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Corporations Insuring Employees' Lives

I. Introduction

The Sixth Circuit Court of Appeals[1] in 1959 reversed a tax court holding that a life insurance contract taken out by a corporation to insure an employee's life was a wagering contract because neither the corporation nor the beneficiary possessed an insurable interest in the employee's life and that the proceeds were thus not excludible as an amount received "under a life insurance contract."[2] In 1964 the Fifth Circuit Court of Appeals[3] affirmed a federal district court's judgment entered on a jury's verdict that a corporation, which was both owner and the beneficiary of a life insurance policy, had no insurable interest in the employee's life and consequently could not exclude under section 101(a)[4] the proceeds which it had received from the insurance company. In both cases the insurance companies had paid the proceeds without asserting a lack of insurable interest as a defense to payment. These recent decisions emphasize that the pragmatic problem of whether a corporation has an insurable interest in its employees' lives is a tax-oriented dispute with the federal government, not a private dispute with the insurance companies. The ambit of the insurable interest concept in tax law is identical with that concept in insurance law; the Commissioner argues that the statutory phrase "insurance contract" obviously means a valid insurance contract implying that the contract must meet the requirements of the state's insurance law, specifically that an insurable interest must exist. To attack the validity of this implication, one could argue three points. First, Congress in using that phrase did not consider whether or not the insurance contract must meet the requirements of state law and thus was not indicating any such intent by its use; second, by analogy, in using other words, such as "corporation," Congress did not intend to impose requirements of state law and thus did not necessarily do so in this situation; and third, the resulting rule imposes a different

1. Ducros v. Commissioner, 272 F.2d 49 (6th Cir. 1959), *reversing* 30 T.C. 1337 (1958). See generally 45 Cornell L.Q. 818 (1960).

2. 30 T.C. 1337 (1958). This decision was actually based on the Int. Rev. Code of 1939, § 22(b)(1), 53 Stat. 9, which stated: "Exclusion from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter: (1) Life Insurance.—Amounts received—(A) under a life insurance contract paid by reason of the death of the insured. . . ."

3. Atlantic Oil Co. v. Patterson, 64-1 CCH U.S. Tax Cases ¶ 9425 (5th Cir. 1964).

4. Int. Rev. Code of 1954, § 101(a)(1), which states as a general rule that "gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured." Compare this language with that used in the Int. Rev. Code of 1939, § 22(b)(1), 53 Stat. 9, quoted in note 2 *supra*.

tax result in different states depending on their laws. In general, one is faced with a situation in which the tax law tail wags the insurance law dog. An examination of this problem area appears to raise two central questions. What are the basic practical uses of life insurance by a corporation? When does a corporation have an insurable interest in its employees' lives? The examination of these questions is the purpose of this note.

II. Practical Uses of Life Insurance by a Corporation

A. *Focus of Discussion*

Assuming for the moment that a corporation can legally insure a particular employee, we first focus the discussion on the areas in which life insurance might be utilized as a practical tool to obtain the business goals of the corporation. Besides the possibility of using life insurance to fund specific plans,[5] such as retirement plans, pension plans, and business purchase agreements,[6] two general business uses suggest themselves. The first is to protect the corporation against the loss of managerial skill and experience resulting from the death of specific employees; the second is to compensate certain employees for their talent and labor without the federal income tax hardships.[7] This first suggested use appears obvious, for it indicates the traditional use of life insurance, which is to spread the risk of loss. However, the second suggested use is relatively recent and evolved through recognition of the advantageous treatments, such as deductions and exclusions, available under the federal income tax law, especially advantageous since the current high income tax rates reach a maximum marginal rate of 48 per cent for corporations[8] and a maximum marginal rate of 70 per cent for individuals.[9]

5. For an excellent technical discussion of this question and for examples of specific plans, see *Life-Insurance—Corporate Business Use,* 34 BNA Tax Management (1963); Foosaner, Taxation of Life Insurance and Annuities (1960). See also CCH 1963 Stand. Fed. Tax Rep., *Tax Rewards in Personal and Business Life Insurance.* See generally, New York Life Insurance Co., *Business Purchase Agreements Funded with Life Insurance* (1956); Note, 9 Vand. L. Rev. 373 (1956).

6. "Many reasons are advanced by employers for adopting such plans: the need to provide for the future of employees in these days of high taxes and low interest rates, the need to secure increased employee interest in production, the aid which plans afford in attracting and keeping good men and the desirability of a more efficient solution of the problem of retiring superannuated employees." Note, 48 Colum. L. Rev. 393 (1948).

7. A detailed examination of the tax advantages to the individual of saving through life insurance is presented in Goode, *Policyholders' Interest Income From Life Insurance Under the Income Tax,* 16 Vand. L. Rev. 33 (1962). See generally CCH 1963 Stand. Fed. Tax Rep., *Tax Rewards in Personal and Business Life Insurance.*

8. Int. Rev. Code of 1954, § 11. For a taxable year beginning in 1963, the maximum marginal rate is 52% (a 30% normal tax plus a 22% surtax). The following year it is reduced to 50% (a 22% normal tax plus a 28% surtax), and in 1965 it will be 48% (a 22% normal tax plus a 26% surtax).

9. Int. Rev. Code of 1954, § 111. For a taxable year beginning on or after

B. *Federal Tax Provisions Concerning Life Insurance*

To gain a proper perspective of the impact of the federal tax law on business decisions concerning life insurance, a concise summary of the tax structure is necessary.[10] Fundamental to the income tax are section 61[11] defining gross income as "all income from whatever source derived" and section 162[12] allowing "as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

In amplifying these fundamental sections, several sections specifically deal with life insurance. Concerning the payment of premiums, section 264[13] prohibits the deduction of premiums paid for insurance on the life of an employee where the taxpayer is either directly or indirectly a beneficiary of the policy. This section, also, prohibits the deduction of interest paid on a debt which was incurred to carry a single-premium life insurance contract as therein defined.[14] When a *cestui que vie*[15] dies, the proceeds received under a life insurance policy are excluded from the gross income of the recipient, "if such amounts are paid by reason of the death of the insured [*i.e.*, the *cestui que vie*],"[16] according to section 101. This exclusion does not apply, however, where there was a transfer of the life insurance contract for valuable consideration.[17] If the insured exercises an option under the

January 1, 1964 and before January 1, 1965, the maximum marginal rate is 77%, which is on amounts over $200,000. This percentage is 70% for the following taxable year beginning in 1965.

10. Of course, all textual references to "sections" refer to sections of the Internal Revenue Code of 1954.

11. Int. Rev. Code of 1954, § 61(a), which states, "except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items . . . (9) Annuities. (10) Income from life insurance and endowment contracts. . . ."

12. Int. Rev. Code of 1954, § 162.

13. Int. Rev. Code of 1954, § 264. Section 264(a) expressly provides that "no deduction shall be allowed for—(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy. (2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract."

14. Int. Rev. Code of 1954, § 264(b).

15. As most readers already know, the *cestui que vie*, sometimes abbreviated "CQV," is the person whose death is a condition of the insurance company's promise to pay the face amount of the policy. This term is used to avoid the ambiguity of using "insured" to designate both the person making the contract with the insurer and the person whose death is a condition of payment.

16. Int. Rev. Code of 1954, § 101(a)(1).

17. Int. Rev. Code of 1954, § 101(a)(2), which states, "in the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee." Two alternative exceptions to this inclusion are then stated.

policy by which the company holds the face amount under an agreement to pay interest thereon, this interest is expressly included in gross income.[18] Or, if the insured exercises an annuity option under the insurance contract, the interest element which is included in any payment is likewise included in gross income, with an express exception for annual receipts by the surviving spouse up to 1,000 dollars.[19]

Furthermore, if an ordinary life insurance contract is exchanged for another such contract, for an annuity contract, or for an endowment contract,[20] section 1035 prohibits the "recognition" of any gain or loss realized on the exchange.[21] Similarly, an endowment contract may be exchanged either for another endowment contract or for an annuity contract[22] and annuity contracts may be exchanged for each other[23] without the recognition of any loss or gain on the exchange.

The last section expressly concerning life insurance is section 72 which provides for taxing the annuity payments under the general annuity rules of that section where the insurance contract includes an annuity which begins during the life of the *cestui que vie*.[24] Where a life insurance policy is surrendered before maturity or where the insurance proceeds are payable in one lump sum, section 72(e) includes any gain in gross income, except that portion qualifying under section 72(e)(3).[25]

The pertinent federal estate tax provision on insurance, section 2042, includes in the gross estate life insurance proceeds receivable by the executor or life insurance over which the decedent possessed at his death any of the incidents of ownership. As a fringe benefit, therefore, a corporation may own life insurance on an employee's life and name his wife or his children as beneficiary of the policy. Thus, the employee's death would cause his family to receive money not burdened by estate tax liability.

C. *Specific Uses*

1. *Corporate Protection Against Loss—(a) Basic Policy Decisions.—*

> What corporate purpose could be considered more essential than key man insurance? The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself against the loss of two of its most vital assets—

18. INT. REV. CODE OF 1954, § 101(c). "Interest.—If any amount excluded from gross income by subsection (a) or (b) [of section 101] is held under an agreement to pay interest thereon, the interest payments shall be included in gross income."
19. INT. REV. CODE OF 1954, § 101(d).
20. INT. REV. CODE OF 1954, § 1035(b), defines "endowment contract," "annuity contract," and "life insurance contract" for purposes of § 1035.
21. INT. REV. CODE OF 1954, § 1035(a)(1).
22. INT. REV. CODE OF 1954, § 1035(a)(2).
23. INT. REV. CODE OF 1954, § 1035(a)(3).
24. INT. REV. CODE OF 1954, § 72.
25. INT. REV. CODE OF 1954, § 72(e).

managerial skill and experience. In fact, the government has not seriously contended here that key man insurance is not a corporate purpose.[26]

Thus, it is fairly certain that the death of a key man is the loss of an asset to the corporation.[27] General business knowledge about the corporation, personal contacts in the marketing community, special technical skill which helps the corporation meet competition, and organizational concepts of efficiency are but a few of the essential characteristics which key men bring to the corporation with their employment and which they take from the corporation with their death or departure. Specifically, the scientific knowledge and ingenuity of a research engineer, the customer's confidence in a leading salesman, and the managerial skills and employees' respect for a personnel officer all contribute to the corporation's progress in making money. In addition to the immediate loss of these intangible assets, the corporation usually incurs expenses in finding and hiring a satisfactory replacement and always loses other employees' time in training the novice and teaching him the specific responsibilities of his new position.

Assuming that the corporate policy makers decide that the corporation should protect itself against this potential loss with life insurance, the next question is what type of insurance policy should be procured. Various insurance companies offering numerous policies present a myriad of choices, but basically the choice is among term insurance, ordinary life insurance, paid-up insurance, and endowment policies. Professionals in the insurance field possess a great understanding of each of these basic types, and consequently are in a superior position to advise businesses on the proper selection.

Generally, term insurance, sometimes called "pure insurance," is becoming recognized as the best insurance vehicle with which to attain corporate protection against the loss of key men for several reasons. Term life insurance gives the best protection against loss for the cheapest cost. Although other policies such as ordinary life insurance may offer combined advantages of investment and of accessible collateral for possible loans, some corporate policy makers weigh other factors when selecting the type of policy. For instance, because all business corporations are concerned with making money, one criterion with which to judge a corporation's success at profit making is to compute its annual earnings as a percentage of its invested capital.

26. Emeloid v. Commissioner, 189 F.2d 230, 233 (3d Cir. 1959), *reversing* 14 T.C. 1295 (1950). On a question arising under the excess profit tax, the taxpayer persuaded the court that the money which the corporation borrowed to purchase single-premium life policies insuring the lives of its two principal officers and stockholders did constitute "borrowed invested capital" as that term was used in the excess profit law.

27. See generally notes 118 to 133 *infra* and accompanying text.

Increased expenses decrease earnings unless those expenses generate additional income greater than the expenses. Applying these axiomatic principles of business to the purchase of life insurance generally indicates that ordinary life insurance, endowment policies, etc., would not be a wise *investment* unless its return was greater than the return on capital invested in the corporation. Because of the limited security investments of life insurance companies and the regulations imposed by states upon life insurance companies, it is a rare example where the investment return on a life insurance policy exceeds the profit ratio on invested capital in a successful corporation. Second, concerning the loan collateral argument, not expending the extra amount for these other policies would increase profits which if accumulated would reduce the need for loans. Third, what happens to the cash surrender value of an ordinary life insurance policy when the key man dies? Under various theories, either it is returned to the corporation with the insurance proceeds (an amount equal to the face amount of the policy *less* cash surrender value) or it is forfeited to the insurance company which returns the insurance proceeds (an amount equal to the full face amount of the policy). Regardless of the theory, the practical result is that the insured corporation only receives the face amount of the policy. These three aspects of ordinary life insurance as contrasted to term life insurance indeed should be weighed when selecting the type of life insurance with which to protect the corporation against the loss of a key man.

(b) *Tax Aspects Before Death of the Key Man.*—Although insurance policies are carried to protect the corporation against a true loss and section 162 of the Internal Revenue Code allows deductions for ordinary and necessary business expenses, the corporation is not permitted to deduct premium payments on its key man insurance policy when it designates itself as the beneficiary under section 264.[28] Thus, the premiums are paid by the corporation in after-tax dollars, an additional factor emphasizing the necessity of protection at the cheapest cost. Regardless of the use to which the policy is put, even a use which would give rise otherwise to deductible business expenses, the corporation cannot deduct the premiums.[29] For example, where the insurance policies are assigned to a creditor as collateral and where the continued payment of the premiums is necessary to maintain the loan, the deduction of the premiums is disallowed.[30] This

28. INT. REV. CODE OF 1954, § 264(a)(1), prohibits the deduction because the corporation would be "directly . . . a beneficiary under the policy." See, *e.g.*, Raymond L. Klinck, 11 CCH TAX CT. MEM. DEC. ¶ 19,378 (1952).

29. Treas. Reg. § 1.264-1(a) (1960).

30. Williamson Veneer Co., 10 B.T.A. 1259 (1928). See also Desks, Inc., 18 T.C. 674 (1952).

non-deductability of premiums also is applicable where the corporation pays the premiums, but is only "indirectly a beneficiary under the policy."[31] For example, a corporation could not deduct the premiums which it paid on a policy insuring the life of an officer and stockholder where the stockholders,[32] in proportion to their percentage ownership of the corporation, were the beneficiaries.[33] But since a corporation would be neither directly nor indirectly a beneficiary under the policy, however, it could deduct premiums which it paid to insure the life of its debtor[34] or which it paid on policies assigned to it as security if this were necessary to maintain the security.[35]

To prepay the premiums on its key man life insurance policies, assuming the corporation has sufficient cash to do so, results in a small tax savings. The insurance company will discount those premiums which are prepaid, and the discount income or savings effected is not includible in the corporation's gross income. But if the corporation borrows money to pay "a substantial number of future premiums on the contract,"[36] it will lose the interest deduction usually allowed under section 163.[37] Of course, interest paid on loans secured by the cash value of ordinary life insurance policies generally remains deductible.[38]

If the corporation owns key man insurance policies and designates the stockholders as beneficiaries,[39] the premiums paid to the insurance company may be construed as dividends under 316,[40] and the Com-

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31. INT. REV. CODE OF 1954, § 264(a).

32. The *cestui que vie's* wife was the named beneficiary in proportion to his ownership in the corporation.

33. 3 CUM. BULL. 543 (1920). Anyway, these premium payments by the corporation seem to be dividends to the stockholders and as such non-deductible.

34. 1 CUM. BULL. 104 (1919).

35. Commissioner v. Charleston Nat'l Bank, 213 F.2d 45 (4th Cir. 1954); Dominion Nat'l Bank, 26 B.T.A. 421 (1932), in which the Commissioner acquiesced in XI-2 CUM. BULL. 3 (1932).

36. INT. REV. CODE OF 1954, § 264(b)(2).

37. INT. REV. CODE OF 1954, § 264(a)(2).

38. See, *e.g.*, Keith v. Commissioner, 139 F.2d 596 (2d Cir. 1944).

39. See, *e.g.*, 3 CUM. BULL. 543 (1920), which states: "Where a corporation insures the life of its president, the stockholders being beneficiaries in proportion to their stock holdings and the wife of the president (not herself a stockholder) being a beneficiary in proportion to her husband's stock holdings, no deduction for the payment of premiums can be allowed . . . since the corporation itself is indirectly a beneficiary under the policy. The premiums paid on such a policy are a charge against surplus and represent dividends to the stockholders. . . . This applies as well to the officer upon whose life the insurance is carried."

40. Ducros v. Commissioner, 272 F.2d 49 (6th Cir. 1959), expressly left this question open.

"We have not considered the right of the Government to tax the premiums paid as a dividend to the beneficiaries or to follow the cash surrender value of the insurance into the hands of the beneficiaries as these questions were not presented either to the Tax Court or here." *Id.* at 52.

missioner probably would argue this point. To rebut the Commissioner's argument, a stockholder might argue, among other points, (1) that the corporation's right of ownership allows it to change the beneficiary and thus he has received no benefit, (2) that selling his stock before the *cestui que vie* dies would deprive him of the proceeds and of any benefit, or (3) that he has no insurable interest in an officer of the corporation and consequently could not insure himself against loss, a point which the law of the individual states determines.[41] A possible fallacy in the first two arguments is that they presuppose that "benefit" only arises when the *cestui que vie* dies, a narrow interpretation of "benefit" which disregards the possession of the contingent opportunity to receive the proceeds. By analogy, is it persuasive to say that an insured received no "benefit" under his fire insurance policy because his building did not burn and no "benefit" under his liability insurance policy because a law suit was not filed against him?

A corporation that elects to file its return under subchapter S[42] is not concerned with the constructive dividend argument. Because the earnings computed without deducting the premiums paid on key man life insurance under section 264, are taxed directly to the stockholders as individual income,[43] in effect the premiums paid are taxed to the stockholders. Another tax consequence is that the bases of the shareholders' stock increase proportionally to the premiums thus paid.[44] Furthermore, if the key man life insurance policy has a cash surrender value, the corporate earnings and profits are increased when the premium actually paid is less than the annual increase in the cash surrender value.[45] This last proposition applies to the corporation whether or not it qualifies to be taxed under subchapter S.

If the corporation purchases its life insurance policies with a mutual insurance company or purchases participating policies from a stock insurance company, the "dividends" it receives are treated as a partial refund of the premiums and, as such, are excluded from gross income.[46] Of course, any excess of the "dividends" over the premiums paid is conversely included in gross income.[47] Following the general rule that interest is received when credited if the credit is immediately subject to withdrawal,[48] interest on accumulated life insurance

41. See generally, Note, 49 GEO. L.J. 594 (1961).
42. INT. REV. CODE OF 1954, §§ 1371-77.
43. INT. REV. CODE OF 1954, § 1376.
44. INT. REV. CODE OF 1954, § 101(a)(1).
45. See generally, Albrecht, *"Dividends" and "Earning or Profits,"* 7 TAX L. REV. 157 (1952).
46. INT. REV. CODE OF 1954, § 72(e)(1); Treas. Reg. § 1.72-1(a), -1(b) (1960).
47. Treas. Reg. § 1.72-11(b) (1960).
48. Treas. Reg. § 1.451-2 (1960).

dividends, which is neither restricted nor limited on the time or manner of payment, is taxable in the year credited.[49]

Finally, consider the tax aspects of surrendering or of selling the life insurance policy with a cash value before the *cestui que vie* dies. Either surrendering the policy for its cash value or selling the policy for valuable consideration gives rise to ordinary income when a gain is realized, and this gain is computed by subtracting from the amount of premiums paid any portion attributable to other benefits, *e.g.*, disability income and double indemnity.[50] That this gain actually represents accrued and unpaid interest is the theory supporting its taxation as ordinary income.[51] Any interest[52] paid on money which was borrowed to pay the premiums increases the cost basis of the policy;[53] likewise, the discounted cost (the amount actually paid) is used where the premiums were prepaid.[54] If a loss results from the sale or surrender of an insurance policy, the loss is not "recognized" on the theory that it merely was the cost of protection while the policy was effective.[55]

Selling a policy to the employee who is the *cestui que vie* is a special situation. In such a case, if the consideration is less than the fair market value, the employee is taxed as compensation to him on the difference between the fair market value and the consideration actually paid.[56] To evaluate "fair market value," the Treasury Department uses the "replacement value" of the policy which is either the interpolated terminal reserve plus any prepaid premiums (where additional premiums are due) or the cost of a single premium policy

49. INT. REV. CODE OF 1954, § 72(e)(1)(B).

50. Rev. Rul. 55-349, 1955-1 CUM. BULL. 232, which states: "For the purpose of computing the aggregate premiums or consideration paid for an endowment contract under the provisions of section 22(b)(2)(A) of the 1939 Code any portion of the total premium paid which is attributable to other benefits, such as a disability income benefit, is not to be included as a part of the total premium paid for the endowment contract."

51. Estate of Crocker, 37 T.C. 605 (1962). "Although a part of the total increment received by the petitioner here may have been due to 'dividends' rather than to a specified percentage of interest earned on the reserve attributable to his policy, it is clear that the greatest portion must have been due to the latter. . . . We accordingly conclude . . . that the amount received above the cost of the policy is ordinary income in its entirety and not capital gain, and that this excess is to be computed by subtracting, from the amount received, petitioner's cost as stipulated by the parties." *Id.* at 613. See also Roff v. Commissioner, 304 F.2d 450 (3d Cir. 1962), *affirming* 36 T.C. 818 (1961) (sale of annuity contracts).

52. As stated above, this interest is non-deductible under the INT. REV. CODE OF 1954, § 264(a)(1), (b).

53. Chapin v. McGowan, 271 F.2d 856 (2d Cir. 1959).

54. I.T. 3513, 1941-2 CUM. BULL. 75.

55. See, *e.g.*, London Shoe Co. v. Commissioner, 80 F.2d 230 (2d Cir. 1935).

56. Rev. Rul. 59-195, 1959-1 CUM. BULL. 18.

at the *cestui que vie's* current age (where the insurance policy is paid-up.)[57]

(c) *Tax Aspects After Death of the Key Man.*—Section 101 excludes from gross income the amounts received "under a life insurance contract, if such amounts are paid by reason of the death of the insured."[58] Thus, the corporate beneficiary owning key-man insurance policies receives the life insurance proceeds tax free as an exclusion. Most of the current litigation[59] concerning this issue involves an interpretation of the phrase "under a life insurance contract" contained in section 101.[60] The Commissioner argues that this phrase implies an inherent requirement of insurable interest, which is a requisite to a valid life insurance contract. This legal limit will be analyzed later,[61] however, and further comment at this point is inappropriate. Yet, the reader should note the importance of this common law rule to the tax problem.

Transferring any life insurance policy, including key-man policies, for valuable consideration may require the transferee to include in his gross income part of the proceeds which he received. To measure the amount of this inclusion (if any), one must subtract the sum of the consideration paid for the policy and any additional premiums paid by the transferee to keep it in force, from the proceeds.[62] Taxation will not occur and the exclusion remains applicable, however, when the transferee's basis in the policy is determined by referring to the transferor's basis or when the transferee is either the *cestui que vie* or a corporation in which the *cestui que vie* is a stockholder or an officer.[63] To launch a corporate program of obtaining key-man insurance policies, the corporation's officers could sell their existent life insurance policies to their corporation without the corporation losing the exclusion when it receives the proceeds upon their death. An additional practical consequence of the exception which retains

57. Treas. Regs. § 25.2512-5 (1958).

58. INT. REV. CODE OF 1954, § 101(a)(1).

59. See, *e.g.*, Ducros v. Commissioner, 272 F.2d 49 (6th Cir. 1959), *reversing* 30 T.C. 1337 (1958).

60. See footnotes 118 to 133 *infra* and accompanying text.

61. INT. REV. CODE OF 1954, § 101(a)(2).

62. "In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee." INT. REV. CODE OF 1954, § 101(a)(2).

63. "The preceding sentence [note 62 *supra*] shall not apply in the case of such a transfer—(A) if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or (B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer." INT. REV. CODE OF 1954, § 101(a)(2).

exclusion is that tax-free corporate reorganizations do not destroy the exclusion of the proceeds from gross income.[64]

A corporation electing to file its tax returns under subchapter S also receives the benefit of the exclusion in section 101. Furthermore, none of the proceeds received by the electing corporation from its key-men life insurance policies is taxable to its stockholders in the year when the proceeds were received. In this respect the corporation's earnings and profits, which includes the amount by which the proceeds exceed the cash surrender value of the policy, can exceed the taxable income of the corporation.[65] However, this statement that corporate earnings and profits can exceed the taxable income of the corporation is a general one and is not limited to subchapter S corporations. Whenever the proceeds received by a corporation exceed the cash surrender value of the policy[66] this generalization is true.

Although the corporation may exclude the life insurance proceeds from its gross income, distributing the proceeds to the stockholders is a dividend and, consequently, taxable.[67] If the corporation is the beneficial owner of the life insurance policies (*e.g.*, if a trustee or an agent receives the proceeds for the corporation) the distribution to the stockholders will be taxed as a dividend.[68] If stockholders rather than the corporation are named as beneficiaries under the policy, the proceeds which they receive from the insurance company may be construed as a "dividend" from the corporation.[69] Although one court

64. For example, "the X Corporation purchases for a single premium of $500 an insurance policy in the face amount of $1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. The X Corporation transfers the policy to the Y Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the Y Corporation determined by reference to its basis in the hands of the X Corporation). The Y Corporation receives the proceeds of $1,000 upon the death of A. The entire $1,000 is to be excluded from the gross income of the Y Corporation." Treas. Reg. § 1.101-1(b)(5), example (2) (1960).

65. Treas. Reg. § 1.1377-2(b) (1960), which states: "Except as otherwise provided in section 1377, the earnings and profits of the taxable year of an electing small business corporation are computed in the same manner as the earnings and profits of corporations generally. Therefore, such earnings and profits can exceed the taxable income of the corporation, as in the case of a corporation which uses percentage depletion in computing its taxable income or which receives tax-exempt interest on certain governmental obligations."

66. If a corporation received life insurance proceeds of $10,000 from a policy with a cash surrender value of $6,000, the simple bookkeeping entry would be:

debit "cash"	$10,000		
		credit "cash value of life insurance"	$ 6,000
		credit "surplus"	$ 4,000

67. See, *e.g.*, Cummings v. Commissioner, 73 F.2d 477 (1st Cir. 1935).

68. Golden v. Commissioner, 113 F.2d 590 (3d Cir. 1940).

69. Contrast Treas. Reg. § 1.264-1(b) (1960), which states: "Whether or not the taxpayer [*i.e.*, the one who pays the premiums] is a beneficiary under the policy, the proceeds of the policy paid by reason of the death of the insured [*i.e.*, the *cestui que vie*] may be excluded from gross income whether the beneficiary is an individual or a corporation . . . ."

has rejected this contention,[70] the Commissioner expressly refuses to follow that decision,[71] which forewarns of additional litigation on the issue. Considering the existing doubt, it appears likely that the Commissioner will achieve at least a partial inclusion of the proceeds in the beneficiaries' gross income as a constructive dividend from the corporation.[72]

2. *Compensation to Employees Using Group Term Life Insurance.*— Fringe benefits in the form of shorter working hours, longer paid vacations, pension plans, profit sharing plans, stock option plans, health insurance, and life insurance have become common place in our industrial society.[73] These, not mere salary increases, are often the goals of employees. The advantages of these fringe benefits being furnished by the corporate employer rather than by the individual employee are twofold: (1) bulk purchases by the corporation (*e.g.*, of health and group life insurance policies) yield a lower per unit cost than available to the employee individually, and (2) the federal government pays for part of the cost in allowing deductions because the employer pays for the benefit with pre-tax dollars while an individual generally would have to pay for the benefit with post-tax dollars.[74] Consequently, a corporation can give benefits with a

70. Ducros v. Commissioner, 272 F.2d 49 (6th Cir. 1959). In this case the Commissioner argued that the proeeeds of the insurance policy on the life of the corporation's president received by the beneficiary stockholders were taxable as dividends to the stockholders. To buttress this contention, the Commissioner emphasized that the insurance policy was an asset on the corporation's balance sheet, that the corporation paid the premiums, and that the corporation possessed the right to change the beneficiary. Rejecting the Commissioner's argument, the court stated that these factors relate to the policy itself and not to the proceeds of the policy.

71. Rev. Rul. 61-134, 1961-29 INT. REV. BULL. 20.

72. However, the court deciding *Ducros* expressly refused to decide either whether the premiums paid by the corporation were dividends to the stockholders who were the beneficiaries or whether the cash surrender value of the policy may be traced from the corporation to the stockholders as a dividend. Ducros v. Commissioner, *supra* note 70, at 52.

73. The growing importance of these benefits has often been discussed. *E.g.*, "The familiar picture of transferring one's accumulated wealth through the use of traditional inter vivos and testamentary devices has heen changed: one chooses employment under which a present share of earned income is replaced by a claim to future consumption. Retirement, disability, or untimely death must be anticipated, and provided for." Lynn, Foreman, & Wehr, *The New Inheritance: Employee Benefit Plans as a Wealth Devolution Device*, 11 STAN. L. REV. 242, 244 (1959). The authors supported this statement with the following quotation: "Major fringe benefits hy U.S. industry will top $12 hillion this year (1957), equal to 6% of total wage payments by private business. In 1956 alone, says Commerce Department, industry paid $5.71 billion for welfare and pension funds, $3.19 billion for old-age and survivors' insurance, another $1.85 billion for unemployment insurance, and $983 million for accident compensation." Time, Sept. 9, 1957, p. 99.

74. For example, if a corporation gives an employee a benefit costing ten dollars ($10.00), the corporation receives a deduction and the benefit usually is excluded from the employee's gross income. On the other hand, if the corporation gives an employee ten dollars ($10.00) as compensation, the corporation still receives a

maximum value to the employee at minimum cost to the employer.

Although various types of fringe benefits involve life insurance, the most frequent and advantageous benefit is the furnishing of group term life insurance to some or all employees. First, group term life insurance can be discriminatory in favor of officers, stockholders, supervisors, and highly compensated employees. Without approbation by the Internal Revenue Service and in contrast to qualified pension and profit sharing plans, a corporation can execute this type of fringe benefit and receive favorable tax treatment (which will be discussed below), provided the corporation can find an insurance company to write the policy.

Second, an insured employee who participates in the plan need not pass a physical examination. In fact, although one is an uninsurable risk under individual policies, he can receive insurance under the group term life insurance policy as long as he does not sever his employment with the corporation.

Third, the younger employees' premiums subsidize the older employees' premiums, because the average age of the employees insured under the policy usually determines the premium cost which the corporation pays. While a younger employee may consider this as a distinct disadvantage, he still can anticipate the time when his insurance will be subsidized by the other young employees. Moreover, when the corporation pays the premium, the younger employee probably is apathetic to this feature of group term life insurance, a feature which is mentioned as neither an advantage nor a disadvantage.

Fourth, group term life insurance is inexpensive. Truly, it is pure insurance. It possesses no so-called investment or savings element, it possesses no cash surrender value, and consequently the corporation receives exactly what it buys—protection against death for its employees.

Fifth, variations and options are possible with group term life insurance. For example, the plan might permit the individual employee to obtain additional term insurance by a small deduction from his pay check. Or the group policy might give the individual employee the right to convert his insurance into ordinary life at his option. These are but a few examples. Many more are possible.

These five features of group term life insurance consider only the business purpose or non-tax aspect of this benefit. More important perhaps is the tax aspect, namely, the three advantages which the current law gives. These advantages are: (1) that the corporation

deduction but this amount is included in the employee's gross income. After paying his income tax (assume 20%), the employee only has eight dollars ($8.00) with which to buy the particular benefit.

can deduct the premiums it pays, (2) that, to a limited extent, the premiums are excluded from the employees' income, and (3) that the proceeds received by the employees' beneficiaries are excluded from the recipients' gross income.

First, the corporation's deduction of the premiums is governed by the same basic rules on deductibility of life insurance premiums paid by the employer corporation which were discussed above, and which will not be reiterated. In summary, however, if the corporation is neither directly nor indirectly a beneficiary under the policy,[75] if the premiums are paid to the insurance company as additional compensation to the employee,[76] and if the total compensation to the individual employee is reasonable,[77] the corporation may deduct the premiums paid.

Second, the Revenue Act of 1964, among other things, added a new section to the Internal Revenue Code which generally includes in the employee's gross income the cost of group term life insurance only to the extent that such cost exceeds the sum of the cost of 50,000 dollars of such insurance and the employee's contribution toward purchasing the policy.[78] To help enforce this inclusion, the employer who provides such group term life insurance is required to file an informational return.[79] According to previous Treasury Regulations, "premiums paid by an employer on policies of group term life insurance covering the lives of his employees are not gross income to the employees, even if they designate the beneficiaries."[80] To curtail undue utilization of this fringe benefit before Congress changed the law, the Treasury Department had somewhat restricted this tax feature through its revenue rulings.[81] Yet, thinking that a loophole still existed, the late President Kennedy recommended that Congress limit this exclusion to the cost of 5,000 dollars group term insurance.[82]

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75. INT. REV. CODE OF 1954, § 264(a)(1).

76. See, *e.g.*, Semon Bache & Co. v. Commissioner, 54 F.2d 1084 (2d Cir. 1931); C. F. Smith Co., 13 CCH TAX CT. MEM. DEC. ¶ 20,442 (1954).

77. See, *e.g.*, Hubert Transfer & Storage Co., 7 CCH TAX CT. MEM. DEC. ¶ 16,321 (1948).

78. INT. REV. CODE OF 1954, § 79 (as amended by the Revenue Act of 1964).

79. INT. REV. CODE OF 1954, § 6052 (as amended by the Revenue Act of 1964).

80. Treas. Reg. § 1.161-2(d)(2) (1960).

81. See, *e.g.*, Rev. Rul. 55-357, 1955-1 CUM. BULL. 13 (the portion of the premium paid by withholding from the employee's pay check is to be included in his gross income); Rev. Rul. 54-165, 1954-1 CUM. BULL. 17 (Treas. Reg. § 1.62-2(d)(2), applies although the group term insurance is convertible into ordinary life insurance); Mim. 6477, 1950-1 CUM. BULL. 16 (where a policy combines term and ordinary insurance, only that portion allocable to the term insurance is excludible).

82. President Kennedy's tax message to Congress on January 24, 1963, P-H FED. TAX REP. BULL., ¶ 27,512.22 (Jan. 25, 1963): "Neither the current value of group term life insurance protection nor the benefits received thereunder are now subject to tax if purchased for an employee by his employer. This is, in effect, a valuable form of compensation, meeting the widespread desire to provide protection for one's

Congress followed his suggestion but, as first stated, raised the amount to 50,000 dollars. The prerequisite to this exclusion—that one must be an "employee"—still remains, however. While this requirement denies the exclusion to partners and to proprietors, it grants the exclusion to employees, who may or may not be stockholders, of subchapter S corporations.

Third, receipt of the proceeds is governed by section 101, as discussed previously, which excludes the single payment from the beneficiary's gross income,[83] which taxes the interest on proceeds left on deposit with the insurance company,[84] and which includes in gross income the interest element in installment receipts except for 1,000 dollars annually paid to the surviving spouse.[85]

Under a more general topic of life insurance and fringe benefits, other types of insurance such as individual term, individual permanent, group permanent, and split-dollar insurance would be discussed.[86] However, none of these offer the numerous advantages of group term life insurance and consequently are left for the text of a more comprehensive and detailed analysis, as are programs of deferred compensation[87] and the numerous uses of life insurance policies as funding media.

III. Corporations' Insurable Interest in Employees' Lives

A. *Definition, Reasons, and Development of Insurable Interest in Life*

Up to this point, the discussion has surveyed briefly the practical uses of life insurance by corporations with emphasis upon the income tax considerations. This discussion rests on the premise that the

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family, which other taxpayers must pay for with after-tax dollars. I recommend that the current annual value to the employee of employer-financed group term life insurance protection be included in income, with an exception for the first $5,000 of coverage to correspond to the present exclusion for uninsured death benefits."

83. Int. Rev. Code of 1954, § 101(a)(1).

84. Int. Rev. Code of 1954, § 101(c).

85. Int. Rev. Code of 1954, § 101(d)(1)(B).

86. *Life Insurance—Corporate Business Use*, 34 BNA Tax Management 27-39 (1963), presents an excellent detailed analysis and discussion of life insurance as a fringe benefit.

87. "The specific tax advantages generally attributed to deferral plans are numerous. First, the lower income of retirement years places that income in lower tax brackets. Second, people of age sixty-five and older receive two personal exemptions (§ 151(c)) which allows them to receive more income tax free. Third, the retirement income credit (§ 37) further reduces taxes. Fourth, when an employee elects to receive a lump sum at retirement, this income receives capital gain treatment (§§ 402(a)(2), 403(a)(2), 1201, 1202). And fifth, postponing the tax payment permits the employee to benefit from the investment of that portion which would otherwise be paid to the federal government. Strecker, *Taxation of Retirement Provision*, 27 Law & Contemp. Prob. 67, 71 (1962).

corporation legally could insure a particular employee. Examining this premise is the next logical step in analyzing the problem area as defined in the introduction. The practical importance of the concluding theoretical discussion appears obvious from the Commissioner's argument that the statutory phrase "insurance contract" means a valid insurance contract, *i.e.*, that the contract must satisfy all requirements of insurance law including the existence of an insurable interest. Thus, the corporation is not allowed to exclude the proceeds from gross income unless the Commissioner's argument is met or discredited.

Defining insurable interest is not an easy matter. Using circuitous reasoning, one could define an insurable interest as that prerequisite relationship between a person and an event which is essential for the existence of a life insurance contract. Needless to say, such a definition is little help in trying to understand that relationship called "insurable interest." Some authors honestly state that a precise definition of insurable interest is impossible to formulate because of the universal aspect of the concept in insurance law.[88] After the concept had evolved, one critic reached this conclusion, but attributed the difficulty to another reason—that the concept per se rests on an inadequate legal basis.[89] Indeed, several of the leading treatises in the field of insurance law offer no definition of the phrase,[90] and even distinguished jurists have had little success in their attempts to define insurable interest.[91] Professor Patterson has offered the most understandable definition of insurable interest, as "a relationship between the insured and the event insured against such that the occurrence of the event will cause substantial loss or harm of some kind to the insured."[92] Also, some states define insurable interest in their statutes.[93] While a perfectionist might contend that any at-

88. "Insurable interest in connection with life insurance cannot be precisely defined, as in the effort to avoid wagering policies, no clear rule has been established by the courts." 3 COUCH, INSURANCE § 24:119 (2d ed. 1960).

89. "The doctrine of insurable interest resting on so unsubstantial a foundation, it has not unnaturally resulted that great difficulty has been experienced in reaching a consistent and comprehensive definition of what an insurable interest is, after all." COOKE, THE LAW OF INSURANCE § 59 (1891).

90. See, *e.g.*, 2 APPLEMAN, INSURANCE LAW AND PRACTICE §§ 761-65 (1941); 3 COUCH, INSURANCE § 24:119 (2d ed. 1960), quoted note 88 *supra*.

91. *E.g.*, "It is not easy to define with precision what will in all cases constitute an insurable interest, so as to take the contract out of the class of wagering policies. It may be stated generally, however, to be such an interest, arising from the relations of the party obtaining the insurance . . . as will justify a reasonable expectation of advantage or benefit from the continuance of his life. It is not necessary that the expectation of advantage or benefit should always be capable of pecuniary estimation." Warnock v. Davis, 104 U.S. 775 (1881).

92. PATTERSON, ESSENTIALS OF INSURANCE LAW § 34 (2d ed. 1957).

93. *E.g.*, "The term 'insurable interest' is defined as meaning . . . in the case of other persons [not related by blood or law], a lawful economic interest in having the life of the insured continue as distinguished from an interest which would arise only by death of the insured." PA. STAT. ANN. tit. 40, § 512 (1962).

tempted definition of insurable interest is either too general and too vague to be practically useful or too precise and too specific to be universally applicable, certainly Professor Patterson has stated a workable definition, especially for the limited scope of this note.

Two general public policies support the requirement of insurable interest in life.[94] The first is the policy that wagering is harmful to the individual and to society,[95] because it rewards unproductive labor and fosters idleness in contravention of the protestant ethic,[96] an almost universally accepted code in England when the requirement was developed in the common law. The policy against murder is the second.[97] To allow a person to insure the life of another with whom he had no relationship would reward and possibly motivate the murder of the *cestui que vie*.[98] The major deterrent against intentional homicide, of course, is the criminal code's punishment for the commission of such heinous crimes rather than this insurance law concept. Often authorities list a third policy reason, namely, to retain the indemnity principle in insurance.[99] Being primarily relevant to property insurance, however, this policy has little application to life insurance[100] other than credit insurance,[101] for the amount of recovery

94. See PATTERSON & YOUNG, CASES & MATERIALS ON INSURANCE 242 (4th ed. 1961). See generally PATTERSON, ESSENTIALS OF INSURANCE LAW § 34 (2d ed. 1957).

95. See, *e.g.*, Warnock v. Davis, 104 U.S. 775 (1881). "Such a policy [*i.e.*, one in which there was no insurable interest] would constitute what is termed a wager policy, or a mere speculative contract upon the life of the assured, with a direct interest in its early termination." *Id.* at 778. "Many courts have stated broadly that insurance contracts in which the beneficiary lacked insurable interest were against public policy and void, usually *upon the ground that they are mere wagering or gambling contracts.*" 2 APPLEMAN, INSURANCE LAW AND PRACTICE § 761 (1941) (Emphasis added.)

96. Ponder the current strength of this public policy in the current context of American life with its easy accessibility to legal casinos (*e.g.*, Las Vegas), to legal pari-mutual betting at race tracks (*e.g.*, Churchill Downs), and to the common knowledge that the odds were 7 to 1 against Clay in his championship bout against Liston.

97. PATTERSON, ESSENTIALS OF INSURANCE LAW § 34 (2d ed. 1957).

98. As most readers already know, the *cestui que vie*, sometimes abbreviated "CQV," is the person whose death is a condition of the insurer's promise to pay the face amount of the policy. This term is used to avoid the ambiguity of using "insured" to designate both the person making the contract with the insurer and the person whose death is a condition of payment.

99. See note 97 *supra*.

100. "No American case has been found in which the amount of recovery on the policy was limited either by the value of the interest of the insured or beneficiary in the life of the insured, or by the circumstance that the same life was insured under other policies. It is commonly said that the life insurance contract is not a 'contract of indemnity.'" PATTERSON & YOUNG, CASES & MATERIALS ON INSURANCE 233 (4th ed. 1961). *But cf.*, "Life insurance in sueh a ease [key man insurance] is like that of fire and marine insurance, a contract of indemnity." United States v. Supplee-Biddle Co., 265 U.S. 189, 195 (1924).

101. Cenerally, courts recognize that a creditor possesses an insurable interest in his debtor's life. However, the amount of insurance which a creditor legally may obtain and the amount of the proceeds which he may retain when sued by the

is determined in advance contractually by the face amount of the policy, not by measuring the pecuniary value of the *cestui que vie's* life after its loss occurs. Arguably, the concept of insurance as a contract of indemnity perhaps was contraposed against the notion of a wagering contract and, as such, manifests that basic policy in a positive context.[102] Yet, a corporation insuring itself against the death of a key man basically is entering a contract to indemnify it against the resulting loss.

To understand the development of insurable interest concept in Anglo-American jurisprudence, one should begin historically with the origin of insurance. The practice of insuring the risks inherent in maritime trade developed in the Italian city-states. Italian merchant seamen introduced this practice to the British seamen and traders, which practice became common in Britain by the sixteenth century. The hazard and uncertainty of maritime ventures, the most risky commercial activity of the period, naturally inferred that any promise to pay a fixed sum if a vessel did not arrive safely in port was a gamble, a wager, a game. Insurance covering marine risks expanded to cover other losses, including the loss of life. Being unable to ascertain "the antiquity of this practice," the author of an early English treatise cites the French book *Le Guidon* as mentioning life insurance "as a contract perfectly well known at that time [1661] in other countries," but reporting "that it was a species of contract wholly forbidden in France, as being repugnant to good morals, and as opening a door to a variety of frauds and abuses."[103] However, in England common law wagers were legal and enforceable in the courts, and the judicial doctrine of stare decisis perpetuated this legality, even as to wagers on human lives, despite the puritanical influence on public opinion in that period.[104] Responding to public opinion and being cognizant of the utter disregard for human feelings which some gamblers ex-

decreased debtor's personal representative have been questioned in the courts. Limiting the amount of insurance to the amount of the debt would deprive the creditor's protection against losing both the interest on the debt and the expense of the insurance (*i.e.*, the premiums plus interest). The only principle apparent in the case law states that a creditor's life insurance on his debtor is valid if the amount is not too greatly disproportionate. For example, the creditor's insurance on the debtor's life was held valid in Ulrich v. Reinoehl, 143 Pa. 238, 22 Atl. 862 (1891) (debt $110; insurance $3,000), and in Grant's Adm'rs v. Kline, 115 Pa. St. 618, 9 Atl. 150 (1887) (debt $743 including $470 for premiums which creditor paid on abandoned policies; insurance $3,000). However, some courts construe the insurance as security for the debt, thus limiting the creditor to the amount of the debt plus interest. *E.g.*, Chapman v. Scott, 234 S.C. 469, 109 S.E.2d 1 (1959).

102. Note, 49 GEO. L.J. 594, 597 (1961).

103. PARK, MARINE INSURANCE 430 (3d ed. 1792).

104. Consider, as examples, the two following cases: In the Earl of March v. Pigot, 5 Burn. 2802, 98 Eng. Rep. 471 (1771), the parties exchanged reciprocal notes promising to pay the other a specific number of guineas (500 and 1600 in the two notes respectively) if the maker's father predeceased the payee's father. Although the

hibited, Parliament passed statutes which required an insured to have an insurable interest in property[105] and in life[106] as a condition precedent to the existence of a valid contract, Parliament's intent being to void contracts made "by way of gaming or wagering."[107] English judges applied these statutes liberally and invalidated any insurance contract which suggested that it was a wager.[108]

When American judges began developing their common law,[109] they either relied on these later English cases or adopted the position enunciated in the English statutes as embodying their state's general public policy.[110] For example, a Massachusetts court, delivering one of the earliest American opinions on insurable interest, held that an insurable interest in life was a prequisite to recovery on the insurance policy, because otherwise "it would be a mere-wager policy," whose enforcement would be "contrary to the general policy of our laws."[111]

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reporter's footnote expressly stated, "such a wager would now be void by 14 Geo. 3, c. 48," neither the parties nor the court, which included Lord Mansfield, questioned the validity of the wagering contract. Mr. Justice Aston's statement that "it was originally intended to be a bet between two young heirs apparent; and the material point to be settled was to fix the difference of the chances of survivorship of their fathers" evidences the fact that the court recognized the contract to be a wagering contract.

In the Earl of Chesterfield v. Jansen, 1 Atk. 301, 26 Eng. Rep. 191 (1750), *S* gave *J* a "bond" promising to pay *J* £ 10,000 if *S* survived *M* in consideration for £ 5,000. *M* died. In payment of this bond, *S* gave *J* a time note containing certain penalty provisions for default. Having paid £ 2,000 of the £ 10,000 debt, *S* died. *S*'s executors filed a bill to relieve the estate of the debt and to cancel the note, alleging that it was "an unconscionsable bargain." Despite the wagering nature of the contract, the court enforced the debt against the estate although it did declare the penalty provisions to be void.

105. Marine Ins. Act, 1746, 19 Geo. 2, c. 37 (repealed).

106. Life Assur. Act, 1774, 14 Geo. 3, c. 48, which states: "An act for regulating insurance upon lives, and for prohibiting all such insurances, except in cases where the persons insurance shall have an interest in the life or death of the person insured. . . . [N]o insurance shall be made by any person or persons, bodies politick or corporate, on the life or lives of any person or persons . . . wherein the person or persons for whose use, benefit . . . [etc., the policies were] made, shall have no interest, or by way of gaming or wagering; and that every assurance made, contrary to the true intent and meaning hereof, shall be null and void, to all intents and purposes whatsoever."

107. Life Assur. Act, 1774, 14 Geo. 3, c. 48.

108. See, *e.g.*, Halford v. Kymer, 10 B. & C. 724, 109 Eng. Rep. 619 (1830).

109. See generally Kimball, *The Role of the Court in the Development of Insurance Law*, 1957 Wis. L. Rev. 520.

110. See, *e.g.*, 3 Couch, Insurance § 24:1 (2d ed. 1960), which states in part: "In this country, however, the courts were quick to recognize the necessity of an insurable interest, and it is now almost universally held, either by force of statutory regulations or upon general principles of public policy or similar grounds, that an insurable interest is necessary to the validity of a policy. . . ." See generally Cammack v. Lewis, 82 U.S. (15 Wall.) 643 (1872).

111. Lord v. Dall, 12 Mass. 115 (1815) (sister, dependent on her brother for support and education, has an insurable interest in his life). Specifically, the court's opinion stated: "It is said, that, being a contract of assurance, the law on the subject of marine insurance is applicable to it; and, therefore, unless the assured had an

Incidentally, this development coincided with the prevalent protestant ethic and American public opinion which were extremely hostile to gambling and wagers.[112] Thus, regardless of the legal ground or reasoning, the requirement of an insurable interest as a prerequisite to a valid insurance contract became firmly entrenched in the American common law. In fact, so well established was the doctrine by 1891 that a vehement, outspoken critic of insurable interest who considered it "a false, artificial and confusing restriction" on the law of contracts realized that his voice cried in the wilderness.[113] Currently, several states have codified this requirement of insurable interest.[114] The one exception to this entire discussion is New Jersey, whose courts have held that New Jersey law does not require an insurable interest in life, absent a statute to the contrary.[115]

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interest in the subject-matter insured, he is not entitled to his action. This position we agree to; for, otherwise, it would be *a mere wager-policy*, which we think would be *contrary to the general policy of our laws*, and therefore void." *Id.* at 117 (Emphasis added.)

112. However, it is interesting to note that in this period lotteries for worthy causes were sanctioned. See generally WILLIAMS, LOTTERIES, LAWS AND MORALS (1958). For example, in 1748 leading Philadelphians, including Benjamin Franklin, sponsored a lottery to raise £ 3,000 to purchase cannons for the city's defense. In 1746 the first of several lotteries for King's College, now Columbia University, was held. *Id.* at 29. Ecclesiastical goals, such as money to build churches, were the objects of numerous lotteries. *Ibid.* And one of the most historically interesting lotteries was authorized by the Virginia legislature in 1826 to aid the financial problems of Thomas Jefferson. *Id.* at 40.

113. COOKE, THE LAW OF INSURANCE § 58 (1891). Because the book is an antique and perhaps unavailable to the reader, and because of the author's colorful antagonism for the insurable interest requirement, a part of his opinion is quoted. "If, however, the contract of insurance is for the benefit of another than the insured, there seems on principle no reason why it should not be governed by the rules applicable to contracts generally, as to who may obtain the benefit thereof. In such cases there is ordinarily no restriction as to the class of persons that may obtain such benefit. But in the case of contraets of insurance, there has become established a false, artificial and confusing restriction as to the class of persons that may obtain the benefit of such a contract. That is to say, the doctrine is, that *the beneficiary must have an insurable interest in the life of the insured.* This doctrine is based on the supposition that it is contrary to public policy, that one person should have an expectation of a benefit conditioned on the happening of the death of another; that the temptation to destroy the life of such other, in order to obtain such benefit, must be balanced, or counteracted, as it were, by the existence of an *insurable interest* in his life. But the theory that it is contrary to public policy, that one person should have an expectation of a benefit conditioned on the happening of the death of another, finds little, if any support from the rules applied to analogous cases; for it is just this expectation that exists in the case of a devise or legacy, or in case of dower and other life tenancies; yet it never seems to have been seriously suggested that on that ground devises, legacies or life tenancies are invalid, as contrary to public policy." COOKE, THE LAW OF INSURANCE § 58 (1891).

114. See, *e.g.*, CAL. INS. CODE ANN. § 286. "[A]n interest in the life or health of a person insured must exist when the insurance takes effect, but need not exist thereafter or when the loss occurs."

115. Howard v. Commonwealth Benefit Ass'n, 98 N.J.L. 267, 118 Atl. 449 (1922). The New Jersey law on this subject is discussed in Fulda, *Insurable Interest in Life, New Jersey View*, 1 RUTGERS L. REV. 29 (1947).

B. *Current Status of the Law*

A corporation possesses an insurable interest in the lives of its key men. This basic principle of insurance law has become so imbedded in the American common law, as discussed above, that only a statute could remove it. The problem with which the courts wrestle is not whether the principle is valid and applicable, but whether the *cestui que vie* was a key man. Thus, once the court decides that a specific individual was or was not a key man, the result flows automatically from the axiomatic application of the principle—a corporation has an insurable interest in the lives of its key men; a corporation has no insurable interest in the lives of ordinary employees.[116] Terminating the employment with the corporation does not invalidate a life insurance policy, provided that the insurable interest existed at the inception of the policy.[117]

To define a key man, courts and other authorities have enunciated several descriptive phrases. For example, a key man is one on whose services the corporation depends for its prosperity,[118] one "whose death would be the cause of substantial loss" to the corporation,[119] one whose "relation to and knowledge of the financial and manufacturing interest of the plaintiff [corporation] was such that his death could not fail to result in serious and substantial loss to its creditors and all others interested in its prosperity,"[120] or one from whose death "in the ordinary course of events, financial loss or disadvantage will naturally and probably result."[121] These phrases should sound familiar,

116. See Annot., 75 A.L.R. 1362.

117. Grigsby v. Russell, 222 U.S. 149 (1911). Some states have a statute to this effect. *E.g.*, CAL. INS. CODE ANN. § 286, quoted in part, note 114 *supra.*

118. "A corporation is often quite dependent upon the services of particular officers for its prosperity. Under such circumstances a corporation has an insurable interest in the life of such an officer. . . ." Wurzburg v. New York Life Ins. Co., 140 Tenn. 59, 63, 203 S.W. 332, 333 (1918).

119. United Security Life Ins. & Trust Co. v. Brown, 270 Pa. 270, 272, 113 Atl. 446, 447 (1921) (no insurable interest in the life of a storage house manager). In full, the quotation reads: "To sustain a contract of this character [*i.e.*, life insurance], it must further appear that there is a real concern in the life of the party named [*i.e.*, *cestui que vie*], whose death would be the cause of substantial loss to those who are ordinarily named as beneficiaries. This does not follow the cessation of ordinary service, but arises where the success of the business is dependent on the continued life of the employee."

120. Mutual Life Ins. Co. v. Board, Armstrong, & Co., 115 Va. 836, 80 S.E. 565 (1914) (insurable interest in the life of the president and general manager of the corporation). The court states: "His [the deceased's] relation to and knowledge of the financial and manufacturing interest of the plaintiff [the corporate employer] was such that his death could not fail to result in serious and substantial loss to its creditors and all others interested in its prosperity." *Id.* at 838, 80 S.E. at 566.

121. United Security Life Ins. & Trust Co. v. Perugini Union Mut. Relief Ass'n, 273 Pa. 554, 117 Atl. 413 (1921), where the court said: "'It is enough that in the ordinary course of events, financial loss or disadvantage will naturally and probably result from the death of the one whose life is insured to the person obtaining the policy.'" *Id.* at 557, 117 Atl. at 414.

for even a cursory analysis of them indicates that these phrases employ the same words which are used to define or to describe insurable interest. Thus, the determination of who is a key man is essentially a determination of the employees in whom the corporation has an insurable interest. Stating that Mr. *X* is a key man is merely stating the conclusion that the corporation possesses an insurable interest in the life of Mr. *X*. In short, the "key man" concept, which has no independent identity from the "insurable interest" concept, provides no guidance in determining the scope of the latter concept.

The test which courts use to determine whether the corporation has an insurable interest in the life of an employee is whether the relationship between the corporation and the employee is such that his death will cause substantial loss or harm to the corporation.[122] This test, which in essence relies both on the definition of insurable interest and on the definition of a key man, for they are the same, is a question of fact.[123] Of course, since the relation between the employee and the corporation is the crucial determinative fact, every case requires that the court examine the facts involved in order to resolve the issue.[124] Consequently, cases may be cited as holding that a corporation has an insurable interest in the life of its president and director,[125] its president,[126] vice president,[127] secretary,[128] treasurer,[129] general manager,[130] department manager,[131] and branch manager.[132] Yet, these titles of authority and responsibility do not conclusively determine the existence of an insurable interest. There is no

122. "The insurable interest of a corporation under such circumstances is a question of fact, and the test is whether a pecuniary loss may be reasonably expected to result to the corporation from the death of the insured. This is a correct statement of the law as held in numerous cases." Wagner v. Nat'l Engraving Co., 307 Ill. App. 509, 512, 30 N.E.2d 750, 751 (1940).

123. *Ibid.*

124. See, *e.g.*, Atlantic Oil Co. v. Patterson, 63-1 CCH U.S. TAX CASES ¶ 9445 (N.D. Ala. 1963) (judgment entered on jury's verdict as to who actually took out the insurance policy).

125. *E.g.*, First Nat'l Bank v. Forester, 223 Ala. 218, 135 So. 167 (1931); West End Savings Bank v. Goodwin, 223 Ala. 185, 135 So. 161 (1931).

126. *E.g.*, United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924); Mut. Life Ins. Co. v. Board, Armstrong & Co., 115 Va. 836, 80 S.E. 565 (1914).

127. *E.g.*, Murray v. G. F. Higgins Co., 300 Pa. 341, 150 Atl. 629 (1930) (*Cestui que vie* was vice president, director, and superintendent, signed checks and contracts, etc.)

128. *E.g.*, Reilly v. Penn Mut. Life Ins. Co., 201 Iowa 555, 207 N.W. 583 (1926).

129. *E.g.*, First Columbus Nat'l Bank v. D. S. Pate Lumber Co., 163 Miss. 691, 141 So. 767 (1932); Baker v. Keet-Rountree Dry Goods Co., 318 Mo. 969, 2 S.W.2d 733 (1928).

130. *E.g.*, Sandlin's Admr'x v. Allen, 262 Ky. 355, 90 S.W.2d 350 (1936); Wurzburg v. New York Life Ins. Co., 140 Tenn. 59, 203 S.W. 332 (1918).

131. *E.g.*, Am. Trust Co. v. Life Ins. Co., 173 N.C. 558, 92 S.E. 706 (1917).

132. *E.g.*, Alexander v. Criffith Brokerage Co., 228 Mo. App. 773, 73 S.W.2d 418 (1934).

insurable interest in these officers unless the facts of the specific case demonstrate that the individual conducted the affairs of the corporation as a person usually holding the title would effectuate his responsibility.[133] The activities of an individual, not the individual's title, create the relationship with the corporation which gives the corporation an insurable interest.

Some authorities indicate that to prove the existence of an insurable interest one must demonstrate a twofold pecuniary interest: (1) that the employee's experience, knowledge, and skill are necessary for the success of the corporation, and (2) that the employee's death would cause the corporation a substantial loss.[134] In essence, however, these are merely different aspects of the same interest, for the absence of anything necessary for success of a corporation would cause it a substantial loss.

A split of authority exists on the question of who has judicial standing to raise the defense of lack of insurable interest. The English rule states that only the insurer can raise the question,[135] a rule which is adopted in a small number of American states.[136] Basically, this rule implies that an insurance contract without an insurable interest is voidable, not void.[137] Thus, unless the insurance company elects to avoid the contract rather than pay the proceeds, a contract exists analogous to a contract with a minor. However, the majority of American courts allow others besides the insurer to raise the defense and thus imply that the contract is void, not merely voidable.[138] This difference is based on an historical accident of development, not on judicial decisions which considered the difference. A statute generated the English rule requiring insurable interest and where it was inapplicable the English common law sanctioning wagers applied; judicial opinions generated the American rule based on a general policy against wagering and a special abhorence of wagering with

133. See, *e.g.*, United Security Life Ins. Co. v. Brown, 270 Pa. 270, 113 Atl. 446 (1921) (mere designation of an employee as "manager" was not sufficient to demonstrate an insurable interest, because there was no proof that the success of the business depended on his life).

134. Note, 49 GEO. L.J. 594, 606 (1961), and cases cited therein.

135. Worthington v. Curtis, L.R. 1 Ch. 419 (1875).

136. Clements v. Terrell, 167 Ga. 237, 145 S.E. 78 (1928); Poland v. Fisher's Estate, 329 S.W.2d 768 (Mo. 1959). *But see* Annot., 175 A.L.R. 1276 (1948).

137. This implication is based on the following words: "[T]here are two reasons for which the appeal must fail. First, because the statute is a defence for the insurance company only, if they choose to avail themselves of it. If they do not, the question who is entitled to the money must be determined as if the statute did not exist. [And at common law insuranee contracts without an insurable interest, being wagering contracts, were legally enforceable obligations.] The contract is only made void as between the company and the insurer." Washington v. Curtis, L.R. 1 Ch. 419, 425 (1875).

138. *Cf.*, CALIF. INS. CODE § 280: "If the insured has no insurable interest, the contract is void."

lives. Early American litigants did not question the right to raise the defense; consequently, cases were reported in which noninsurers used the defense.[139] These cases form the precedent for allowing any party to raise the question. Dictum by the Supreme Court implies that the Commissioner can raise the question of insurable interest where the ultimate issue is taxation of the proceeds,[140] a point expressly made in the cases noted in the introduction.

C. *Analysis and Recommended Changes*

An adequate analysis of the requirement that a corporation have an insurable interest in its employees' lives before it can procure a valid life insurance policy necessitates examining the nature of American corporations today to see how this requirement of insurable interest supports the public policies upon which it is based.

Professor Berle has expounded the economic theory that the classical, free enterprise concept of small, independent entrepreneurs competing among themselves to sell their wares and to attract investors' savings for expansion is inapplicable to America today.[141] Instead, a relatively small number of giant economic complexes completely dominate their industrial field.[142] Consider, for example, the automotive industry with General Motors, Ford, and Chrysler, the electrical appliance industry with General Electric and Westinghouse, the steel industry with U. S. Steel, and the tobacco industry with R. J. Reynolds and American Tobacco. While one might question Professor Berle's suggestions and conclusions, it is difficult to refute his initial premise concerning the American economic scene. Nevertheless, this basic premise does not deny the existence of small closed corporations.

With this background it becomes necessary to distinguish sharply between two denotations of the words "key man." First, many corporations colloquially call their top echelon of manging executives "key men," a fact which has never been determinative of legal issue. Second, the legal denotation of "key man," as discussed above, states the conclusion that the corporation possesses an insurable interest in his life and that his life is essential to the prosperity of the company. True, these two aspects of "key man" arise from the same economic facts. However, the first states a sociological conclusion that an individual is successful and, to use the colloquial, "has it made"; the second states a legal conclusion in the area of insurance law. The

139. *E.g.*, Grigsby v. Russell, 222 U.S. 149 (1911); Bromley's Adm'r v. Worthington Life Ins. Co., 122 Ky. 402, 92 S.W. 17 (1906).

140. United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924).

141. BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION (1954).

142. See generally STATISTICAL ABSTRACT OF THE UNITED STATES 1963, Table No. 648.

discussion in this note, which recognizes the existence of the first denotation, is concerned only with the second.

In this context, examine the relationship of specific employees to their corporate employer and the loss accruing to the corporation upon their death. For example, although a corporation loses a plant manager's technical knowledge and skill when he dies, usually several young, intelligent assistant plant managers are available for promotion to eliminate the loss. In this case has the giant corporation actually suffered any greater economic loss than when an assembly line foreman, who knows thoroughly both the intricate process and his subordinates' capabilities, dies? The education, experience, and ability of the corporation's president will be gone upon his death, but is the cost of finding and acquiring a new replacement any bigger than the cost of hiring and training employees to program the corporation's computers or to design improved products? The point is simple. Both the giant size of corporations today and the increased amount of training and skill required to gain employment cause the distinction between an essential employee (*i.e.*, a key man) and a nonessential employee (*i.e.*, an ordinary employee) to diminish. The demand for more highly skilled labor increases the expense of training these ordinary employees; the gigantic size of these corporations infers that one individual is less significant economically to the corporation.

If this be an economic reality, why maintain and reconstruct the legal distinction? The author suggests that there is no valid reason for so doing, despite the existence of the sociological distinction. The legal distinction between key men and ordinary employees should be abolished; a corporation should have an insurable interest in all employees' lives. Parenthetically, the contention that a corporation should have an insurable interest in all of its employees is neither radical nor original, for North Carolina has a statute giving, unqualifiedly, an employer, including corporations, an insurable interest in the life of every employee.[143] It is doubtful that this has increased either wagering via life insurance policies or murders in that state, a point which refers to two of the public policies supporting insurable interest.

The primary advantage of abolishing this meaningless distinction between key men and other employees is the more logical results obtainable under current business conditions. A second advantage

143. N.C. GEN. STAT. § 58-204.1 (1963). "Insurable interest in life and physical ability of employee or agent. *An employer,* whether a partnership, joint venture, business trust, mutual association, *corporation,* any other form of business organization, or one or more individuals, or any religious, educational, charitable corporation, institution or body *has an insurable interest and right to insure the physical ability of the life* or both the physical ability and the life, *of an employee for the benefit of such employer.*" (Emphasis added.) See generally Note 29, N.C.L. REV. 351, 401 (1951).

is the simplicity of the proposed rule's application. Whereby many difficult problems, which otherwise would arise, are avoided. For cxample, is a Phi Beta Kappa member, who later was graduated from the Harvard Business School, who completed the corporation's managerial training program, who is climbing the executive ladder of authority, but who has been an employee of the corporation only four years, a key man? Is a super-salesman, who consistently wins his company's top salesman award but who has no authority or responsibility besides selling, a key man? These difficult problems and others would be avoided by adopting the contention presented. A third advantage relates to those two policies which generally are cited to support the requirement of insurable interest. As mentioned with the North Carolina statute, it is doubtful that the new rule would have the practical effect of encouraging either wagering or homicide.

But, a critic might retort that all of these arguments are premised on the large corporation and that these objections to the current rule of law are inapplicable to the small closed corporation. Truly in small corporations one can more easily distinguish between key men and ordinary employees (applying the usual social connotations to those words). However, as the size of the business decreases, every employee becomes relatively more important and necessary for the corporation's economic prosperity. For example, consider the route man of a small diaper service who knows all the company's customers personally, who thus fosters much good will, and who also can be trusted to collect amounts due on account where the company has inadequate accounting procedures to detect petty theft. Or, consider a supply room clerk who knows the exact location and approximate quantity of the supplies where the corporation has no formal organization of the supply room and no accounting method of inventory of supplies. These concrete examples indicate both the valuable service which so-called ordinary employees render to a small corporation and the relative economic dependence of the corporation on their continued service. Thus, empirically, the arguments to abolish the distinction are equally valid to small corporations.

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