their ability to serve their clients' needs, there was a general consensus that including those identified in subparagraph (B) should suffice for the great majority of estate plans. Thus, estate planners strongly support the adoption of the language in subparagraph (B).

It should also be noted that, regardless of the decision relating to the choices presented by the bracketed language in paragraph (2) of subsection (b), the test concerning whether the beneficiaries designated in paragraph (2) are the primary beneficiaries of the policy proceeds takes place at the inception of the life insurance policy, i.e., when the policy is issued. The fact that there may be contingent trust beneficiaries or that the proceeds would be payable to different beneficiaries based on subsequent events or conditions is not relevant to the determination. One need only identify those trust beneficiaries that would receive the policy proceeds were the insured life to expire immediately after the policy is issued and the trust were to terminate at the same time. Among these beneficiaries, the proceeds must be payable primarily to those specified in paragraph (2) of subsection (b). If that is so, the condition is satisfied and may not be challenged thereafter or on the basis that subsequent events might change who would receive the proceeds.

As for the term "primarily," it will often be the case that one is able to calculate that more than fifty percent of the policy proceeds will be payable to the required class of beneficiaries under paragraph (2), but this may not always be the situation. For example, if the purpose of the trust is to provide a lifetime benefit to a spouse or funds for children to obtain an education, the

amount may be indeterminate. This, however, does not mean that the policy proceeds are not primarily for the benefit of these individuals if upon the inception of the policy they are the people who will immediately and mainly benefit from the trust, even though there are others not designated in paragraph (2) who may also benefit concurrently or benefit subsequently upon the satisfaction of some condition in the future. In short, the term is intended to be applied in a common sense manner rather than in a hyper-technical manner that would require that a precise dollar amount be payable to certain beneficiaries.

Finally, the amendment is drafted as it would appear in the UTC were it to be part of the Code when the latter is enacted or as it would appear as an amendment to a previously enacted version of the Code. In either case, since Section 1106 of the UTC, as originally drafted, already deals with the applicability of the UTC to trusts existing at the time of enactment, there may be no need to address that issue in this amendment. However, if an issue should arise regarding which trusts *and* life insurance policies are subject to the amendment, the following language may be helpful in resolving that issue:

> This section applies to any trust existing before, on, or after the effective date of this section, regardless of the effective date of the governing instrument under which the trust was created, but only as to a life insurance policy that is in force and for which an insured is alive on or after the effective date of this section.