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Bad Policy For Good Policies: Article 9's Insurance Exclusion

Andrew Verstein
Yale Law School, andrew.verstein@yale.edu

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Article 9 of the Uniform Commercial Code excludes from its scope any transfer of an interest in a life insurance policy. Thus, any lender whose security is a life insurance policy may not look to the UCC to determine her rights. This Article argues that the exclusion should be eliminated because it leaves insurance governed by antiquated and problematic law. Three specific problems are considered: non-UCC law does not have a satisfactory alternative to UCC perfection; non-UCC law is insufficient to prevent lenders from abusively taking more than their share of value from defaulted policies; and non-UCC law allows insurance companies to hinder securitization through the "reservation problem." The result is that Americans borrow $121 billion worth of policy loans, almost all of which comes without serious competition. Eliminating the life insurance exclusion will rationalize the law of lending in this area, and improve prospects for a secondary market.

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* Associate Research Scholar in Law and John R. Raben/Sullivan & Cromwell Executive Director, Yale Law School Center for the Study of Corporate Law, Yale Law School. The author would like to thank Eric Brunstad, Matthew Grieder, Mitzi Huang, George Mullin and Debbie Cotton for their insightful comments. All errors remain the author's own.

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$100 billion worth of American life insurance policies are "impaired," meaning that the insured would realize more money by selling the policy on the secondary market than by surrendering the policy to the insurance company.[1] Many consumers benefit from selling or surrendering their life insurance policies, but selling one's life insurance is a serious step that many people later regret. Rather than selling her policy, an insured could instead borrow against it, with less permanence and worry. Borrowing is not without its own risks.[2] Nevertheless, for many insureds, borrowing is a better choice than selling.

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[1] Neil A. Doherty & Hal J. Singer, *The Benefits of a Secondary Market for Life Insurance Policies*, 38 REAL PROP. PROB. & TR. J. 449 (2003). *See also* DELOITTE-UCONN ACTUARIAL CTR., DELOITTE CONSULTING LLP & THE UNIVERSITY OF CONNECTICUT, THE LIFE SETTLEMENT MARKET: AN ACTUARIAL PERSPECTIVE ON CONSUMER ECONOMIC VALUE (2005), *available at* http://www.quatloos.com/uconn_deloitte_life_settlements.pdf.

[2] Recent events in the financial markets have shown that improvident borrowing and excessive indebtedness can lead to harms of all their own.

Borrowing against life insurance is widespread. Americans currently secure about $121 billion dollars worth of loans with their life insurance policies.[3] The vast majority of these loans were made by their issuing insurance company and without any serious competition from other lenders. This is in part because of difficulty and uncertainty in the law governing the assignments of life insurance policies. Though it is legal to sell or pledge a life insurance policy, life insurance policies may not serve as security for the purposes of an Article 9 lien.

Revised Article 9 of the Uniform Commercial Code is governing law for almost all security interest transactions in all states.[4] The product of extensive scholarly drafting and professional insights, the UCC is lauded for its clarity, coherence and logic.[5] Despite its potential benefits, Article 9 excludes from its scope transfers of interests in insurance policies.[6] Forty-

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Moreover, some insurance borrowing arrangements can be disadvantageous, fraudulent, or predatory. *See infra* Part III.D.

[3] FED. RES., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDING, FOURTH QUARTER 2009 32 (Mar. 11, 2010), *available at* http://www.federalreserve.gov/releases/z1/current/z1r-1.pdf.

[4] U.C.C. § 9-109(a)(1) (2000) ("[T]his Article applies to a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract.").

[5] *See, e.g.*, Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2021 (1994) ("In embarking upon the revision of what many consider the most successful commercial statute ever . . . ."); Donald J. Rapson, *Default and Enforcement of Security Interests under Revised Article 9*, 74 CHI.-KENT L. REV. 893, 893 (1999) ("Article 9 has been rightfully lauded as the 'jewel' of the Uniform Commercial Code . . . ."); Edward L. Rubin, *Efficiency, Equity and the Proposed Revisions of Articles 3 and 4*, 42 ALA. L. REV. 551, 557 (1991) ("[T]he greatest conceptual achievement in the field was Article 9 of the U.C.C. Its drafters, Gilmore and Dunham, had unified the various forms of security instruments-chattel mortgages, trust receipts, field warehouses, pledges and so forth-into a single coherent framework with a new, generic terminology."); Karl N. Llewellyn, *Why We Need the Uniform Commercial Code*, 10 U. FLA. L. REV. 367, 379 (1957) ("[T]he whole of Article 9 brings into simplified and workable form the law of all chattel security.").

[6] U.C.C. § 9-109(d)(8) (2000) ("This article does not apply to . . . a transfer of an interest in or an assignment of a claim under a policy of insurance, other than an assignment by or to a health-care provider of a health-care-insurance receivable and any subsequent assignment of the right to payment, but Sections 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds"). Notice an *ad hoc* exception for health-care insurance receivables. *See id.* Moreover the code does not exclude the proceeds of insurance policies from its scope. *Id.*; *see also* U.C.C.

eight of the fifty states follow the UCC in excluding insurance policies from the scope of their state's version of Article 9.[7] A lender who accepts a life insurance policy as collateral to secure a debt may not look to Article 9 to determine her rights and responsibilities. But as states adopted Article 9, they repealed their other security statutes. So while the practice of

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§§ 9-315, -322. But this inclusion is meant to allow secured parties whose collateral is destroyed to maintain their interest in the subsequent insurance money. *See* Peter Coogan, *The New UCC Article 9*, 86 HARV. L. REV. 477, 515 (1973). Neither exception is relevant to the discussion at hand.

[7] ALA. CODE § 7-9A-109 (D)(8) (LexisNexis 2006); ALASKA STAT. § 45.29.109(d)(8) (LexisNexis 2010); ARIZ. REV. STAT. ANN. § 47-9109 (West 2005); ARK. CODE ANN. § 4-9-109(d)(8) (LexisNexis 2001); COLO. REV. STAT. ANN. § 4-9-109(d)(8) (LexisNexis 2010); CONN. GEN. STAT. ANN. § 42a-9-109 (West 2009); DEL. CODE. ANN. tit. 6, § 9-109 (2005); DC CODE § 28:9-109 (LexisNexis 2001); FLA. STAT. ANN. § 679.1091(4)(h) (West 2003); GA. CODE ANN., § 11-9-109(d)(8) (West 2010); HAW. REV. STAT. § 490:9-109(d)(8) (2008); IDAHO CODE ANN. § 28-9-109(d)(8) (2001); 810 ILL. COMP. STAT. 5/9-109(d)(8) (West 2004); IND. CODE ANN. § 26-1-9.1-109(d)(8) (LexisNexis 2005); IOWA CODE ANN. § 554.9109(4)(h) (West 2004); KAN. STAT. ANN. § 84-9-109(d)(8) (1996); KY. REV. STAT. § 355.9-109 (4)(h) (West 2006); LA. REV. STAT. § 10:9-109(d)(8) (West 2002); ME. REV. STAT. ANN. tit. 11, § 9-1109(4)(h) (West Supp. 2010); MD. CODE ANN., COM. LAW, § 9-109(d)(8) (LexisNexis 2002); MICH. COMP. LAWS ANN. § 440.9109(h)(4) (LexisNexis 2001); MINN. STAT. ANN. § 336.9-109(d)(8) (West 2002); MISS. CODE ANN. § 75-9-109(d)(8) (LexisNexis 1972); MO. ANN. STAT. § 400.9-109 (d)(8) (West 2003); MONT. CODE ANN. § 30-9A-109(4)(h) (2009); NEB. REV. STAT. § 9-109(D)(8) (2006); NEV. REV. STAT. § 104.9109(4)(h) (LexisNexis 2007); N.H. REV. STAT. § 382-A:9-109(d)(8) (LexisNexis 2009); N.J. STAT. ANN. § 12A:9-109(d)(8) (West 2004); N.M. STAT. ANN. § 55-9-109 (d)(8) (West 2001); N.C. GEN. STAT. ANN. § 25-9-109(d)(8) (LexisNexis 2001); N.D. CENT. CODE § 41-09-09(4)(h) (LexisNexis 2001); OHIO REV. CODE ANN. § 1309.109(d)(8) (West 2010); OKLA. STAT. ANN. tit. 12A, § 1-9-109(d)(8) (West 2001); OR. REV. STAT. § 79.0109(4)(h) (2009); 13 PA. CONS. STAT. ANN. § 9109 (d)(8) (West 2002); R.I. GEN. LAWS § 6A-9-109(d)(8) (LexisNexis 2001); S.C. CODE ANN. § 36-9-109(d)(8) (West 2003); S.D. CODIFIED LAWS § 57A-9-109(d)(8) (West 2004); TENN. CODE ANN. § 47-9-109(d)(8) (LexisNexis 2001); TEX. BUS. & COM. CODE ANN. § 9.109(d)(8) (West 2002); UTAH CODE ANN. § 70A-9a-109(d)(8) (LexisNexis 2009); V.I. CODE ANN. tit. 11A, Art. 9 § 9-109(d)(8) (West 2009); VT. STAT. ANN. tit. 9A, § 9-109(d)(8) (LexisNexis 2001); VA. CODE ANN. § 8.9A-109(d)(8) (LexisNexis 2001); WASH. REV. CODE ANN. § 62A.9 A-109(d)(8) (West 2003); W. VA. CODE § 46-9-109 (d)(8) (LexisNexis 2007); WIS. STAT. ANN. § 409.109(4)(h) (West 2003); WYO. STAT. ANN. § 34.1-9-109 (d)(vii) (LexisNexis 2009). *But see* CAL. COM. CODE § 9109 (West 2002); LA. REV. STAT. § 10:9-109(d)(8) (West 2002).

borrowing on insurance policies grows exponentially,[8] there is less statutory law than ever. In that absence of statutory law, the common law governs from subterranean obscurity.

Article 9's Official Comments rationalize the insurance policy exclusion by stating, "Such transactions are often quite special, do not fit easily under a general commercial statute and are adequately covered by existing law."[9] However, by the late 1960s, the Drafting Committee was criticizing the exclusion and the above-stated rationale:

> It is hard to see where loans made by outsiders 'are adequately covered by existing law' and why they did not 'fit easily under a general commercial statute.' Indeed, it would appear that the law needs some rules to cover the growing practice of insurance premium financing where the loan by an outsider is always secured by a pledge of the insurance policy."[10]

This Article argues that security interests in life insurance policies can and should be within a general commercial statute, the Uniform Commercial Code's Article 9 and its concomitant state enactments.

The law as it currently operates is woefully inadequate. This is because the exclusion does more than decline UCC-specific legal procedures. It causes interests in life insurance policies to tumble down the rabbit hole into the pre-statutory common law. Economic innovation and industry practice have far outpaced the law in this area, and that has

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[8] The target market for life settlements, a subset of the impaired policies most attractive for a policy loan, is anticipated to grow at three times the rate of population growth in the coming decades. *See* SUNEET KAMATH & TIMOTHY SLEDGE, BERNSTEIN RESEARCH CALL, LIFE INSURANCE LONG VIEW – LIFE SETTLEMENTS NEED NOT BE UNSETTLING 6 (Sanford C. Bernstein & Co.) (2005).

[9] Uniform Commercial Code: 1962 Official Text with Comments (Article 3 to End), 621 (1963), *reprinted in* XXIII Uniform Commercial Code Drafts, 401 (Comp., Elizabeth Slusser Kelly, 1984). The Comments to the current draft of the UCC no longer explain the policy exclusion at all.

[10] Homer Kripke, Associate Reporter of the Review Committee for Article 9 of the Uniform Commercial Code, Memorandum Re: Problems of Inclusion and Exclusion. 4-5 (Feb. 16, 1968). Permanent Editorial Board for the Uniform Commercial Code, Document No. 10 in VI Uniform Commercial Code: Confidential Drafts, (Comp., Elizabeth Slusser Kelly & Ann Puckett, 1995). Kripke's comments were primarily directed at the exclusion of third party loans to the insured.

potentially harsh consequences for the consumers whose finances are impacted by the insurance industry.

Part I explains the basics of insurance financing transactions, emphasizing the importance of policy loans and sales to insurance customers, and how a vibrant secondary market serves those interests. Part I gives the reader a sense of what is at stake.

Part II explains the trouble with UCC § 9-109(d)(8) by showing three areas where the law is irregular, unfair, or at odds with modern business practice. Section A considers the "perfection problem," which are those difficulties a party may experience in trying to perfect her security interest in an insurance policy. The current law grants priority in an uncertain and inefficient manner, to the detriment of secured parties, insureds, and insurers alike. The perfection problem is well known to those who follow these issues,[11] though the growing importance of an efficient secondary market makes it more important than ever.

Sections B and C present new problems with the exclusion. No previous scholarship has noticed or addressed these issues. Section B, the "surplus problem," explains the law regarding the division of surplus from sale, surrender, or maturity of the policy. An important question that emerges in any insurance policy financing is "upon default, who gets what?" The rise of the secondary market has seen a variety of creditors who hope to receive the full maturity or resale value of the policy upon which the loan is secured. Because the policy is often worth more than the loan it secures, there is often a windfall to the creditors. These creditors are often unjustly enriched, and the present legal regime is insufficient to deter them.

Section C explains how the secondary market is threatened by a particularly bedeviling combination of draftsmanship and old law. Nearly all existing insurance policies are assigned in a manner that impedes the creditor's ability to resell the policy. The resale is impeded as a result of a reservation clause in the policy assignment, and so is referred to as "the reservation problem."

Each of these problems would be solved if security interests in life insurance policies were included within the scope of Article 9 of the UCC. Because interests in insurance policies are choses in action or things in

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[11] Gerald T. McLaughlin, *"Seek but You May Not Find": Non-UCC Recorded, Unrecorded and Hidden Security Interests under Article 9 of the Uniform Commercial Code*, 53 FORDHAM L. REV. 953, 959 (1985); Stephen Knippenberg, *Insurance Policies as Collateral Under Article 9: Withdrawal of the Section 9-104(g) Exclusion*, *in* APPENDICES TO REPORT OF THE ARTICLE 9 STUDY COMMITTEE OF THE PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, 219 (1992).

action,[12] Article 9 would treat insurance policies as general intangibles.[13] Security interests in general intangibles are perfected by filing with the Secretary of State.[14] They are subject to a well-understood foreclosure and disposition regime.[15] Contractual restrictions on assignment of interests in general intangibles are invalid.[16] These features of Article 9, in addition to its general coherence and uniform treatment of other security interests, promise substantial improvements to this area of financing.

Part III goes on to consider and reject objections to this proposal. Five such objections are considered. Historical analysis shows that there was never a compelling reason for the exclusion, and policy analysis shows that exclusion is an inappropriate mechanism for protecting consumers or the insurance industry. Part IV concludes by taking stock of the problem and imagining the significance of this proposed solution for the broader financial market.

I. WHY PEOPLE BORROW AGAINST THEIR INSURANCE POLICIES, AND WHY IT SHOULD BE EASIER.

Judge Crippin in *St. John v. American Mutual Life Insurance Co.*, noted that "[W]ithout the right to assign, insurances on lives lose half their usefulness."[17] An insured's right to assign an insurance policy to a third party is not seriously contested. The right was clearly recognized by the Supreme Court of the United States in 1911.[18] But the law may make it difficult,[19] and as a result compromise half the usefulness of an insurance policy.

Many different rationales might motivate an individual to borrow against her life insurance policy.[20] Most simply, an insured may desire to keep her insurance policy but be unable or unwilling to continue paying

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[12] *See infra* note 94.

[13] U.C.C. § 9-102(1)(42) (2000).

[14] U.C.C. § 9-310 (2000).

[15] U.C.C. § 9-610(a) (2000).

[16] U.C.C. § 9-408 (2000).

[17] St. John v. Am. Mut. Life Ins. Co., 13 N.Y. 31, 39 (1855). In that case, perhaps not by coincidence, the surrender value of the policy was approximately half of the death benefit.

[18] Grigsby v. Russel, 222 U.S. 149 (1911).

[19] *See infra* Part II.

[20] Sachin Kohli, *Pricing Death: Analyzing the Secondary Market for Life Insurance Policies and its Regulatory Environment*, 54 BUFF. L. REV. 279, 293-95 (2006) (listing manifold reasons policy owner may wish to part with it).

premiums. Perhaps needs have changed, as would be the case if dependants have grown up or passed away. Perhaps her current policy is under-funded and she desires capital with which to invest in a better-suited life insurance product.[21] Perhaps she needs an emergency fund to finance current expenses in the event of economic hardship.[22] More than ever, our law respects such transactions and understands life insurance policies as instruments for planning for the aftermath of rapid declines in health other than death,[23] and as a financial asset more generally.

Recently, great attention has been directed towards so-called "life settlements" or "viatical settlements."[24] In these transactions, insureds sell their policies to investors who then pay the premiums and stand to collect the death or "maturity" benefit. It is clear that some consumers benefit from this novel way of liquidating their insurance assets, but the irreparable quality of a sale increases the risk of fraudulent or unfair transactions.[25]

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[21] Perhaps 40% of life insurance policy sales result in the purchase of a another financial product. Heather D. Mitchell, *The Producer's Role in a Life Settlement*, LIFE INS. SELLING, Feb. 1, 2004, (magazine), at 3 (statement of Scott Butterworth).

[22] Andre P. Liebenberg, James M. Carson & Robert E. Hoyt, *The Demand for Life Insurance Policy Loans*, 77 J. RISK AND INSURANCE 651 (SEPT. 2010), *available at* SSRN: http://ssrn.com/abstract=1653049.

[23] Wayne M. Gazur, *Death and Taxes: The Taxation of Accelerated Death Benefits for the Terminally Ill*, 11 VA. TAX REV. 263, 266 (1991) ("Arguably, an income tax exclusion for accelerated death benefits . . . blur[s] the present distinction between the income taxation of life insurance, which traditionally emphasizes survivor protection, and the taxation of retirement, health, and long-term care requirements.").

[24] *See* Ffiona M. Jones, Note, *The Viatical Settlement Industry: The Regulatory Scheme and Its Implications for the Future of the Industry*, 6 CONN. INS. L.J. 477, 480 (2000).

[25] According to one study, the price paid by third parties for life insurance policies tended to exceed surrender value, but amounted to only a small fraction of the present value of the policy's maturity payment. On average, insureds were paid 20% of the face value of the policy, but the policies purchased were worth 64% of the face value to the purchaser who holds them to maturity. More worryingly, it is not clear that insureds realize that this difference is so large since many industry estimates downplay relevant expenses the insured will bear in a policy sale. DELOITTE-UCONN ACTUARIAL CTR., DELOITTE CONSULTING & THE UNIVERSITY OF CONNECTICUT, THE LIFE SETTLEMENTS MARKET: AN ACTUARIAL PERSPECTIVE ON CONSUMER ECONOMIC VALUE 8 (2005); *see also* Joy D. Kosiewicz, Comment, *Death for Sale: A Call to Regulate the Viatical Settlement Industry*, 48 CASE W. RES. L. REV. 701 (1998) (describing potential abuses).

Another way for a cash strapped consumer to deal with premium payments is to borrow against the insurance policy for those same amounts. Loans secured by life insurance mark a palatable halfway point between the extremes of outright sale of the policy on the one hand and continued premium payment (which may no longer be possible for some insureds) on the other. Policy-secured loans allow an insured to monetize her valuable asset without permanently losing her residual interest in her policy. If she later regrets borrowing against her policy, she may be able to repay her creditor and again own the proceeds in full.[26] If the insured dies before having borrowed much of her line of credit, the surplus value above the debt belongs to her or her estate.[27]

Today many consumers borrow from their life insurance companies. However, because the current legal regime discourages third-party creditors from making favorable bids, insureds must often borrow from their insurance company without being able to consider competing offers from other lenders.[28] The bargaining power of the insured and the lending insurance company is grossly unequal, and one may reasonably deduce that this inequality harms consumers and generally discourages consumers from borrowing against their insurance. Insurance statutes and market competition only partially mitigate these harms.

If we improve the law, with the result being a freer market, what is the benefit? This section addresses that question, explaining how the power to liberally sell or borrow against a policy will tend to benefit consumers by obtaining greater value for them than the transactions in which they currently engage. A liberal secondary market involving securitization of life insurance policies will also benefit investors, insurance companies, and the market as a whole.

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[26] *See* 44 C.J.S. *Insurance* § 563 (2007).

[27] *See* 44 C.J.S. *Insurance* § 562 (2007).

[28] Insurance companies take steps to discourage insureds access to third-party financing. *See* Lori Widmer, *Life Settlement Regulation Makes It Harder to Avoid the Market*, AGENT SALES J., Feb. 2010 ("Many have gone so far as to ban the mere mention of life settlements to policyholders, and a number of insurers include contract stipulations that expressly prohibit agents from entering into such discussions."). Some insurance companies have restricted agents from informing customers about third party assignability rights, while one insurance company has added a "right of first refusal." James C. Magner, *What is Life Insurance? The Evolution of Financial Products*, 35 EST. PLAN 24, 30 (2008). Accumulator Universal Life III offered by Phoenix Home Life Variable Insurance Company, a Connecticut-domiciled affiliate of Phoenix Life Insurance. *Id.* at 30 n.55.0z.

A. HOW CONSUMERS BENEFIT FROM A LIBERAL AND EFFICIENT ASSIGNMENT REGIME

Insurance companies provide loans pursuant to the terms of the particular insurance policy and applicable state laws. Insurance companies will often lend up to the surrender value of an insurance policy, which is the amount of cash the insurance company would pay to an insured who chooses to discontinue the policy. For a term-life policy, the surrender value is generally zero. For whole-life policies, which have an internal savings component, the surrender value, or the maximum borrowing amount, is generally no greater than the reserve set aside to fund the anticipated payment upon maturity.[29]

It is, in any event, set by statute or by the contract at the time the policy is originated.[30] The surrender value at any given moment can be called the *ex ante* value of the policy, because it represents the current value as determined under a contract that does not account for intervening changes in facts.

If third party lenders were unimpeded by difficult and confusing laws, they would have incentives to provide better terms to some insureds than insurance companies. This is because they have an incentive to lend against the *ex post* value of the securing insurance policy, which accounts for subsequent changes in circumstances, while insurance companies do not have such an incentive.

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[29] Doherty & Singer, *supra* note 1, at 451 (explaining that "[i]n the case of the lapse of a term-life policy, a policyholder who could no longer afford premium payments simply lost his insurance coverage and received nothing. In the case of a surrender of a universal, or whole-life policy, the predetermined schedule of surrender values offered by the insurance company—representing at most the reserve set aside to fund future insurance costs at standard rates—did not compensate a policyholder for the full actuarial value of the impaired policy.").

[30] *See* ALASKA STAT. § 21.45.080(a) (2010); ARIZ. REV. STAT. ANN. § 20-1209(A) (2010); Del. Code Ann. tit. 18, § 2911(a) (2005); GA. CODE ANN. § 33-25-3(5) (2003); ME. REV. STAT. ANN. tit. 24-A, § 2510(1) (2000); MASS. GEN. LAWS ch. 175, § 132 (1998); MINN. STAT. ANN. § 61A.03(g) (West 2005); MONT. CODE. ANN. § 33-20-131(1) (2009); NEV. REV. STAT. ANN. 688A.110(1) (LexisNexis 2009); N.J. STAT. ANN. § 17B:25-8 (West 2006); OR. REV. STAT. § 743.186(1) (2009); 40 PA. STAT. ANN. § 510(h)(2) (West 1999); S.C. CODE ANN. § 38-63-220(l) (2002); VT. STAT. ANN. tit. 8, § 3731(7)(A) (2009); WASH. REV. CODE. ANN. § 48.23.080(1)(b) (West 2010); W. VA. CODE ANN. § 33-13-8(a) (LexisNexis 2006).

History may illuminate the present: insurance companies used to act as abusive monopolists when their customers wished to discontinue premium payments. Professor Gazur recounts a story of the early abuses of insurance company monopoly on the loan and surrender markets:

> In London, [Elizur Wright] visited the insurance auctions at the Royal Exchange. There he saw old men standing on the life insurance auction block, their policies being offered to the highest bidder at a fraction of their actual worth. In one case a man had paid premiums for forty-four years and could meet the payments no longer. "This was done, I was told, because the companies made it a rule never to buy their own policies," wrote Mr. Wright.[31]

Although the worst abuses have been long curtailed, insurance companies still profit when their customers have fewer options in monetizing their policies. In particular, there is a direct relationship between lapse rate and profitability, and an inverse relationship between lapse rate and credit availability.

Insurance companies will ordinarily lend up to the surrender value of the policy, but no further. They may choose not to lend at all if the state statute does not require it.[32] An insured that is unable to get a policy loan

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[31] Wayne M. Gazur, *Death and Taxes: The Taxation of Accelerated Death Benefits for the Terminally Ill*, 11 VA. TAX REV. 263, 273 (1991), *citing* ALBERT W. ATWOOD, THE GREAT STEWARDSHIP 75 (1945).

[32] 5 PLITT ET AL., COUCH ON INSURANCE § 80:4 (3d. ed. 2005) (insureds right to loan may be conditioned on having paid premiums on time for a prescribed period of months or years); *see also* MASS. GEN. LAWS ch. 175, § 142(2) (1998) (stating that "[a]fter premiums have been paid for at least three full years on any policy of life insurance issued or delivered in the commonwealth by any life company, the holder thereof, upon written application therefore to the company at its home office and upon an assignment of the policy to the company, in a form satisfactory to it, shall be entitled to a loan from the company of a sum not exceeding its loan value, on the sole security of the policy."); N.Y. INSURANCE LAW § 3203(8)(A) (McKinney 2006); OHIO REV. CODE ANN. § 3915.05(G) (LexisNexis 2010); Del Rio v. Prudential Ins. Co., 199 N.E. 32, 34 (1935) (insurer was compelled to comply with a statute requiring the making of a loan after three full years of premiums had been paid by insured); Umstattd v. Metropolitan Life Ins. Co., 110 S.W.2d 342, 350 (1937); Gray v. Aetna Life Ins. Co., 178 Tenn. 88, 156 S.W.2d 391, 393 (1941) (insured required to have paid a certain amount before being eligible for policy loan); 44 C.J.S. *Insurance* § 354 (2007).

sufficient to cover her premiums may surrender her policy or allow it to lapse.

Insurance companies build a rate of lapse into their business models.[33] They assume that some insureds will stop paying the premiums rather than wait to collect the full maturity sum, even when the maturity amount is substantially greater than the premiums probably required to service the policy. If insureds could borrow up to the true value of their policy at a competitive rate, they could pay their premiums on credit and avoid lapse, or borrow against their policies rather than use the surrender option.

Primary markets for insurance products are largely competitive,[34] so initial surrender prices should be actuarially fair at the time a consumer begins coverage. Even without laws forbidding the abusive practices Gazur reported, insurance companies have an incentive to offer *ex ante* reasonable surrender options because it is one feature consumers may compare as they decide which policy to select. Customers will pay less for an insurance policy if they think that it will be subject to unfair borrowing or surrender terms.

However insurers have no *ex post* incentive to update the surrender value to become actuarially fair.[35] The contract has been signed, and the competitive pressure is gone. In particular an insurance company is unlikely to improve the surrender or borrowing terms if an individual learns that her health prospects have worsened.

Poor health means that the insurance contract is likely to pay sooner than initially expected. Consequently, the insurance policy becomes more valuable. The insured, now having a shorter life span than was predicted by the insurer's initial models, will pay fewer premiums and wait a shorter time before her estate can collect. But this is true only if she holds the policy until maturity. No extra value is realized if she surrenders the policy or allows the policy to lapse.

If the surrender value represents the amount of money needed to pay the maturity sum in the future, and the maturity date has moved sooner, the surrender value should increase. But the insurance contract generally do

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[33] DOMINIQUE LEBEL, TOWERS PERRIN TILLINGHAST, PRESENTATION AT SOCIETY OF ACTUARIES ANNUAL MEETING: PRICING LAPSE-SUPPORTED PRODUCTS/LAPSE-SENSITIVE PRODUCTS (Oct. 16, 2006) (A lapse-supported product is "a product where there would be a material decrease in profitability if, in the pricing calculation, the ultimate lapse rates were set to zero (assuming all other pricing parameters remain the same).").

[34] Doherty & Singer, *supra* note 1, at 468.

[35] *Id.* at 462.

not require such an increase, and insurance companies do not gratuitously do so. Surrender values are generally not updated for new health information, so they will remain low.

In the same way, if the insured wishes to borrow against the value of the policy, the insurance company will lend an amount, and at an interest rate, that reflects the initial contracting conditions. There will be no effort to compensate for the changed health conditions of the insured. Policy provisions[36] and state statutes[37] typically recognize no surrender value for term life insurance against which to borrow, even if the insured is likely to die within a year or two, and receive far more than the concomitant premiums could ever equal. Insurance companies exploit these individuals by offering loans with unnecessarily low credit limits and comparatively unattractive terms, and so encourage lapse.

Third parties may be willing to lend greater amounts and at lower rates, reflecting the updated longevity risk upon yield. In the short run, competition from third-party lenders will give better options to insureds. In the long run, competition will cause issuer insurance companies to issue policies that more closely track the updated longevity of consumers, granting greater and better *ex post* surrender values and borrowing terms to consumers.[38] In particular, consumers with the worst adverse health conditions and least ability to service their premiums will be most helped by increased competition in this market.

The outstanding value of life insurance policy loans in the US in 2009 exceeded $121 billion.[39] The vast majority of these loans had no serious competition, and it is reasonable to believe that more competition among lenders would improve the secondary market. There are perhaps $100 billion worth of impaired policies.[40] Almost $12 billion of policy face values were sold to investors in 2008, a number which could easily grow to

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[36] Francis v. Universal Life Ins. Co., 223 So. 2d 188, 192 (La. Ct. App. 3d Cir. 1969), *application denied*, 254 La. 781, 226 So. 2d 771 (1969).

[37] *See* ALASKA STAT. § 21.45.080(b) (2010); ARIZ. REV. STAT. ANN. § 20-1209(B) (2010); DEL. CODE ANN. tit. 18, § 2911(c) (2005); GA. CODE ANN. § 33-25-3(12)(b) (2003); ME. REV. STAT. ANN. tit. 24-A, § 2510(2) (2000); MONT. CODE. ANN. § 33-20-131(2) (2009); NEV. REV. STAT. ANN. § 688A.110(1) (LexisNexis 2009); N.J. STAT. ANN. § 17B:25-8 (West 2006); OR. REV. STAT. § 743.186(4) (2009); S.C. CODE ANN. § 38-63-220(l) (2002); VT. STAT. ANN. tit. 8, § 3731(7)(J) (2009); W. VA. CODE ANN. § 33-13-8(b) (LexisNexis 2006).

[38] Doherty & Singer, *supra* note 1, at 472.

[39] FED. RES., *supra* note 3, at 32.

[40] Doherty & Singer, *supra* note 1, at 452-53.

$90-140 billion by 2016.[41] Every one of these policies has a resale value larger than its surrender value and so is eligible for a larger policy loan or a lower rate than the insurance company would offer.[42] The target market for life settlements, the sale of an insurance policy, is anticipated to grow at three times the total population in the coming decades.[43]

There are clearly an enormous number of people who may be interested in, or well served by, loans secured by their life insurance policy. Competition from third party lenders will improve their prospects, as will a robust secondary market with securitized insurance-linked assets.

The insurance business has a set of terms and practices all its own, so it is fruitful to address some terminology. A *collateral assignment*[44] is an assignment of the policy as collateral. The creditor has no rights in the policy until the borrower defaults, at which time the creditor's interest in the pledged collateral may be used to satisfy the debt. A transfer of the entire interest in the insurance policy to a third party will be effected through an *absolute assignment*.[45]An absolute assignment of a life insurance policy is the irrevocable transfer of all of the owner's rights in the policy, typically made in order to give the policy away or to sell it.[46] An

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[41] Conning Research and Consulting, Inc., Life Settlements: A Buyers' Market for Now, Oct. 8, 2009.

[42] For example, a policy with a face value of $5 million may have a surrender value of $1 million, reflecting the statutory or contractual conditions at the time the policy was signed. If the insured discovers that she has two years to live, she may find that the policy has a value on the secondary market of, say, $3 million. Someone may be willing to pay her $3 million for the right to collect $5 million when she dies. That purchaser will pay the premiums until she dies, too. Similar math applies to borrowing. If the insured wishes to borrow, and absent new competition, the insurance company will lend to her as though she has $1 million collateral – the surrender value of the policy. A third party will be willing to lend against $3 million, recognizing a greater resale value upon which to foreclose in case of default. The third party may be willing to lend a larger amount, or at a more attractive rate for a loan which is recognized as oversecured.

[43] KAMATH & SLEDGE, *supra* note 8, at 1-2; *see also* Matthew Goldstein, *Why Death Bonds Look so Frail*, Bus. Wk., Feb. 25, 2008 (putting the market for life settlements at about $15 billion).

[44] *See, e.g.*, Example Assignment of Life Policy to Secure and Future Debts, 10 AM. JUR. *Legal Forms* 2D § 149:183 (2010).

[45] *See, e.g.*, 9 CHRISTOPHER GADSEN, *Estate Planning*, *in* WEST'S PENNSYLVANIA FORMS § 14:7 (1995).

[46] MURIEL L. CRAWFORD & WILLIAM T. BEADLES, LAW AND THE LIFE INSURANCE CONTRACT 356 (6th ed. 1989).

absolute assignment can also be used to secure a loan.[47] A party may sign an absolute assignment in favor of a lender, but the lender does not presently gain the rights and privileges of ownership, nor will the lender simply come to own the policy upon default by the borrower. A court will treat the absolute assignment in form as a collateral assignment.

B. TOWARDS A THRIVING SECONDARY MARKET

Creditors will more readily lend against insurance policies if they are able to efficiently dispose of policies upon default.[48] If a dependable legal framework is provided, the secondary market for insurance policies should thrive and dramatically improve borrowing opportunities for insureds.[49] Arguments for robust secondary markets may seem naïve given the unfolding of the financial crisis,[50] nonetheless, it is generally accepted that secondary markets in assets tend to raise the value of those assets.

Generally, a vibrant secondary market increases demand for qualifying policies, conferring greater surplus to the seller or borrower consumers. This is for three reasons. First, secondary markets allow investors to sell their investments prior to maturity. Increased liquidity attracts a much greater pool of investors with shorter time horizons, or who anticipate that their portfolio needs may change. Without a liquid secondary market, fewer lenders will value insurance as collateral. Those who accept it will demand a proportionally higher return to compensate them for risks and opportunity costs associated with a long-term investment.

Second, a vibrant secondary market gives rise to greater specialization of actors. It takes specialized skills to evaluate the risks and return associated with a given policy. Where parties find it difficult to resell

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[47] *Id.* at 360.

[48] Even those opposed to Article 9 inclusion seem to accept this statement. *See* Steven L. Harris & Charles W. Mooney, Jr., *How Successful Was the Revision of UCC Article 9?: Reflections of the Reporters*, 74 CHI.-KENT. L. REV. 1357, 1375 n.75 (1999). Consumer groups agreed with the Drafting Committee that non-Article 9 law had the practical effect of making credit secured by insurance policies much less available, but they did not see this as a good thing.

[49] *See, e.g.*, Doherty & Singer, *supra* note 1, at 459; *see also* 35 Est. Plan. 24, 24 ("The most significant innovation the life insurance industry has experienced in recent memory has been the development of the so-called secondary market").

[50] Doherty & Singer, *supra* note 1, at 459 (arguing that life insurance policy securitization and marketing will have a similarly beneficial effect in reducing risk as does mortgage securitization in its own market).

a policy, they must research policies for their own long-term holdings. But where resale is possible, a savvy investor may dedicate resources to evaluating policies. She may invest in far more policies than she would be comfortable holding to maturity because she anticipates selling them to investors lacking the specialized evaluating skills.[51] More policies will be funded and better investment research skills will be developed in a specialized market with liquid secondary sales. Lenders may lend more on insurance than they otherwise would, knowing that they will not have to hold collateral to maturity.

Third, vibrant markets lead to price discovery, which allows non-speculators to be comfortable investing in a given asset class. Fourth, where policies are liberally sold and resold, they can be combined, bundled, and securitized in a way that reduces risk. The benefits of investing in pools, rather than in their individual underlying assets, are well known. [52]

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[51] It is also true that some investors may dedicate less resources to evaluating assets when they know that they will be passed onto to less specialized secondary purchasers. That is one key cause of the present financial crisis. Too many investors or lenders allowed their internal controls to lapse because they knew that they would not bear the costs of their errors, and too many secondary purchasers trusted ratings agencies or bond insurers. However, the above point about the raise of specialized investment evaluation skills remains valid. If it costs $10 to develop a method for determining whether investment X is $1 more profitable than investment Y, or vice versa, then few companies will develop that method. But if a company can the sell their interest in X or Y to a third party, and then use the proceeds to buy either X2 or Y2, that company can use the method again. The more iterations, the greater the return on the knowledge investment. Capital is better allocated when companies profitably invest in vetting and evaluation methods. Doubtless, many companies failed to adequately evaluate the viability of many subprime, exotic, or complex assets. But the few that did evaluate, and the many more that could have, did so because of technology that only made sense in a securitized market where primary investors didn't have to buy and hold.

[52] *See* LIFE SETTLEMENTS TASK FORCE, STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 6 (2010) ("the majority of investors in today's life settlements market are large institutional investors looking to acquire pools of policies"). The benefits of pooled investments accrue only if the risks of individual assets are not highly positively correlated. Pooled life insurance policies will generally meet this condition. Mortality rates generally do not rise and fall in tandem for geographically spread policy holders. The possibility for pooling is one of the major enablers of an insurance industry. If one individual's death was strongly positively correlated with many other individuals, insurance companies would not be able to reduce risk by holding a large portfolio.

There is a growing interest in assets that have no correlation with market forces,[53] so secondary markets would serve a legitimate economic need of investors who seek to hedge. Investors seeking a strong yield without strong market exposure should find life insurance policies a potentially attractive asset class. Major institutional investors like UBS, Merrill Lynch, Citibank[54] and Berkshire Hathaway[55] have already entered this market. Investors have always been able to gain partial exposure to this asset by investing in insurance companies. But such investments are not ideal for hedging because the risk is affected by the management of, and investment portfolio held by, a particular insurance company. Moreover, since beneficiary payments under life insurance policies constitute a liability to insurance companies, the corresponding bet is actually to short the insurance company.

There are risks to these assets. Investors in insurance policies through intermediaries must trust that the company is truly investing their money in assignments of life insurance policies. Not all such companies are scrupulous agents for their investors. Some hide behind the opacity of their investment to squirrel away funds.[56] If investors are not to be disappointed here as they were with housing securities, these securities must be appropriately marketed and regulated. And securitized life insurance assets are not immune to whatever forces precipitated the current financial

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[53] *Id.* ("Institutional investors reportedly view life settlements as an alternative asset class that is not correlated to traditional asset classes because returns principally are based on the death rates of the insured individuals rather than the performance of financial instruments or the overall economy. Diversification to uncorrelated assets is especially attractive to investors during periods of unfavorable economic conditions"); *see also* Matthew Goldstein, *Profiting from Mortality*, BUS. WK., July 30, 2007, at 44; Sam Rosenfeld, *Life Settlements: Signposts to a Principal Asset Class* (Wharton Fin. Inst. Ctr., Working Paper No. 09-20, 2009), *available at* http://fic.wharton.upenn.edu/fic/papers/09/0920.pdf.

[54] *See* Harold G. Ingraham, Jr. & Sergio S. Salani, *Life Settlements as a Viable Option*, J. FIN. SERV. PROFS. 72, 75 (2004). *But see* Matthew Goldstein, *Goldman Retreats from Life Settlements*, REUTERS.COM, Dec. 18, 2009 2:27 PM EST, http://www.reuters.com/article/idUSN1823436220091218 ("life settlement derivatives appears [sic] to be a casualty of the worst financial crisis since the Great Depression").

[55] John Hoogesteger, *Berkshire Unit Lends $400M to Startup*, MINNEAPOLIS/ST. PAUL BUS. J. (Feb. 3, 2002, 11 PM CST), *available at* http://twincities.bizjournals.com/twincities/stories/2002/02/04/story1.html.

[56] PCO, Inc. v. Christensen, 58 Cal. Rptr. 3d 516, 516 (Cal. Ct. App. 2007) (PCO executives converted all $89 million intended for viatical investment).

crisis.[57] But risks are no greater here than in any other area, and whichever financial reforms are attempted will succeed or fail for securitization here as elsewhere.[58] Moreover, some of the most potentially worrying products have been cancelled due to market forces.[59]

It should be clear that secondary markets in insurance increase the demand for third-party creditors to lend to customer borrowers. It should also be clear that this increased demand is to the benefit of borrowers. What follows is an explanation of the current law of insurance-secured financing. It will be shown that the law is confused and antiquated, and the most logical reform proposal will virtuously liberalize the market for loans as well.

II. WHERE EXCLUSION LEAVES INSURANCE

Article 9 of the Uniform Commercial Code governs almost all security interests transactions in all US jurisdictions. Although it is preempted by any inconsistent state laws,[60] most states have redacted any prior inconsistent laws. The Code's merits are well-recited and have only grown as more states and more transactions have come under its scope. Article 9, in particular, rationalized and reformed a truly confusing area of the law.

As mentioned before, Article 9 excludes interests in and assignments of insurance policies from its scope.[61] Nearly every state

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[57] *See, e.g.*, *Rep. Collin C. Peterson Holds a Hearing on the Over-the-Counter Derivatives Market: Hearing Before the H. Comm. on Agriculture*, 111th Cong. (2009) (Rep. Boswell asking, "does this securitization of life settlements not only add another element of possible risk to an industry that is already in need of more transparency and consumer safeguard, but is it something you -- we should even allow?").

[58] The author acknowledges the intuitive worry that derivatives in the insurance space have a worrying resonance to the fact that AIG's non-insurance activities threatened their core insurance business, and indeed, the entire economy. However, the analogy should be resisted, owing to the difference between securitization of insurance products, and securitization of non-insurance products by insurance companies.

[59] Goldstein, *supra* note 53 ("The Wall Street company once had big plans to sell derivatives pegged to the index [which tracks the life expectancy of a group of people who have sold their life insurance policies to an investment pool] to investors seeking exposure to the estimated $15 billion life settlements market.").

[60] U.C.C. § 9-109(c)(1)-(3) (2011).

[61] U.C.C. § 9-109(d)(8) (2011). *But see* CAL. COM. CODE § 9109 (Deering 2010); LA. REV. STAT. ANN. § 10:9-109(d)(8) (2011). Of course, there is an ad hoc

follows the UCC in excluding insurance policies from their secured transactions statute.[62] Where a lien or assignment is not covered by the UCC, the court must decide which other body of law to apply.

It would be natural to look to whichever statute governed security interests before the UCC, but this is generally incorrect. Having adopted the Uniform Commercial Code, many states repealed the statutes governing chattel mortgages and pledges that had previously also governed interests in, and assignments of, insurance policies. This repeal leaves something of a statutory void for assignments of life insurance policies. [63]

For example, pre-code chattel security in Illinois came in through six devices: the pledge, the chattel mortgage, the conditional sale, the trust receipt, accounts receivable financing, and the factor's lien in favor of wholesalers. [64] By 1962, all but one had been eliminated. The conditional sale was a creature of the Uniform Sales Act,[65] which was repealed following the adoption of the UCC.[66] The Uniform Trust Receipt Act was repealed following the adoption of the UCC,[67] as was the validating statute for accounts receivable financing,[68] chattel mortgages,[69] and the factor's lien in favor of wholesalers.[70] Only the common law pledge remained. Similar stories can be told of every other state.[71]

The little statutory law that remains is not particularly appropriate to insurance policy liens. For example, some states have reserved a

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exception for health-care insurance receivables, *see id.*, but this hardly relevant. Moreover the code does not exclude the proceeds of insurance policies from its scope. *Id.* at §§ 10:9-109, -315, -322. But this inclusion is meant to allow secured parties whose collateral is destroyed to maintain their interest in the subsequent insurance money. *See* Coogan, *supra* note 6, at 515.

[62] *See, e.g.*, FLA. STAT. ANN. § 679.1091(4)(g) (LexisNexis 2011).

[63] *See, e.g.*, ME. PUB. L. of 1963, c. 362 (1963).

[64] 2B Daniel R. Murray *et al.*, UNIFORM COMMERCIAL CODE WITH ILLINOIS CODE COMMENTS 9 (2010 ed., 2010).

[65] *Id.*

[66] 810 ILL. COMP. STAT. 5/10-102 (2011) (repealing ILL. REV. STAT. ch. 121 1/2, ¶ 1 *et seq*.).

[67] *Id*. (repealing ILL. REV. STAT. 121 1/2, ¶ 166 *et seq*.).

[68] *Id*. (repealing ILL. REV. STAT. 121 1/2, ¶ 220 *et seq*.).

[69] *Id*. (repealing ILL. REV. STAT. 95, ¶¶ 26-27).

[70] *Id*. (repealing ILL. REV. STAT. 82, ¶ 102 *et seq.*).

[71] *See, e.g.*, 12A PA. STAT. ANN. § 10-102 (1953) (repealing Uniform Conditional Sales Act, 69 PA. STAT. ANN. § 361 *et seq.* (1931); Uniform Trust Receipts Act; 68 PA. STAT. ANN. § 551 *et seq.* (1953); a general chattel mortgage statute, 21 PA. STAT. ANN. § 940.1 *et seq.* (1953); and a factor's lien act, 6 PA. STAT. ANN. § 221 *et seq.* (1953)).

banker's lien that gives bank loans a general lien on all assets.[72] There are cases in which this might accomplish the desired effect of allowing an individual to borrow against her insurance policy, but it is a cumbersome way to organize a loan. It may be better to say that there remains no statutory law that directly governs insurance liens and assignments. Thus, to a great degree, the governing pre-Code law is not just pre-Code statutory law, but pre-statutory common law. [73]

Not only does this deny the insurance policy transactions the benefits afforded by the UCC, it also forces insurance-based lending to rely on law that has languished in isolation from growing case law and reforming trends. Article 9 explains itself with nearly syllogistic clarity.[74] Where clarification is required, the centralization of uniform law has encouraged a comprehensive scholarly treatment that explores, reconciles, and renews the law.[75] No such commentary fixes similar attention to niche subject of state-by-state case law on insurance-linked finance transactions.

The possibility of this problem was not lost on the Commenters for the 1972 Article 9. Professor Peter Coogan, Consultant to the Review Committee for Article 9, discussing the effect of the exclusion of bank deposit accounts from Article 9 explained how "[t]his illustrates one of the problems with respect to the exclusions generally, of section 9-104."[76] He

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[72] CAL. CIV. CODE § 3054 (Deering 2010); DuBrutz v. Bank of Visalia, 87 P. 467, 468 (Cal. Ct. App. 1906) (bank surrenders life insurance policy). Note, however, that California transactions do not need to resort to these sorts of statutes, since California's Article 9 does not exclude life insurance loans. This example is provided only illustratively.

[73] Law Research Serv., Inc. v. Martin Lutz App. Printers, Inc., 498 F.2d 836, 840 (2d Cir. 1974).

[74] *See* Timothy R. Zinnecker, *Socrates, Syllogisms, and Sadistic Transactions: Challenges to Mastering U.C.C. Article 9 Through Deductive Reasoning*, 13 CHAP. L. REV. 97, 136 (2009).

[75] *See, e.g.*, Bender UCC REPORTER-DIGEST; THE ABCS OF THE UCC (American Bar Association); LARY LAWRENCE, ANDERSON ON THE UNIFORM COMMERCIAL CODE (WEST); HAWKLAND ET AL., HAWKLAND'S UNIFORM COMMERCIAL CODE SERIES (West); THOMAS M. QUINN, QUINN'S UNIFORM COMMERCIAL CODE COMMENTARY AND LAW DIGEST (West); BRADFORD STONE & KRISTEN DAVID ADAMS, UNIFORM COMMERCIAL CODE IN A NUTSHELL (West); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE (HORNBOOK SERIES) (West); UCC L.J.; Margit Livingston, *Survey of Cases Decided Under Revised Article 9: There's Not Much New Under the Sun*., 2 DEPAUL BUS. & COMM. L.J. 47 (2003) (surveying case law developments).

[76] Program, *Impact of 1972 Revisions On Secured Financing Transactions Under UCC Article 9,* 33 BUS. LAW. 2491, 2532 (1978).

goes on to say "we have the awful problem that part of this was statutory and those statutes have all been repealed, like the chattel mortgage, the assignment of contracts, all that stuff, has been repealed, so that you go to the pre-pre-statutes, and sometimes you cannot find it."[77]

The insurance policy exception never enjoyed enthusiastic support from the drafters of the UCC. The written reflections of the Reporters indicate neither serious policy commitments to this exclusion, or even a concerted industry opposition to its inclusion. Relatively mild opposition from the insurance industry was persuasive in light of the Reporters' sense that this exclusion simplified the drafting process. Even taking that conclusion for granted, the Reporters expressed reservations about extending the insurance exclusion to third party interests as well as issuer policy loans.

The problems with all exclusions are the same: the most recent statutes were repealed in conjunction with the adoption of a new uniform code. Article 9 does not apply to the excluded items, so they are orphans left in the care of truly ancient law.

Professor Coogan asked Bill Davenport, General Counsel for First Bank of Chicago, about the law applicable to bank deposit accounts, and Davenport's reply centered on case law so old that Coogan interrupted, "We are now including a generation-some people may be of a generation that does not remember [the case]. Would you just explain it."[78] An exclusion from Article 9 does not just freeze the applicable law as that of the early 1960's. Exclusion kicks life insurance policies back a hundred years to the common law operative before any legislative reforms at all.[79]

There was some hope among the drafters of Article 9 that the common law on insurance pledges would come to resemble the Article 9 law and thus "the exclusion would be more formal than real."[80] Like so

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[77] *Id.* at 2533.

[78] *Id.* at 2532 (discussing Benedict v. Ratner, 268 U.S. 353 (1925) and prior, related Illinois case law).

[79] Despite the obvious problems with reverting to the law of substantially different times, this is only one of many examples of the general phenomenon. *See, e.g.*, Teemu Ruskola, *Colonialism without Colonies: On the Extraterritorial Jurisprudence of the U.S. Court for China*, 71 LAW & CONTEMP. PROBS. 217, 223 (2008) (the U.S. Court for China, from 1906 to 1943, "was called on to 'ascertain the common or unwritten law in force in the colonies prior to the Declaration of Independence and then to attempt to apply it to modern conditions in China'. . . .") (quoting a Shanghai lawyer).

[80] 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 315 (photo. reprint 1999) (1965).

many theories of legal convergence, that hope has not materialized.[81] As a result, the applicable common law remains splintered, inconsistent, irregular, and generally ill-suited to the demands of modern finance.[82] It has failed to improve because all the other pledges and assignments were plucked away to develop case law under the UCC.

The distance between growing UCC law and languishing non-UCC laws leads to the distressing possibility that cross-jurisdiction transactions might implicate different security rules. The Reporters acknowledged this ambiguity under currently law:

> It would be odd if a designation of applicable law by a debtor and secured party were to control some of these matters. Consider an example that may arise under current law. Former 9-318(4) makes ineffective terms in certain contracts that restrict assignments of the right to payment under the contracts. Under California's nonuniform version of Article 9, security interests in most insurance policies are within the scope of the article. Under New York's (and most states') version, security interests in insurance policies are excluded. If an insurance policy provides that it is governed by the law of New York, it would seems [sic] appropriate for New York's law to determine whether a term restricting assignment of the policy is effective. Since New York's Article 9 does not cover an assignment of the policy, New York's 9-318 would not appear to render ineffective the restriction on assignment. Now assume that the owner of the policy, a California resident, assigns it as security to a California bank, and the security agreement provides that it is governed by the law of California. Does California's 9-318(4) then render the restriction in the policy ineffective?

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[81] One of federalism's early indulgences was the notion that federal common law would come to influence and unify the various state common laws. *But see* Erie R.R Co. v. Tompkins, 304 U.S. 64 (1938).

[82] Karl Llewellyn, *Problems of Codifying Security Law*, 13 LAW & CONTEMP. PROBS. 687, 688 (1948) (the Chief Reporter for the Uniform Commercial Code noting the inefficiencies created by the hodgepodge of older commercial laws: "What is not minor is the price in complexity, inconvenience, and often in unfairness which must be paid when legal patterns of happenstance origin are taken in all their history-ridden detail as the basis for the doing of remodeling jobs which are themselves piece-work").

> We are inclined to think it should not, but the answer is uncertain.[83]

Unheard of in other areas, conflicting security rules from state to state are a reality for lawyers practicing law in this area. These issues would evaporate if all policies were governed by the UCC, [84] but because they are not, life insurance policies remain tangled in the interstate conflicts of law problems of a bygone era. The confusion and antiquation of that era gives rise to three problems, each of which serves to frustrate those third party lending, and secondary market trading, that would benefit consumers.

A. THE PERFECTION PROBLEM

The perfection problem refers to the difficulty in finding a rational, coherent, and clear perfection equivalent in non-UCC law.[85] Strictly speaking, it is impossible for any party to perfect an interest in a life insurance policy. This is because perfection is a concept introduced by the UCC, but the UCC excludes life insurance policies from coverage. One wishes that under the non-UCC regime, similar procedures could achieve perfection's goal: allowing parties to discover prior liens, and then establish their own priority in a durable and just manner. However, conflicts amongst assignees are common and messy under the non-Article 9 regimes. This is because the law governing priority is not as firmly established as might be inferred from industry practice. Subparts (1)-(3) show the places where industry consensus lacks doctrinal support.

Moreover, even if accepted that non-UCC law speaks coherently and with adequate approval of industry practice, industry practice remains unjust and inefficient. Subpart (4) explains the public policy problems with the status quo practice. The perfection problem thus indicates the gulf between non-UCC reality and the clear and efficient perfection parties have come to expect through Article 9. Under the UCC, notification would follow the method of any general intangible: attachment plus notification. With attachment plus notification, the problems of secret liens, private notification, and doctrinal uncertainty would be much reduced. The status

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[83] UNIFORM COMMERCIAL CODE art. 9, pt. 4: RIGHTS OF THIRD PARTIES (Proposed Official Draft, Oct. 1996).

[84] U.C.C. § 9-301 (1999).

[85] Other commentators have noticed the perfection problem in the past, though none have used that title. *See, e.g.*, McLaughlin, *supra* note 11, at 959; Knippenberg, *supra* note 11.

quo exacerbates problems in a context of uncertainty by over-valuing notification to insurers and under-valuing public notification.

1. Notice to Insurance Company

Industry practice is to assume that priority of security goes to the assignee that first provides notice to the insurance company. Although there is some doctrinal support for this state of affairs, [86] the importance of insurer notification is not always dispositive at common law.

Requirements of notice are for the benefit of insurance companies.[87] Courts often emphasize that the notice requirement is part of the contract between the insured and the insurer, and cannot affect the rights of third parties, such as the assignee.[88] Thus, courts adjudicating between non-insurer assignees often ignore notice to insurance companies, deciding the case on other factors.[89]

A substantial minority rule allows priority to the first assignee, regardless of notice to the insurer.[90] This minority rule was recently

[86] Patten v. Mutual Ben. Life Ins. Co., 6 S.E.2d 26 (S.C. 1939); Richards v. Griggs, 16 Mo. 416 (1852); Murdoch & Dickson v. Finney, 21 Mo. 138 (1855); Houser v. Richardson, 90 Mo. App. 134 (1901); Klebba v. Struempf, 23 S.W.2d 205 (Mo. App. 1930).

[87] *See* Equitable Life Ins. Co. of Iowa v. Mitchell, 248 Ill. App. 401, 404 (Ill. App. Ct. 1927) ("It has been repeatedly held that provisions of a life insurance policy requiring notice of an assignment to be given to the company are for the benefit of the company and it alone may complain or object because of a failure to comply with the terms of the policy."). Note that this demonstrates an important difference between UCC and non-UCC treatment of insurance companies. Notice under the UCC is for the benefit of all creditors and potential creditors, not for the benefit of one creditor or the notified party.

[88] *See, e.g.*, Allhusen v. Caristo Const. Corp., 103 N.E.2d 891, 892 (N.Y. 1952); Herman v. Connecticut Mut. Life Ins. Co., 105 N.E. 450, 451 (Mass. 1914).

[89] *See* Fidelity Mutual Life Ins. Co. v. City Nat'l. Bank, 95 F. Supp. 276, 282 (N.D. W. Va. 1950) (first-in-time assignee has priority). *See also* Fidelity & Deposit Co. v. Moore, 14 S.E.2d 307, 310 (Va. Ct. App. 1941) (case determined on intent of the assignor).

[90] Fidelity Mut. Life Ins. Co. v. City Nat'l Bank, 95 F. Supp. 276, 282 (N.D. W. Va. 1950); *see also In re* Leterman, Becher & Co., 260 F. 543, 547 (2d Cir. 1919); Superior Brassiere Co. v. Zimetbaum, 212 N.Y.S. 473, 475 (N.Y. App. Div. 1925) ("By the first assignment, the rights of the assignor pass to the assignee . . . . Notice of the assignment to the debtor adds nothing to the right or title transferred."). The insurance company should correspond to the "debtor" in each of

affirmed by the Court of Appeals for the Second Circuit in *Rose v. AmSouth Bank of Florida*.[91] There, the court overruled the district court's ruling that New York law required insurer notification in order for an assignment to be valid against a subsequent assignee. Thus, the newest and clearest ruling on priority gives the interest in an insurance policy to the earliest assignee, rather than earliest notifying assignee, in contradiction of industry practice.

2. Possession

The legal significance of possession of the original life insurance policy is treated inconsistently. As a matter of commercial practice, life insurance companies do not attribute legal significance to possession of a sole "original" policy.[92] Additionally, the requirement of possession is not practical for interests in group life insurance policies.[93]

Nevertheless, insurance policies are choses in action at common law, [94] and the common law pledge provides a mechanism for perfecting an interest in an insurance policy by possession.[95] Until the early nineteenth century, the only way to create a valid security interest in personal property

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those cases. An assignee was due proceeds and assigned them twice, similar to an insured who assigned the policy twice.

[91] Rose v. AmSouth Bank, 391 F.3d 63, 66 (2d Cir. 2004) (citing Salem Trust Co. v. Manufacturers' Finance Co., 264 U.S. 182, 198 (1924)) (noting that the Salem court—which ruled on the basis of then-extant federal common law, and on which the district court relied—specifically commented that under New York Law the earlier assignee would have prevailed, notwithstanding its failure to take possession or provide notice).

[92] Louisiana Official Revision Comments to R.S. – 2001, § 10:9-107.1(b), revised, 2004 (c) 2008.

[93] James Stuckey, *Lousiana's Non-Uniform Variations in U.C.C. Chapter 9*, 62 LA. L. REV. 793, 813 (2002).

[94] Missouri State Life Ins. Co. v. Langreder, 87 F.2d 586, 592 (7th Cir. 1937); U.S. Life Ins. Co. v. Ludwig, 103 Ill. 305, 312 (Ill. 1882); Considine v. Considine, 7 N.Y.S.2d 834 (1938); Coleman v. Anderson, 82 S.W. 1057 (Tex. Civ. App. 1904), *aff'd*, 86 S.W. 730 (Tex. 1905).

[95] RESTATEMENT (FIRST) OF SECURITY § 1 cmt. a (1941) ("Where a chose in action is represented by an indispensable instrument, whether negotiable or non-negotiable, the chose in action may be pledged."); RESTATEMENT (FIRST) OF SECURITY § 1 cmt. e (1941) ("Indispensable instruments include . . . insurance policies.").

was through physical possession by the pledgee. [96] Non-possessory security interests were presumptively fraudulent.[97] Non-possessory security interests found greater expression and acceptance in later years, but development was neither linear nor logical. Rather, the "the law of personal property security transactions [had come] to resemble the obscure wood in which Dante once discovered the gates of hell."[98]

There is substantial authority that assignments of insurance policies may be perfected by physical delivery of the policy. [99] In a case concerning unearned premiums on a life insurance policy, the bankruptcy court determined that Maine common law requires possession of the collateral as prerequisite to the enforceability against third parties of pledge of intangibles, and that "[A] pledge of insurance policies requires that the pledgee maintain physical possession of the policies."[100] This result is by no means unique.[101] Some decisions have even specified that no written assignment is necessary where the policy is delivered.[102]

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[96] Peter F. Coogan, *Article 9 – An Agenda for the Next Decade*, 87 YALE L.J. 1012 (1978). *See, e.g.*, Silverman v. McGrath, 10 Ill. App. 413 (1882) (possession essential to a valid pledge); W.W. Kimball Co. v. Polakow, 190 Ill. App. 174 (1914) (At common law, all pledges of personal property void unless title and possession went to pledgee.).

[97] *See* Griffen v. Henry, 99 Ill. App. 284 (1901) (At common law, transaction was fraudulent per se and incapable of explanation where pledgor retained possession.). *See also* Coogan, *supra* note 96, at 1012; JAMES ANGELL MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY 255-70 (West Publishing 1956).

[98] GILMORE, *supra* note 80, at 27. *See generally id.* at 288-90.

[99] *See* McLaughlin, *supra* note 11, at 959.

[100] *See In re* Maplewood Poultry Co., 2 B.R. 550, 554 & n. 5 (Bankr. Me. 1980) (internal citations omitted).

[101] *In re* Mile Hi Restaurants, Inc., 233 F. Supp. 936 (D. Colo. 1964); Taylor v. S. Bank & Trust Co., 151 So. 357 (Ala. 1933) (life insurance policy); Puckhaber v. Henry, 93 P. 114 (Cal. 1907) (assignment and delivery of life policy); Collins v. Dawley, 4 Colo. 138 (1878) (life insurance policy); Helms v. First Nat. Bank, 28 So.2d 262 (Fla. 1946) (by implication; life insurance); Equitable Life Ins. Co. v. Mitchell, 248 Ill. App. 401 (1927) (life insurance policy); Embry's Adm'r v. Harris, 52 S.W. 958 (Ky. 1899) (life policy); Arrowood v. Duff, 152 S.W.2d 291 (Ky. 1941) (life insurance policy); Lake v. New York Life Ins. Co., 45 So. 959 (La. 1908) (life insurance; dictum); Foote v. Sun Life Assur. Co., 173 So. 477 (La. Ct. App. 1937) (dictum; life insurance policy); Connecticut Mut. Life Ins. Co. v. Allen, 235 Mass. 187 (1920) (life insurance policy); Detroit Life Ins. Co. v. Linsenmier, 217 N.W. 919 (Mich. 1928) (life policy); Palmer v. Mut. Life Ins. Co., 130 N.W. 250 (Minn. 1911) (life policy); Prudential Ins. Co. v. Sheehan, 133

This raises the troublesome possibility that security interest in life insurance policies might be perfected by possession without notification.[103] The common law pledge existed in every state prior to the Uniform Commercial Code.[104] While Article 9 controls formerly-pledged transactions of other kinds, the life insurance carve-out puts these policies squarely within the case law that has always governed pledges. As a result, this case law has given great importance to physical possession of policies.

It should provide no comfort to note that not all jurisdictions follow this rule, with some vindicating the industry practice of disregarding physical possession.[105] Opportunities for confusion and conflict abound. Physical possession may matter in one state, but not in another, such that the perfection regime is ruefully diverse.

Not only do jurisdictions differ from one another, intra-jurisdictional variation is also substantial. It is often difficult to disentangle judicial decisions interpreting the common law of pledges rather than the statutory pledge act of a given state – only the latter being repealed in many of the states that have adopted the Uniform Commercial Code. The portions of those decisions that interpret the common law, and the cases so

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S.W.2d 1060 (Mo. Ct. App. 1939) (life insurance policy; no formal or written assignment necessary); Fidelity Union Trust Co. v. Phillips, 68 A.2d 574, (N.J. Super. Ct. Ch. Div. 1949) (by implication; life policy); MacQueen v. Dollar Sav. Bank Co., 15 N.E.2d 529 (Ohio 1938) (life insurance, pledged by deposit without written assignment); Woofter v. Fourth Nat'l Bank, 78 P.2d 683 (Okla. 1938) (insurance policy and benefit certificate); Page v. Detroit Life Ins. Co., 11 Tenn. App. 417 (1929) (life insurance policy); Sun Life Assur. Co. v.Weyen, 136 F. Supp. 592 (D.C. Wash. 1955); Massachusetts Mut. Life Ins. Co. v. Bank of California, 60 P.2d 675 (Wa. 1936) (life policy). *See* 5 RUSS ET AL, COUCH ON INSURANCE § 37:47 (3d ed. 2008).

[102] *See In re* Bickford's Estate, 38 N.Y.S.2d 785 (1942) (no written assignment necessary where policy is delivered); Woofter v. Fourth Nat'l Bank, 78 P.2d 683 (Okla. 1938) (pledge did not require written assignment).

[103] Shanklin v. Madison County, 21 Ohio St. 575 (1871) (A chose in action may be equitably assigned without any written transfer). *See also* RESTATEMENT (FIRST) OF SECURITY § 1, cmt. (e) (1941) (defining an insurance policy as an "indispensable instrument," an interest in which may secured by possession).

[104] *See* 1 GILMORE, *supra* note 80, § 14.1.

[105] *See* Metro. Life Ins. Co. v. Haack, 50 F. Supp. 55, 63-64 (W.D. La. 1943) (stating that an insurance policy cannot be pledged by possession); Commercial Nat'l. Bank v. Chapman, 206 F.2d 349, 349-51 (5th Cir. 1953) (holding that a statute authorizing pledge by delivery without assignment was ineffective, so creditor took no rights against beneficiaries of the policy).

distant in time as to predate those repealed statutes, make an uneven sample from which to rediscover the common law of choses.

3. Notification to Third Parties

Industry practice has it that insurers have no general duty of notification to any actual or potential creditor, and the common law agrees to some extent. As a result, important information may not be shared, to the frustration of many parties.

It is clear that subsequent assignees have no right to the information they need to determine whether their interest is subordinated.[106] The insurer has no general duty to notify assignees that the insured has discontinued premium payments.[107] Thus, an assignee may become an unsecured creditor when she finds that the insurance policy has lapsed for want of payment.

For this reason, it is generally incumbent upon assignees to diligently request information from policy issuers and, when necessary, pay premiums for the policies. But some statutes differ, reducing inter-jurisdictional uniformity and putting a burden on the issuing insurer.[108]

Moreover, actions or representations by the insurer may give rise to estoppel,[109] and the insurer's knowledge of the terms of the assignment has given rise to liability. [110] Thus, "[t]he outcome in the lapse cases is by no means a certitude either for the assignee or the insurer."[111] It becomes a

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[106] *See* discussion *infra* Part A.4.

[107] *See* Standard Fire Ins. Co. v. United States, 407 F.2d 1295, 1300-01 (5th Cir. 1969); Sorenson v. Nat'l. Life Ins. Co., 201 N.W.2d 510, 512 (Wis. 1972); Lewis State Bank v. Travelers Ins. Co., 356 So. 2d 1344, 1346-48 (Fla. Dist. Ct. App. 1978); Mut. Benefit Life Ins. Co. v. First Nat'l Bank, 74 S.W. 1066, 1070 (Ky. 1903).

[108] *See* CAL. INS. CODE § 10173.2 (West 2005) (stating that notice is required); 215 ILL. COMP. STAT. ANN. 5/234 (West 2000) (stating that notice is required); N.Y. INS. LAW § 3211 (McKinney 2006) (stating that assignment may call for notice that premiums are due).

[109] Missouri Cattle Loan Co. v. Great S. Life Ins. Co., 52 S.W.2d 1, 10-11 (Mo. 1932) (holding that assignee relied on insurer's promise to provide notice if premiums were due).

[110] Bank of Poplar Bluff v. Metro. Life Ins. Co., 723 S.W.2d 514, 517-23 (Mo. Ct. App. 1986) (the court looked to the contract of assignment and the policy assigned to determine whether the insurer was obliged to provide notice to assignee).

[111] Knippenberg, *supra* note 11, at 7.

complicated matter to determine which right of notice a secured party may expect.

4. Public Policy

As described above, in subsection 1, industry practice assumes priority is determined through a race-notification regime. Moreover, it is a race to notify the insurance company, not the Secretary of State, as it would be under the UCC. Even if this were as well-founded in law as it is in practice, it is doubtful that this expresses defensible policy.[112] Insurance company notification constitutes a non-public system of filing, and it is plagued by those problems endemic to non-public systems of security interests.

Where insurers have received a notice of assignment, there is no assurance that other creditors will be similarly notified. Insurance company records are proprietary, private records. Even where insurers are required to give notice to assignees of premium non-payment, insurers are under no obligation to notify subsequent assignees of prior policy assignments, nor even to respond to information requests by creditors. [113]

There is no reliable mechanism for creditors to determine whether their claims are likely to be subordinated. A creditor who wishes to learn about the encumbrances on a policy has no central public filing system to consult. Indeed, an investigation with the Secretary of State of the debtor may deceive some creditors into overestimating their security vis-à-vis a borrower. [114] Interests in life insurance policies will not be recorded there.

This multiplies the possibilities for secret liens and mischief, as parties are induced to lend on terms implying higher degrees of security than they may eventually receive. This leads to litigation, into which even

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[112] Immel v. Travelers Ins. Co., 26 N.E.2d 114, 117 (Ill. 1940) ("It is essential to the prompt payment of losses that life insurance contracts be denied negotiability, and prompt payment of losses has come to be one of the most desirable of the attributes of such contracts. Life insurance is depended on for the payment of estate taxes, for the education of children, for all forms of immediate cash demands and for the very living of the family of the deceased policy-holder pending administration . . . . [T]he companies, in good faith, may safely pay promptly to those shown by their records to be entitled to payment.").

[113] *See, e.g.*, Wells v. John Hancock Mut. Life Ins. Co., 149 Cal. Rptr. 171, 174 (Cal. Ct. App. 1978).

[114] McLaughlin, *supra* note 11, at 959.

the insurance company may be drawn.[115] And it ends in a reduction in value offered to the insured. With secured lenders sliding into unsecured status, life insurance policy interests will be traded in a market for lemons.[116] Increasingly, lenders will offer terms and interest rates consistent with unsecured loans, rather than the preferable rate befitting properly secured collateral.[117]

All of these problems multiply in the context of a securitized secondary market for policies. Securitization requires policies that can be combined without hindering the pool. Policies that carry litigation risks, or the details of which are unclear because of an uncooperative issuer, will not find an easy home. Rating agencies list legal risks and a dearth of acceptable policies as two of the major impediments to the ratings needed to create marketable securities out of life insurance policies.[118] And the difficulty of investigating policies creates a cost that will be paid with each investigation – a cost that will be paid more often in a liquid secondary market.[119]

Finally, it is distasteful for a private record to be maintained on the terms of the most likely creditor. The issuer insurance company stands as a

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[115] *See, e.g.*, Aetna Life Ins. Co. v. Bunt, 754 P.2d 993, 994-95 (Wash. 1988); Am. W. Life Ins. Co. v. Hooker, 622 P.2d 775, 776-77 (Utah 1980); King v. Vineyard, 477 P.2d 700, 701-03 (Okla. Civ. App. 1970); Stanfill v. Defenbach, 239 F.2d 685, 686 (9th Cir. 1957).

[116] *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489-94 (1970).

[117] *See generally* James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473, 480-81 (1984); Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1060-62 (1984); Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929, 951-55 (1985).

[118] *See, e.g.*, WINSTON CHANG & GARY MARTUCCI, STANDARD & POOR'S, CREDIT FAQ: UNCOVERING THE CHALLENGES IN RATING LIFE SETTLEMENT SECURITIZATIONS, (2009); DBRS INC., METHODOLOGY – RATING U.S. LIFE SETTLEMENT SECURITIZATIONS, (2008), *available at* http://www.dbrs.com/research/218570 (follow "Rating U.S. Life Settlement Securitizations" hyperlink under "Related Research"). *See also* LIFE SETTLEMENTS TASK FORCE, *supra* note 52, at 16-17 (stating that market participants agree that ratings will be required to make viable securities); 5 RUSS & SEGALLA, *supra* note 101, § 77:45.

[119] LIFE SETTLEMENTS TASK FORCE, *supra* note 52, at 16 (stating that market participants agree that the cost of investigating and warranting policies in the pool against legal risks are impractical burdens).

potential lender under the policy as a matter of state law.[120] Further, the issuer stands to profit from the lapse of a policy when the insured is unable to obtain adequate financing. Insurance companies may face temptations to err in favor of their role as creditor and business, rather than in their role as a filing place for other lenders.

Even if insurance companies faithfully discharge all of their duties, there will be an appearance of impropriety to a creditor who finds that the private registration has not worked in his favor. Consider *Rose* again,[121] where an assignee-plaintiff claimed to have sent written notification to the insurer, but the insurer claimed to have no record of it. The Court of Appeals found that plaintiff had notified the insurance company.[122] And yet, the district court had ruled for the defendant, crediting an estoppel claim that plaintiff had not done enough to confirm that the insurance company recorded their assignment and informed subsequent assignees.[123] In another jurisdiction, the Court of Appeals could have affirmed the district court on the matters of law and the Roses would have lost their priority because of the insurance company's error.

Moreover, even as the case was resolved, the subsequent assignee may be legitimately aggrieved. They requested information from the insurer as to prior liens and were told that there were none.[124] They were deceived as to their priority by insurance company error. Either way, the insurance company's error determined the rights between rival claimants.

Disappointing as this error may be, it would be scandalous if one of the litigant creditors were the insurance company itself. As it stands, insurance companies profit from increased lapse, and lapse increases if creditors, aware of their precarious position with respect to non-public filing, are discouraged from providing alternative financing. It would be far better if the parties were to register their liens with the Secretary of State.[125]

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[120] 5 RUSS & SEGALLA, *supra* note 101, § 77:45.

[121] Rose v. AmSouth Bank, 296 F. Supp. 2d 383 (E.D.N.Y. 2003), *rev'd*, Rose v. AmSouth Bank of Florida, 391 F.3d 63, 66-67 (2d Cir. 2004). Though reversed, the lower court is still instructive here because jurisdictions differ, and some follow the priority rules of the district court. In this instance, the Court of Appeals reversed as a matter of law because it applied New York Law.

[122] *Rose*, 391 F.3d at 66-67.

[123] *Rose*, 296 F. Supp. 2d at 395.

[124] *Rose*, 296 F. Supp. 2d at 388.

[125] Another advantage of Article 9 is that is includes provisions for many types of errors arising from filing with the appropriate filling agency.

5. UCC Solution

As described above, industry practice has it that interests in insurance policies are perfected by notification to the insurance company, with physical possession of the policy having no legal effect. However, as also described above, the non-UCC law provides ample examples where the law contradicts insurance industry practice. Regardless of whether *Rose* can be distinguished in one jurisdiction or another,[126] the law here is a field of brambles, much underestimated in its propensity to entangle otherwise benign transactions. Professor Knippenberg summarizes the non-UCC law in this way:

> The long and short of it is, there are risks and costs both to lenders seeking to secure a debt through an assignment of life insurance, and to insurers who are driven to interpleader actions or, not infrequently, forced to justify as defendants the payment of proceeds to one or another of multiple claimants. These risks and costs are of the sort that are predictably generated where, for lack of thorough statutory treatment, there is room left by uncertainty for argument. [127]

He concludes that "the law governing assignment, then, is sufficiently flaccid, incomplete and non-uniform to suggest insurers and assignees alike would benefit from . . . Article 9."[128] A fundamental policy of Article 9 of the Uniform Commercial Code is to discourage secret liens,[129] and it could be applied here to give parties greater comfort in their security.

The UCC should be amended to remove the life insurance exclusion and treat life insurance policy interests as general intangibles, while still acknowledging the realities of the insurer's special role. Issuer loans against policies should be treated as purchase money security interests under § 9-107. Such loans should be automatically perfected for a period of time, and then achieve super priority if perfected through notice. Short term financing for an insured who is late in an insurance premium payment may never need to be filed. Nor would an insurance company be forced to file at a moment of great inconvenience, merely because of the

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[126] Rose v. AmSouth Bank of Florida, 391 F.3d 63, 65 (2d Cir. 2004).
[127] Knippenberg, *supra* note 11, at 8.
[128] *Id.* at 9.
[129] *See In re* Cushman Baking, 526 F.2d 23, 28-29 (1st Cir. 1975).

time that the insured requires a loan. But in a timely manner, all liens on a policy must soon be disclosed. Setting a time limit for filing of liens will ensure that potential lenders know how long they must wait in order to discover all potential claimants.

Purchase Money Security Interest status is appropriate for two reasons. First, it is recognition that such loans often finance premiums that permit the continued life of the policy.[130] Second, such status acknowledges the insurers' other statutory responsibilities. Issuing insurance companies are required to offer policy loans by insurance statutes in most states.[131] Without purchase money secured status, even a perfected security interest could take second priority on a loan whose value had long been promised as security to others. No party should be required by statute to lend, as a second lien, on an over-promised asset. Of course, the power of the insurance company to "jump the queue" with purchase money security interest priority will upset some other creditors. But they can be expected to protect themselves with indentures in the agreement with the borrower.

B. SURPLUS PROBLEM

The surplus problem refers to distribution of value of a defaulted security-policy above the value of the debt. When an insured defaults on

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[130] *See* Knippenberg, *supra* note 11, at 232-33. *See generally* Kripke, *supra* note 117, at 951-57 (describing how PMSI creditors enable the insured to obtain new collateral, so they are not really disadvantaging prior creditors.); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 880-902 (1996) (generally discussing efficiency and incentives for priority); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1947-63 (1994) (discussing "three theories and one not so bad" in support of subordination).

[131] *See* ALASKA STAT. § 21.45.080(a) (2010); ARIZ. REV. STAT. ANN. §§ 20-1208(A), 20-1209(A) (2010); DEL. CODE ANN. tit. 18 § 2911(a) (1999); GA. CODE ANN. § 33-25-3(5) (West 2003); ME. REV. STAT. ANN. tit. 24-A, § 2510(1) (2000); MASS. GEN. LAWS ANN. ch. 175, § 132 (West 1998); MINN. STAT. ANN. § 61A.03(g) (West 2005); MONT. CODE. ANN. § 33-20-131(1) (2009); NEB. REV. STAT. § 44-502(8) (2004); NEV. REV. STAT. ANN. 688A.110(1) (LexisNexis 2009); N.J. STAT. ANN. § 17B:25-8 (West 2006); N.Y. INSURANCE LAW § 3203(8)(A) (McKinney 2006); OHIO REV. CODE ANN. § 3915.05(G) (LexisNexis 2010); OR. REV. STAT. § 743.186(1) (2009); 40 PA. STAT. ANN. § 510(h) (West 1999); S.C. CODE ANN. § 38-63-220(l) (2000); S.D. CODIFIED LAWS § 58-15-15 (2004); VT. STAT. ANN. tit. 8, § 3731(7) (2009); WASH. REV. CODE. ANN. § 48.23.080(1) (West 2010); W. VA. CODE § 33-13-8(a) (2006). *See also* Metro. Life Ins. Co. v. Massachusetts Travelers Ins. Co., 471 U.S. 724, 729 (1985).

his debt obligations to a collateral assignee, a number of questions emerge: (1) may the creditor exercise the surrender option of the policy to satisfy the debt; (2) may the creditor wait until the policy matures and collect the proceeds; (3) may the creditor sell the policy to a third party, and under what conditions; and (3) may that third party surrender, wait to collect, or resell? At some stage, one of these options may produce cash in excess of the debt as of yet unsatisfied, provoking the most important question of all: who can keep this surplus of cash above the borrower's remaining debt?

There is a gulf between what the law permits and what is industry practice. Generally, lenders expect to keep the surplus from the policy, or else to sell the policy to a buyer who will someday get to keep the surplus. The borrower often loses more than the initial bargain contemplated, and the law generally regards surplus as the property of the borrower. Statutory treatment is desperately required to curtail the most abusive practices currently extant, as well as to clarify creditors' and third parties' rights to the benefits of their bargains.

As with the previous section considering the perfection problem, it makes sense to look at what third-party lenders believe and what they do. In many cases, lenders' actions are based on wrong assumptions, and increase their own risks needlessly. Lenders will generally lend an amount that falls somewhere between the policy's surrender value and the maturity proceeds. Lenders reason that if the insured defaults, they can surrender the policy with no risk and satisfy the remaining debt. Or, if they have the appetite and sufficient patience, they can pay the premiums until the policy matures and then collect the death benefit. Or they may sell the policy on the secondary market.

These various actions by lenders are based on their understandings (sometimes misunderstanding) of their rights. Creditors believe they have the right to surrender the insurance policy. Most lenders believe that they can foreclose on their security with minimal process or protection for the debtor and sell the policy to a third party, who takes the policy free and clear and may receive the full proceeds.

Some lenders believe that they may keep the full balance paid by the purchasing third party, or paid upon maturity by the insurance company, even if it exceeds the value of the defaulted debt, with no need to return the surplus to the debtor or beneficiaries.[132] Other lenders believe it

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[132] This belief is perpetuated in part by the widespread practice of executing security assignments using absolute assignment forms. Thus, the paperwork already looks like the creditor has been given the whole policy, without regard to specific obligations.

is necessary for the debtor to consent to signing over his remaining rights in the policy, or designate the creditor as the beneficiary, and they make a practice of obtaining this consent from the insured in satisfaction of the debt.

Notwithstanding creditor optimism, there is substantial authority for all of the following contrary propositions: (a) the lender may not exercise the surrender option;[133] (b) the lender may not resell the policy to a third party;[134] (c) the lender may keep the amount of the debt owed, plus interest and premiums paid, but the borrower's estate or beneficiaries are due any surplus.[135] Each of these precedents implies potential litigation and impediments to insurance financing transactions.

Most crucially, (c) is well-supported and contrasts with widespread industry practice. Industry practice has galloped ahead of the law in this area.[136] There is little legal support for the widespread practice of creditor windfall, wherein a creditor is able to keep the surplus above the indebtedness amount, and it smacks of exploitation.

While curtailing exploitation, some provision must be made to allow creditors a reasonable return on their investment. The law should make creditors' rights clearer, and allow creditors to then charge a rate of interest that adequately compensates them for their risk, or else clarify that they intend to purchase the policy, surplus and all, rather than merely lend against it.

1. Windfall From Sale

Notwithstanding industry practice, numerous courts have adopted the view that a creditor who retains more than the amount of the indebtedness will have been unjustly enriched.[137] The clear majority

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[133] *See*, *e.g.*, Brown v. New York Life Ins. Co., 22 F. Supp. 82, 88-89 (W.D.S.C. 1938).

[134] *See*, *e.g.*, Salvidge v. Mut. Life Ins. Co. of New York, 191 N.W. 862, 863 (Iowa 1923); 5 RUSS & SEGALLA, *supra* note 101, § 37:68.

[135] *See, e.g.*, Luxton v. United States, 340 F.3d 659, 653 (8th Cir. 2003); Westchester Enters., Inc. v. Swartwout (*In re* Swartwout), 123 B.R. 794, 799-800 (Bankr. S.D. Ohio 1991); Succession of Goudeau, 480 So. 2d 806, 808 (La. Ct. App. 1985).

[136] *Cf.* Kenneth Kettering, *Securitization and Its Discontents*, 29 CARDOZO L. REV. 1553, 1632 (2008) (stating that securitization has grown immensely over the past twenty years despite shaky doctrinal foundations).

[137] Albrent v. Spencer, 88 N.W.2d 333, 335-36 (Wis. 1958) ("If the amount received is greater than the debt, there is an 'unjust enrichment' with liability for

position is that a creditor-assignee may only take the remaining indebtedness, plus expenses such as payments made to keep the policy alive.[138] Many states have statutes to this effect, patterned off of the Uniform Consumer Credit Code.[139] In the vast majority of cases, courts construe the assignment so as to reserve to the non-creditor beneficiaries any excess of proceeds over indebtedness.[140] The burden is on the creditor to establish what he is due under the indebtedness.[141]

Arguments in favor of a creditor's right of windfall are usually limited in their scope. For example, the assignee of a policy of insurance, assigned by way of security, is sometimes said to occupy the same status as the insured with respect to the rights and liabilities under that particular policy that the insured occupied.[142] In allowing a creditor to foreclose upon and sell an insurance policy, the Florida Supreme Court's *Moon v. Williams* seems to advocate for this view:

> The assignee of a policy of insurance, such as life insurance, assigned by way of security, in general, occupies the same status with respect to the rights and liabilities under the policy that the insured occupied, to the

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the amount exceeding the amount of the debt plus interest."); Rattray v. Banks, 121 S.E. 516 (Ga. Ct. App. 1924); First Nat'l Bank v. Sec. Mut. Life Ins. Co., 222 S.W. 832 (Mo. 1920); Minn. Mut. Life Ins. Co. v. Manthei, 189 S.W.2d 144 (Mo. Ct. App. 1945).

[138] William H. Danne, Jr., Annotation, *Right of Creditor Beneficiary or Assignee of Insurance Policy on Life of Debtor to Excess Proceeds Over Amount Owed on Debt*, 6 A.L.R.6th 391 § 5 (2005).

[139] UNIF. CONSUMER CREDIT CODE (1974) § 4.105(2) (1974) (creditor must pay to the consumer or his or her estate all proceeds received by the creditor in excess of the amount to which the creditor is entitled within 10 days after receipt of the proceeds).

[140] Danne, *supra* note 138. *See, e.g.*, Luxton v. United States, 340 F.3d 659, 662 (8th Cir. 2003). ("[A] collateral assignment transfers only those rights necessary to secure the assignor's debt and extinguishes the named beneficiary's interest only to the extent of the assignor's debt to the assignee.").

[141] *See, e.g.*, Floyd v. Victory Sav. Bank, 189 S.E. 462, 467 (S.C. 1937).

[142] 45 C.J.S. *Insurance* § 757 (2007) (note, however that this passage reads in full "The assignee of a policy of insurance, such as life insurance, assigned by way of security, in general, occupies the same status with respect to the rights and liabilities under the policy which the insured occupied, to the extent of the indebtedness for which the policy was assigned as collateral.").

> extent of the indebtedness for which the policy was assigned as collateral.[143]

The court goes on to say that the assignee may sell the policy by order of court and that the purchaser

> would stand in the position of the insured as to the right to exercise options under the policy, and therefore would thereby acquire the right to surrender the policy for its cash surrender value, or make such other settlement with the company in regard to the policy as could have been made by the insured, had the policy not been assigned.[144]

Although *Moon* does authorize some creditor activity, the *Moon* court is careful to include the limiting phrase "to the extent of the indebtedness."[145] The court does not explain what would happen if the court-ordered sale price exceeded the indebtedness, and it cites to *Metropolitan Life Insurance Co. v. O'Brien*, a case in which the creditor's recovery is limited by the debtor's indebtedness.[146]

A similar argument emerges from the fact that most courts have held that a creditor, holding a policy as collateral, may surrender the policy to the insurance company upon the insured's default.[147] An assignee-creditor has the power to terminate the contract for insurance and end any

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[143] Moon v. Williams, 135 So. 555, 557 (Fla. 1931).

[144] *Id*.

[145] *Id*. at 556.

[146] 52 N.W. 1012, 1013-14 (Mich. 1892) ("Creditors, however, hold only what is necessary for their indemnity for the debt, and the representatives of the insured will be entitled to the balance.") .

[147] Bush v. Block, 187 S.W. 153, 156 (Mo. Ct. App. 1916) (Assignee of life policy taken as security loan, which then comes into default, may convert the policy into a paid-up policy upon notice to the insured); Mut. Benefit Life Ins. Co. v. First Nat'l Bank, 169 S.W. 1028, 1034 (Ky. 1914) (creditor to whom life policy assigned may surrender the policy); Higgins v. Helmbold, 48 App. D.C. 50 (1918); Bank of Idana v. Ill. Life Ins. Co., 9 P.2d 629 (Kan. 1932); McGimpsey v. Sec. BIdg. & Loan Ass'n, 157 A. 441 (N.J. 1931); Wilson v. Prudential Ins. Co., 187 A. 251 (Pa. Super. Ct. 1936); *See* Gen. Am. Life Ins. Co. v. Fraventhal & Schwarz, 101 S. W.2d 953, 954 (Ark. 1937).

future growth in the policy principal. Some creditors may reason *a fortiori* that power of surrender entails the existence of equal or lesser rights.[148]

In *Citizens' Bank v. Pan-American Life Ins. Co.*, a bank purchased a life insurance policy sold in foreclosure by a collateral assignee.[149] The bank sought to have itself listed as a beneficiary under the policy.[150] The court ruled for the bank, analogizing the power of appointment to the right of surrender: "Rights with respect to loans and surrender clauses in a policy are rights of the same nature and character as the one to change beneficiary, and we can think of no reason why the purchaser of the policy in this case should not enjoy the same right . . . ."[151]

Similarly, if the power to destroy the policy is theirs, then any value in surplus of the surrender value persists due solely to their benign neglect of that power. And any premiums paid from that point forward goes to grow the principal and increase the chance that the principal will be realized rather than the surrender value.

There is a sense in which the surplus is created through the creditors' actions alone and so they are entitled to it. But it proves difficult to find a case where the surplus-taker did not acquire the policy after the appropriate judicial sale. No such case validates the right of the creditor to hold a maturity or resale balance in excess of the debt and costs. The most this reasoning proves is that if a party takes the policy after court-ordered sale, they may be able to keep whatever proceeds are later liberated – but it says nothing about the proceeds of the judicial sale itself, which surplus may be properly allocated to the insured.

Perhaps sensitive to unfavorable law, industry practice has it that a creditor who is owed less than the maturity payment will persuade a defaulted debtor to list the creditor as beneficiary on the policy and sign away his residual rights in the insurance in satisfaction of the debt. In this way, the creditor obtains an amount of money greater than the nominal value of the debt and the debtor retains no rights to any residual.

The transaction then acquires the character of a wager contract, with all the worrisome policy implications of the creditor hoping for the early demise of the insured.[152] These surplus allocations are more

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[148] *Accord*, FRANK HERBERT, DUNE 462 (2005) ("The power to destroy a thing is the absolute control over it").

[149] 141 So. 481 (La. Ct. App. 1932).

[150] *Id.*

[151] *Id.* at 482.

[152] *See* Anthony Alt, Note, *SPIN-Life Insurance Policies: A Dizzying Effect on Human Dignity and the Death of Life Insurance*, 7 AVE MARIA L. REV. 605 (2009). *See also infra* III.D.

distasteful than a simple policy purchase. This seems like an unjust windfall for the creditor who loaned money on security and now gets to keep the full value of the collateral. This could not have been part of the initial agreement since the insured has a right to decline such an assignment. Most likely, creditors are squeezing a debtor for an intangible asset during a time of difficulty.

In addition to being distasteful, these conclusions to the lending relationship are legally problematic. Industry practice is to structure the transaction so that it does involve consideration, perhaps by varying the terms of the agreement. But it remains true that if the insured has a right to satisfy the debt from sale of the security, the insured loses economic value for nothing in return when the insured signs away the security in total. Moreover, courts look to the relationship between the insured and the creditor-beneficiary in determining the controlling intention of the policy assignment.

Where courts allow the creditor to take an amount greater than the debt, they emphasize that the assignment was not as security for a loan,[153] that the creditor was a friend[154] or relative.[155]The only cases where creditors seem to be able to take the entirety of the proceeds are where the creditor procured the policy.[156]

For all of the forgoing issues, authority can be found for nearly any position, few rules are clear, and jurisdictions tend to differ. Doubtless, some creditors may have found comfort in their ability to take surplus on a given set of facts, with a given contract, and under a certain reading of the case law. But even such a creditor will may have to anticipate ample litigation and difficulty in securitizing her acquired policies. As Professor Knippenberg put it, "These risks and costs are of the sort that are predictably generated where, for lack of statutory treatment, there is room left by uncertainty for argument."[157] Even if reform might limit creditors'

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[153] Am. Cas. Co. v. Rose, 340 F.2d 469, 471 (10th Cir. 1964); Zolintakis v. Orfanos, 119 F.2d 571 574-75 (10th Cir. 1941) (probably a loan, but doubtful that that creditor-beneficiary could have collected the sums advanced).

[154] *Am. Cas. Co*., 340 F.2d at 471 n.4; Forster v. Franklin Life Ins. Co., 311 P.2d 700, 702 (Colo. 1957).

[155] Wages v. Wages, 42 S.E.2d 481, 482 (Ga. 1947).

[156] Central Nat'l Bank v. Hume, 128 U.S. 195 (1888); Fitzgerald v. Rawlings Implement Co., 79 A. 915 (Md. 1911); Haberfeld v. Mayer, 100 A. 587 (Pa. 1917); Watson v. Mass. Mut. Life Ins. Co., 140 F.2d 673 (D.C. Cir. 1943) *cert. denied* 322 U.S. 746 (1944); WILLIAN R. VANCE, HANDBOOK ON THE LAW OF INSURANCE, 739-40 (Buist M. Anderson ed., 3rd ed. 1951).

[157] Knippenberg, *supra* note 11, at 226-27.

ability to take the surplus from the insured, creditors will benefit from greater legal certainty and reduced litigation.

2. UCC Solution

The surplus problem involves confusion as to the treatment of surplus proceeds and facilitates predatory behavior by creditors. Inclusion in Article 9 is the appropriate remedy. It is not enough to simply clarify in statute that the creditor may not keep surplus unless clearly specified.[158] This clarification is appropriate, and a truthful depiction of the law as best as can be construed, but it creates bad incentives if adopted alone.

Imagine a creditor in possession of a policy with a maturity value of $1,000,000, a surrender value of $100,000 and a resale value, reflecting the expected value of the policy given premium and maturity date, of $200,000. Imagine, further, that the creditor is owed $100,000. Under current industry practice, the creditor is likely to resell the policy for $200,000 to a purchaser willing to wait for maturity. The creditor will keep all $200,000, representing $100,000 of debt and a $100,000 surplus. The better result is that the creditor keeps $100,000 and returns $100,000 to the debtor insured.

But if the law were amended to clarify that the $100,000 belonged to the debtor, this better result will not obtain. Stripped of any potential surplus, the creditor would simply surrender the policy for $100,000. Why? Surrender is always easier than more complex commercial transactions, which are risky in terms of their value, and which require the seller to pay the insurance premiums until disposition.

Surrender also reduces litigation risks. If the debtor has an interest in the surplus, the debtor may litigate if he feels the creditor made unwise choices in selling. He may claim that the creditor made a hasty sale, or a sale to a friend on unfair terms, resulting in a cognizable harm to the debtor's interest. There is no incentive for the creditor to bear those risks. As long as resale has risk but no benefit, and as long as surrender remains a legal option, value will be lost to the debtor-insured.

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[158] There is nothing wrong, *per se*, in allowing an assignee to take the whole surplus. But such transaction is really a sale of the policy, in consideration for a loan, with the seller's right to repurchase for the loan principal plus interest. Presumably the loan offered is at a below market interest rate, as the lender expects to make their real gain on the surplus. But such a transaction should be clearly labeled as such, and not sprung upon a borrower.

Inclusion of interests in insurance policies within the UCC would subject the decision to resell or surrender to Article 9's standard foreclosure provisions. Upon default by the debtor, a secured creditor has a right to dispose of the collateral.[159] The creditor may come to own the collateral, should she wish, by purchasing it in a judicially administered sale.[160] But the disposition need not be judicially administered, nor need it even be a sale,[161] so long as it is commercially reasonable.[162] Dispositions in conformity with reasonable commercial practices are deemed to be commercially reasonable.[163]

Creditors have hitherto had undue freedom with regard to liberal surrender. Surrender should properly be regarded as one of the many options potentially available to the foreclosing creditor. Sometimes surrender would be regarded as a commercially reasonable option, such as where the surrender amount is likely to equal the resale amount. But under the UCC, creditors would no longer be allowed a general safe harbor for surrenders where surplus-creating resales may be possible. So the creditor from the example above would be required to sell the policy for greater value, and share the surplus, less expenses, with the debtor.

Conversely, some creditors have failed to surrender to the detriment of the borrower. In one case, a pledgee held policies with a surrender value sufficient to satisfy its claims, but instead allowed the policies to decrease in value for years until they could no longer satisfy the claims. The court found for the pledgee, allowing it to recover the unsatisfied debt from the pledgor. The court reasoned that the Article 9 statutory obligation of "reasonable care in the custody and preservation of collateral" is inapplicable to interests in life insurance policies.[164] This is an appalling and inefficient result. Inclusion in Article 9 would mean that surrender would sometimes be required as part of the reasonable preservation and disposition of collateral. The legal duties imposed by Article 9 are crucial components to the correction of the surplus problem.

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[159] U.C,C. § 9-610(a) (2000).

[160] *Id.* at § 9-610(f).

[161] *Id.* at § 9-610(a) ("a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral. . . .").

[162] *Id.* at § 9-610(b).

[163] *Id.* at § 9-627(b)(3). There is no recognized market for life insurance policies, though there may someday be a market for the securitized bundles of them. Thus the other methods of reasonable disposition will not work. § 9-627(b)(1)-(2).

[164] Poultry Processing, Inc. v. Mendelson, 584 A.2d 659, 662 (Me. 1991).

Where creditors lend a substantial proportion of the value, this change will not be burdensome. Only where creditors have loaned a small fraction of the value, and yet still expect the whole maturity payment, will this reform decrease the gain to creditors. These transactions are not sympathetic or efficient.

Eliminating the option to simply surrender the policy upon foreclosure will decrease some of the flexibility and security associated with lending on insurance policies. But there are two reasons to think that this change will not substantially harm the availability of credit to borrowers. First, insofar as creditors have expected to keep the windfall surplus, their practice has been to sell, not surrender, the most valuable policies. Under current lending practices, only the least valuable policies are rapidly surrendered – a practice which Article 9 would still respect as a commercial reasonable disposition.

Moreover, since Article 9 invalidates limits on assignment, parties will be free to draft complex hybrid credit/purchase agreements.[165] Consumers may be given an amount near the secondary market value of a policy in exchange for an absolute assignment, with some kind of right of redemption if the insured wishes to restore her interest at a later time. Such transactions would track the windfall benefit currently enjoyed by creditors, but it would make the transaction clear to consumers, as well as ensure them a fair price for losing their investment. It is also reasonable to assume that more transparency and fair prices would encourage consumers to borrow more, thus enlarging the market and opportunities for lenders.

C. THE RESERVATION PROBLEM

The "reservation problem" refers to a subtle problem emerging from drafting practices and non-UCC law, which disrupts the growth of a secondary market around foreclosed collateral assignments. The vast majority of collateral assignments have been executed in a manner that reserves to the assignor certain rights that the assignee needs for flexible resale.

Collateral assignments are performed using standard forms drafted by insurance companies. The considerable uniformity of forms was in part a deliberate effort of the insurance industry.[166] Insurance companies

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[165] U.C.C. § 9-408 (2000).

[166] *See* John F. Handy, Assistant Counsel, *Why Uniformity in Collateral Assignment Blanks?*, 5 PROCEEDINGS OF THE ASSOCIATION OF LIFE INSURANCE

have for years standardized contracts for the benefit of the insured.[167] Collaboration between bankers and insurance companies resulted in a standardized assignment form in 1938.[168] These uniform forms were used almost universally in the following years.[169]

By controlling the means of assignment, and limiting them to finite, boilerplate clauses, insurance companies can prevent creditors from taking advantage of their clients. On the other hand, those same standard contracts can also discourage creditors from accepting insurance policies as collateral for loans. [170]

Standard assignment forms reserve to the assignor the right to designate or change beneficiaries, often called the power of appointment.[171] That is, even once the insured individual gives her policy as collateral for a debt, she still has the sole right to decide who is to be paid when she dies. This reservation exists to prevent the beneficiary from limiting the insured's power to assign the policy.[172] But this reservation casts a cloud over the salability of the policy. It is difficult for a creditor to effectively sell his interest in a policy missing this incident of ownership.

Parties cannot draft around this problem because assignments are only valid on the terms of the insurance policy,[173] which will invariably require the use of standard assignment forms. Many states have codified the requirement that policies are assignable or not assignable on the terms of the insurance contract.[174] Insurance companies will not be expected to

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COUNSEL 307 (1932) (suggesting collaboration with the American Bankers Association).

167 Comment, *The Assignment of Life Insurance as Collateral Security for Bank Loans*, 58 YALE L.J. 743, 754 (1949).

168 *See id.* at 755.

169 *Id*. at 756 nn.81-82.

170 *See, e.g.*, Neil A. Doherty and Hal J. Singer, *Regulating the Secondary Market for Life Insurance Policies*, 21 J. INS. REG. 63 (2003). *See also supra* note 30.

171 *See* 10 AM. JUR. LEGAL FORMS 2D § 149:184 (2010) ("The following specific rights, so long as the policy has not been surrendered, do not pass by virtue of this assignment: . . .(b) The right to designate and change the beneficiary.").

172 *See infra* II.C.1.

173 *See, e.g.*, Immel v. Travelers Ins. Co., 26 N.E.2d 114, 116 (Ill. 1940) (citing 31 CORPUS JURIS, 430; 2 ROGER W. COOLEY, BRIEFS ON THE LAW OF INSURANCE 1829 (1905)).

174 *See* ALA. CODE § 27-14-21(a) (2011); ALASKA STAT. ANN. § 21.42.270 (West 2011); ARIZ. REV. STAT. ANN. § 20-1122 (2011) (West); ARK. CODE ANN. § 23-79-124(a) (West 2011); CAL. INS. CODE § 10130 (West 2011); DEL. CODE ANN. tit. 18, § 2720 (West 2011); GA. CODE ANN. § 33-24-17 (West 2011); HAW. REV.

alleviative this problem, in part because they tend to benefit when third party interests are impaired.

1. Origin in the Vested Beneficiary Problem.

Beginning in the mid-nineteenth century, courts began to restrict the ability of insureds to assign their policies.[175] They did so on the theory that the beneficiary under the policy had a vested interest in the proceeds that could not be divested without his permission. It seemed unjust and problematic that a breadwinner could procure a policy to give peace of mind to her dependants and then secretly assign the policy to a bank. The beneficiary may have come to rely on the benefit. It was also argued that the insured had given the beneficiary a beneficial interest at the time of taking out the policy and was not at liberty to unilaterally divest the beneficiary.

The protection of the vested interest of a beneficiary became the law in all states but Wisconsin,[176] and life insurance policies became *de facto* unassignable. Such restrictions reduced the value of insurance policies to insureds, who were forced to accept whatever price the insurance company saw fit to offer for a policy loan or surrender.

Insurance contracts were soon drafted to reserve the insured's right to change beneficiaries.[177] This reservation clause limited the beneficiary's interest to a mere expectancy and freed the insured's hand to make assignments. A policy that was assigned absolutely would carry with it the

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STAT. § 431:10-228(a) (West 2010); IDAHO CODE ANN. § 41-1826 (West 2011); KY. REV. STAT. ANN. § 304.14-250(1) (West 2011); ME. REV. STAT. ANN. tit. 24-A, § 2420(1) (2010); MONT. CODE ANN. § 33-15-414(1) (2010); N.D. CENT. CODE ANN. § 26.1-33-33 (West 2011); OKLA. STAT. ANN. tit. 36, § 3624 (West 2011); PA. CONS. STAT. ANN. § 512 (West 2011); S.D. CODIFIED LAWS § 58-10-6.1 (2011); VA. CODE ANN. § 38.2-3111 (West 2011); WASH. REV. CODE ANN. § 48.18.360 (West 2011).

[175] *See* Lewis D. Asper, *Ownership and Transfer of Interests in Life Insurance Policies*, 20 HASTINGS L.J. 1175, 1177. For more on the origin of this theory, *see* William Reynolds Vance, *The Beneficiary's Interest In A Life Insurance Policy*, 31 YALE L.J. 343, 347-48 (1922).

[176] *See* 4 GEORGE J. COUCH, CYCLOPEDIA OF INSURANCE LAW § 27:56 (2d ed. 1960). *See also* Ellison v. Straw, 92 N.W. 1094 (1902); Clark v. Durand, 12 Wis. 223 (1860).

[177] *See e.g.*, Asper, *supra* note 175, at 1179; Grimm v. Grimm, 157 P.2d 841, 842 (Cal. 1945); Morrison v. Mut. Life Ins. Co., 103 P.2d 963, 965 (Cal. 1940); Davis v. Modern Indus. Bank, 18 N.E.2d 639, 643 (N.Y. 1939).

power to select beneficiaries. Thus, be it assignor or assignee, someone always had the power to change beneficiaries, and so beneficiary rights would not vest. Thus, reservation clauses were originally drafted to empower insureds vis-à-vis their beneficiaries.

2. Reservation of Selection of Beneficiary Amounts to the Reservation of a Substantial Incident of Ownership.

The power of appointment of beneficiaries is a significant incident of ownership and a crucially important one for the creditor who hopes to sell the policy to a third party purchaser. Incidents of ownership are the economic benefits of owning a policy[178] and are constituent elements of ownership. Regardless of what labels the parties may apply, a transaction that fails to give enough incidents of ownership to the assignee may be contested as less than a transfer of ownership. If an insured purports to assign a policy, but a court finds that the insured has retained for herself too much of the power associated with the policy, the insured will still be deemed the owner. Questions of whether the insured has "really" assigned the policy can become important if, for example, other creditors of the insured seek to foreclose on the policy.

Lists of the incidents of ownership of life policies are inconsistent and contradictory, shifting somewhat from court to court. [179] But it may be helpful to look to an area of the law that, though convoluted, at least speaks with one voice: federal taxation. If an assignee lacks all the incidents of ownership, a life insurance policy may remain in the gross estate of the assignor.[180] The federal estate tax sets rules to determine whether an insurance policy is includable in an individual's gross estate. It lists the following incidents of ownership:

> the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to

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[178] 26. C.F.R. § 20.2042-1(c)(2) (2010).

[179] Asper, *supra* note 175, at 1183 ("This is due in part to the nature of the interests and in part to the fact that few transfers of interest in property are conducted at a higher level of ignorance and inattentiveness.").

[180] 4 GEORGE J. COUCH, CYCLOPEDIA OF INSURANCE LAW § 63:41 (3d. ed. 2010) ("An insured's reservation of the right to change beneficiaries under a life insurance policy is an 'incident of ownership' sufficient to cause inclusion of the policy proceeds in the insured/decedent's gross estate….").

> pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.[181]

Reservation of the power to change beneficiaries is by itself sufficient "incident of ownership" to cause inclusion of the policy proceeds in the insured's gross estate.[182] Conversely, an assignor who has exercised the surrender option of a policy can still have effectively removed the policy from his gross estate.[183]

In a standard collateral assignment, an insured does not grant the insurer access to the power of appointment, or otherwise put that power at risk. It is difficult for a foreclosing creditor to persuade an insurance company to list him as the owner when such a large portion of the ownership has been reserved.

It is also difficult for a creditor to persuade a subsequent purchaser that he owns the policy if he is not listed as the owner. As a matter of industry practice, investors in life insurance policies expect to purchase policies with all the relevant rights attached. They designate themselves as beneficiary so that they can take the full proceeds, and they expect to be able to sell the policy on the secondary market, allowing the next purchaser to designate herself as the new beneficiary. Purchasers may wish to securitize policies for resale, requiring them to all be complete and possessing the full incidents of ownership.

Thus, the current drafting regime creates a difference between policies obtained by absolute assignment and collateral assignment. The former policies, assigned as consideration in sale, will come without strings attached. The latter, assigned as collateral, will lack important features that investors expect and desire.

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[181] 26. C.F.R. § 20.2042-1(c)(2) (2010).

[182] *See* Comm'r v. Estate of Noel, 380 U.S. 678, 682 (1965) (flight insurance policy where insured possessed right to change beneficiary and right to assign policy). *See also* Am. Nat'l Bank & Trust Co. v. United States, 832 F.2d 1032 (7th Cir. 1987) (despite apparent assigning of policy to spouse); Terriberry v. United States, 517 F.2d 286, 289 (5th Cir. 1975); Brown v. Comm'r, 95 F.2d 184 (6th Cir. 1938) (as to policy assigned to decedent, who then reserved right to change beneficiary); COUCH, *supra* note 180.

[183] *Insurance Excluded Despite Withdrawal of Cash* Value, 52 Prac. Tax. Strategies 182, 182 (Mar. 1994) (citing Estate of O'Daniel v. United States, F.3d 321 (5th Cir. 1993)).

3. Harms of the Reservation Problem

As just discussed, investors in life insurance policies demand all the rights provided for in the policy. However, when life insurance is used as collateral, the only valid documentation of assignment will not assign all of the rights. This makes the policies less useful to the first investor, probably a foreclosing creditor, and unsuitable for securitization. The failure of law and practice to match the realities of a robust secondary market acts as a friction, or worse – a time bomb.

At the same time as the fact of these reserved rights could result in judgments against insurance policy creditors status as policy owner, they are footnotes and asterisks that impair securitization and resale. Legal uncertainty is particularly damning in the life insurance secondary market.

Unlike, say, real estate investors, life insurance investors take the ultimate value of the investment as known.[184] That is, investors demand certainty about the ultimate value of life insurance policies and will be unlikely to accept securitized assets which have risk litigation or difficulty in receiving maturity benefits. In the history of the United States, no insurance policy has ever failed to pay upon maturity. And there have been only three instances of the downgrading of an insurance company security.[185] Every online lecture listed by ILIAM lecture emphasizes certainty as one of the core distinguishing values of insurance linked assets.[186]

A robust secondary market must come to rely on securitization, since institutional investors will not wish to purchase individual policies.[187] But securitized policies must be clean of legal nettles. Investors will pass over policies that may be subject to litigation, or are comprised of irregular bundles of incidents of ownership. The secondary market will be stunted if it carries only purchased, rather than foreclosed, insurance policies. And the market for loans on life insurance policies may segregate from the greater market for insurance policies, stunting the value proposition for investors in, and borrowers against, life insurance policies.

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[184] Greg Schmitt, *Trends in Insurance Linked Assets – Part 1*, LIFE SOLUTIONS INT'L (Feb. 10, 2009), http://www.lifesolutionsint.com/news-resources.aspx (follow "Feb. 10 ILIAM – Trends in Insurance-Linked Assets – Part 1").

[185] *Id*.

[186] *See* ILIAM, LIFE SOLUTIONS INT'L (2011) http://www.lifesolutionsint.com/iliam.aspx. ILIAM is the Insurance-Linked Investment Awareness Month, an annual lecture series and conference sponsored by Life Solutions International, one of the leading companies in this industry. *Id*.

[187] SEC STAFF REPORT, *supra* note 52, at 6.

4. Solving the Reservation Problem

Inclusion of life insurance policies under Article 9 will empower parties to solve the reservation problem. Consider first why the problem cannot be drafted away under the current legal regime. A beneficiary's interest does not vest if the insured always retains the power of appointment, and so collateral assignment invariably reserves that right to the insured.[188] But there are other ways to keep the beneficiaries' interest from vesting.

Absolute assignments keep the expectancy from vesting by granting to the assignee the power of appointment.[189] Similarly, the insured could grant the collateral assignee the right to select beneficiaries. This would keep the beneficiary's interest contingent while conveying to the creditor an important right he will want upon foreclosure. But the insured probably doesn't want a mere creditor to have the right to select the beneficiary, at least not until a default occurs. And even if a default occurs, the insured will want the excess of the proceeds to go to her own choice of beneficiaries, rather than granting a windfall to the creditor.

Where the parties intend for the creditor to have access to the full proceeds in the event of default, or to be able to resell with all the incidents of ownership, the vesting problem could be solved through drafting a springing appointment clause. The assignor could grant the assignee a contingent right of appointment that vests only in the event of default. But these clauses are unheard of. Insurance companies have not seen fit to add them to the set of available options, perhaps because of the ease with which securitization might then follow.[190]

The industry practice discussed in Section III is for insureds and their assignees to give notice of assignment to the insurance company on forms issued by the insurance company. Insurance companies do not include springing beneficiary clauses in those forms, so springing beneficiary clauses are not used in collateral assignments and the power of appointing beneficiaries remains reserved in the insured. In this case, the

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[188] Janesville State Bank v. Aetna Life Ins. Co., 274 N.W. 232, 233 (1937).

[189] *See, e.g.*, 9 WEST'S PA FORMS § 14:7 (1995) ("I . . . assign . . . all incidents of ownership with respect to, life insurance policy number ________ issued on my life by [name of life insurance company]. The incidents of ownership hereby assigned include, but are not limited to, the right to designate the beneficiary or beneficiaries of the policy….").

[190] *See infra* Part III.E, explaining why some insurance companies have discouraged securization.

standard form potentially endangers a secondary market because such a market is intolerant of archaic title disputes.

By contrast, Article 9 invalidates any clause that restricts the assignment of security interests in general intangibles.[191] If life insurance policies were included in Article 9, parties would be enabled to draft springing appointment clauses rather than picking assignment forms from the insurance company's limited menu. Insurance contract provisions limiting assignment except where conducted through designated documentation would be invalid. This would render the reservation problem moot.

III. OBJECTIONS

A. CONSUMER PROTECTION

It may be argued that the exclusion of life insurance policies from UCC Article 9 is necessary to protect consumers from unwisely using their policies as collateral.[192] Consumer protection is a worthy goal, and there are serious risks to consumers from insurance policy credit transactions. For example, an impaired life insurance policy could "cut off any interest of the debtor's beneficiaries under the policy if at the debtor's death an outstanding debt existed."[193] Moreover, insureds that lose their policy in default may find themselves unable to obtain a new policy, either because they are now too old or otherwise unattractive to insurers, or because insurers will not issue policies to individuals on whom an active policy exists, though now in the hands of the creditor.

Such arguments should not impede inclusion of life insurance. First, consumers tend to benefit when they can liberally monetize their assets.[194] Second, whatever risks are posed by policy lending, they are less than outright sales. An efficient borrowing and resale regime will give consumers another alternative to life settlements.

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[191] U.C.C. § 9-408(a) (2010).

[192] Ettinger v. Central Penn Nat'l Bank, 2 B.R. 385 (E.D. Pa. 1979), *rev'd on other grounds*, 634 F.2d 120 (3d Cir. 1980) ("This was obviously done to prevent debtors from foolishly or capriciously utilizing their life insurance policies as collateral") (citing I.G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 315 (1965); Ray D. Henson, *Insurance Proceeds as "Proceeds" Under Article 9*, 18 CATH. U. L. REV. 453, 456 (1969)).

[193] *Id*.

[194] *See infra* Part I.

Third, UCC exclusion amounts to the least efficient point of regulation for consumer protection. The law currently allows consumers to borrow against their policies, wisely or not, from anyone they please. True, UCC inclusion would likely increase insurance policy borrowing; non-UCC law has the side effect of discouraging would-be creditors from becoming competitors to the presumptive monopoly of the insurer. But it is rare that the best way to help consumer is to frustrate and raise costs on an otherwise legal transaction. If third-party lending posed a threat to consumers, regulations can be promulgated to address those threats directly, rather than by increasing legal uncertainty and cost. Insureds and creditors should not have their rights frustrated in transactions that have long been allowed.

More interesting consumer protections arguments address compromises in medical privacy.[195] Some life insurance financing agreements require the insured to open her health files to the creditor, or submit to periodic medical examinations. Creditors and investors are interested in the longevity risk associated with their interest in the policy. When financial commitments and health become intermingled, policy tradeoffs must be made between consumer privacy, transparency, and other values.

For example, without deciding the issue, a Florida Court questioned whether a right to medical privacy exists where a medical condition has become an essential condition of a commercial transaction.[196] Such arguments bear consideration. They should be evaluated against the benefits accrued to consumers from ready alienability of their policies. Statutes like HIPAA still apply[197] and will no doubt require more careful attention in the coming years. But the best consumer protections will be targeted to help insureds both keep their privacy and avoid exploitation. The worst solution is to protect consumers by using outdated, unclear law to discourage fair competition between creditors.

A similar response is appropriate to the problem of frauds against consumers, and other exploitative practices. It can be difficult for an individual to procure a new life insurance policy after selling hers or losing it through foreclosure. Individuals may be persuaded to part with an asset

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[195] *See* Andrew Spurrier, Note, *The Death of Death Futures?: The Effects of the Health Insurance Portability and Accountability Act of 1996 on the Insurance and Viatical Settlement Industries,* 4 CONN. INS. L.J. 807, 836 (1998).

[196] State v. Viatical Servs., Inc., 741 So. 2d 560, 564 (Fla. Dist. Ct. App. 1999). *See also* Life Partners v. Morrison, 484 F.3d 284, 295-96 (4th Cir. 2007).

[197] Health Insurance Portability and Accountability Act of 1996, 42 U.S.C. §§ 201 *et seq*.

that they would prefer to keep, or may later regret giving up.[198] And the tax implications of such a transfer can sometimes be surprising.[199] These legitimate concerns may require disclosure and regulatory oversight.[200] Yet our approval of assignments indicates a confidence that these problems can be addressed. It is of independent value that the law be orderly and that consumers get the best possible price for their policies.

B. STATUS QUO AND THE ORIGIN OF THE CODE

This section treats the general conservative objection that the Drafters of the Code knew what they were doing, and we should not amend their work without knowing why they set things up the way they did. Indeed, since most of the problems explained in the preceding sections are not new, it would be strange, if not hubristic, to amend the Code without wondering what the drafters thought of these problems. [201]

It will be shown in this section that this general objection is not persuasive here. The origin of the exclusion lies not in the drafters' thoughtful understanding of subtle economic and legal realities so much as bowing to the pressure of an industry that feared change. As ambitious as Article 9 may have been, the drafters made compromises in order to ease its passage.[202]

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[198] J. Alan Jensen and Stephan R. Leimberg, S*tranger-Owned Life Insurance: A Point/Counterpoint Discussion*, 33 ACTEC J. 110, 113 (2009) ("therefore, it will reduce the ability of the insured to buy additional coverage throughout his life. . . .").

[199] Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 (explaining that individuals who sell their insurance policies may owe taxes on the amount received, less premiums paid. Thus, settlement income does not receive the same tax advantage for the insured as maturity proceeds. Note, however, that tax implications of a policy loan are unlikely to be as surprising and adverse.).

[200] *See generally* Miriam R. Albert, *The* Howey *Test Turns 64: Are the Courts Grading this Test on A Curve? 2* WM. & MARY BUS. L. REV. 39-50 (2011) (statutes and regulations regulating viatical settlements).

[201] Notwithstanding the growing importance of secondary markets. *See infra* Part I.B.

[202] Homer Kripke, *The Principles Underlying the Drafting of the Uniform Commercial Code*, 1962 U. ILL. L. F. 321, 327 (1962) ("The draftsmen and the members of the sponsor organizations knew that to draft a dead-letter bill would accomplish nothing. The Code had to be enacted.").

1. Early Exclusion in Article 9

The first draft of the Uniform Commercial Code, promulgated in 1952, did not exclude insurance policies from the scope of Article 9.[203] Article 9 was first adopted in Pennsylvania without any exclusion,[204] but the integrity of the Code was soon threatened by a seeming drafting error.

The confusion arose from an apparent conflict between the text of the Code and its comments. Comment 4 to Section 9-105 of the 1952 UCC stated:

> 'Instrument' (subsection (1)(g)): the term as defined includes not only negotiable instruments and investment securities but also other intangibles which are evidenced by writings which are in ordinary course of business transferred by delivery, for example, insurance policies.[205]

This Comment clearly indicates the desire of the drafters to classify insurance policies as instruments.

However, the statutory text of the definition does not mention insurance as an instrument, and indeed, implies the contrary: "'Instrument' means . . . [a writing] which evidences a right to payment of money and is of a type which is the ordinary course of business transferred by delivery."[206] To be an instrument, insurance policies must have been transferred by delivery in the ordinary course of business, but the extant commercial practice required more than mere delivery to transfer insurance policies.[207] Life insurance policies were ordinarily transferred by delivery *and* by a written agreement of transfer, not mere delivery. If not an instrument, life insurance policies would seem to have been left out of the Code notwithstanding the drafters' intentions.

There were a number of ways to potentially square the drafters' intentions with the text, but none proved satisfactory. For example, if the commercial practice of delivery was a necessary condition, but not sufficient, then life insurance policies might still fit the definition as

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[203] *See* U.C.C. § 9-104 (1952).

[204] PA. STAT. ANN. tit 12A, § 1-101 *et seq.* (Purdon Supp. 1953).

[205] U.C.C. § 9-105, Comment 4 (1952).

[206] *Id.* § 9-105.

[207] Carl W. Funk, *Problems of Classification Under Article 9 of the Uniform Commercial Code*, 102 U. PA. L. REV. 703, 709 (1954).

instruments. But many lawyers were unwilling to make this interpretive leap without guidance.[208]

An alternative interpretation might have fitted insurance policies into another category of collateral. It could have been argued that insurance policies qualified as chattel paper, the definition of which read "of a type which is in ordinary course of business transferred by delivery with appropriate endorsement or assignment."[209] But a consensus did not form around this interpretation either. The Comments clearly placed insurance in the mutually exclusive "instruments" group. It was impossible to square the text of the statute with the commercial reality of insurance policy transfer, regardless of what the Comments did to keep policies out of other categories. It became necessary to draft an amendment.

In resolving this confusion, the Drafting Committee bowed to industry pressure, and simply excluded life insurance policies. Even the revered Drafting Committee had to consider the political realities of getting legislatures to accept their proposal, as drafter Fairfax Leary explains:

> All along there were other indirect pressures on the draftsmen from special interests. These pressures were felt through various and sundry people who got the information from their contacts and passed it on. There was great pressure to produce an adoptable Code, and, therefore, certain interests who might oppose the Code had to be pacified . . . . [One] was the insurance industry and sure enough you'll find their exemption in 9-104. [210]

Other drafters have made similar remarks and calls for reform. [211]

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[208] *Id*. at 709-10.

[209] U.C.C. § 9-105(b) (1954).

[210] Fairfax Leary, *Reflections of a Drafter: Fairfax Leary*, 43 OHIO ST. L.J. 557, 558 (1982). *See also* Kathleen Patchel, *Interest Group Politics, Federalism, and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code,* 78 MINN. L. REV. 83, 101 (1993) ("[C]ar-trusts and insurance were exempted from Article 9 coverage to pacify, respectively, the railroad interests and the insurance industry."); Soia Mentschikoff, *The Uniform Commercial Code: An Experiment in Democracy in Drafting,* 36 A.B.A. J. 419 (1950) (describing extensive interaction with interest groups); WILLIAM TWINNING, KARL LLEWELLYN AND THE REALIST MOVEMENT 330 (1973) (describing Llewellyn's commitment to a draft which would be adopted, even if it meant excluding areas that should logically be included, like insurance).

[211] Coogan, *supra* note 96, at 1054.

At first, the insurance industry suggested several solutions, including simply expanding the definition of instruments to more clearly cover life insurance policies.[212] Later insurance industry lawyers demanded exclusion from the Code rather than disambiguation.[213]

Resistance came from resistance to relatively small concessions. For example, there was a difference in commercial practice between insurance companies and third party creditors, and insurers did not wish for a Code that would require them to change their practice. Third party creditors were in the habit of taking possession of collaterally assigned policies, while insurance companies tended not to take possession of the collaterally assigned policy. Insurance companies were afraid that they might have had to change their lending practices slightly to be on par with third party lenders.[214] Although this would have increased uniformity and certainty, insurance companies preferred to maintain the status quo. They would have found a policy possession requirement an "inconvenience."[215]

According to one account, insurance companies had no opposition to Article 9 more substantial than that the status quo was adequate enough, and so change should be resisted simply because it constituted change. This is the opinion of Professor Grant Gilmore, Co-Reporter for Article 9: "If [my] personal recollection may be relied on, the attitude of counsel [for the insurance companies] was not that any provision of the Article was incorrect, harmful, or disadvantageous to their client, but was rather that they were disinclined to flee the evils that they knew not of."[216] Professor Coognan, Dean of Commenters on the 1972 revision of Article 9, shared Gilmore's perspective:

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[212] Funk, *supra* note 207, at 711 (citing Willis H. Satterthwaite, Assignments of Life Insurance Policies Under the Uniform Commercial Code (May 2, 1953) (unpublished manuscript) (suggesting that Section 9-105(g) be amended to read: "(g) 'Instrument' means ... or any other writing ... which evidences a right to the payment of money and is of a type which is in ordinary course of business transferred by delivery or by delivery with appropriate indorsement [sic] or assignment")).

[213] Robert Dechert, *The Uniform Commercial Code and its Impact Upon the Life Insurance Business*, *in* 47 PROCEEDINGS OF THE LEGAL SECTION OF THE AMERICAN LIFE CONVENTION 48, 60 (1954).

[214] J.C. Vance, Annotation, *Right of Life Insurance Beneficiary Against Estate of Insured Who Used Policy as Collateral*, 91 A.L.R. 2d 496 (1963); Funk, *supra* note 207, at 710-11.

[215] Dechert, *supra* note 213, at 60.

[214] 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 10.7, at 315 (1965).

> Then there are other exemptions or exclusions which were based solely upon the fact that some group had a big club, and would say that if you were going to leave those in, then we will have to learn a new set of laws and we are just not going to do it. We do not know whether it is good or bad, but we do not want to take the time to learn. The insurance people were one group who got such a consideration.[217]

As Article 9 has proved reliable and stable, other groups that had lobbied for exclusion, like the railroads, voluntarily gave up them up.[218] The insurance industry has grown to enjoy its exclusion and has not expressed any desire to give it up.

The Pennsylvania legislature thus added an insurance exclusion only three months after adopting Article 9. [219] The Drafters of the Code added the exclusion as well. Their decision to resolve the ambiguity in this way was a direct result of insurance company pressure. [220]

2. Exclusion in Revised Article 9

The exclusion was almost eliminated in Revised Article 9.[221] California has a non-uniform version of the Code with respect to interests in insurance, and the Committee was interested in California's choice to remain non-uniform.[222] California first adopted a uniform version of Article

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[217] Comm. On. Unif. Commercial Code, Program, *Impact of 1972 Revisions on Secured Financing Transactions Under UCC Article 9*, 33 BUS. LAW. 2491, 2533 (1978).

[218] *Id*. ("When we asked the railroads, in 1972, whether they really wanted to continue to exclude the equipment trusts from the operation of Article 9, nobody could remember why they did it. So the exclusion of equipment trusts from Article 9 has now been eliminated. Thank God.").

[219] PA. STAT. ANN. tit. 12A, § 9-104(g) (Purdon Supp. 1954); *see also* Funk, *supra* note 207, at 711.

[220] Gilmore, *supra* note 80, at 315. ("This exclusion, like that of railroad equipment trust under subsection (e), was politically inspired.").

[221] *See, e.g.*, NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS. AM. LAW INST. DRAFT UNIFORM COMMERCIAL CODE, REVISED ARTICLE 9. SECURED TRANSACTIONS; SALES OF ACCOUNTS AND CHATTEL PAPER (1995).

[222] Louisiana also chose to exclude policies of insurance from their U.C.C., but it is not clear that the Committee took account of their practices. Article 9 of the Uniform Commercial Code first took effect in Louisiana on January 1, 1990, 9 years before The American Law Institute's promulgation of Revised Article 9. For

9 with respect to insurance, and later narrowed the exclusion of life insurance policies. The revision treated insurance policy loans differently from other loans largely because of insurance company lobbying.[223] California also accepted that loans from an issuing insurance company "essentially involve a set-off," and are not really loans.[224] Thus, California's Section 9 now excludes "[a]ny loan made by an insurance company pursuant to the provisions of a policy or contract issued by it and upon the sole security of the policy or contract."[225] Loans by third parties are not excluded from the UCC.

The drafters preferred the California approach. Professor Homer Kripke, Associate Reporter for the Review Committee, concurred with Gilmore's reflection that the exclusion existed less for good public policy reasons than because of the insurance industry's sense that it was perfectly happy with the status quo:

> We have thus had a clear-cut issue as to the approach of this Committee. The California position seems (at least to the writer) to be more sound theoretically than the existing Code. On the other hand, we seem not to have had any real

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a discussion of Louisiana's non-uniform treatment of Article 9, see James A. Stuckley, *Louisiana's Non-Uniform Variations in U.C.C. Chapter 9*, 62 LA. L. REV. 793 (2002). There is only one glaring problem with the Louisiana approach for the present purposes. Chapter 9 of the Louisiana Code does not adequately protect the rights of those with interests in insurance policies to assign them. By excluding insurance policies from the definition of "general intangible," Louisiana was able to conveniently draft separate provisions specific to insurance, such as the perfection by control provision. *Id.* at 842. But life insurance policies where thereby removed from the scope of U.C.C. § 9-408 which rendered ineffective restrictions on alienability of general intangibles. With no clause protecting the alienability of life insurance policies, the reservation problem still plagues Louisiana.

[223] *See, e.g.*, Further Comments on Chapter 9: Comments on Memoranda of Subcommittees of State Bar Committee an California Bankers Committee, Further Comments of State Bar. ("Therefore, we think that the amendment proposed by the California Bankers Committee is a sound modification of the rule of the Official Draft and will avoid unnecessary opposition from life insurance companies. . . .").

[224] *The Uniform Commercial Code, A Special Report by the California State Bar Committee on the Commercial Code*, 37 J. ST. B. CAL. 119, 200 (1962). But *see infra*.

[225] CAL. COM. CODE § 9109(d)(8).

> trouble with the existing Code and a change would certainly create some opposition.[226]

The superiority of the California approach was thus weighed against resistance from industry groups.

The Drafting Committee met with insurance industry representatives to vet their opposition to ending the life insurance exclusion. Nearly all of their expressed concerns focused on the difficulties incumbent on the obligor of an account that is subject to transfer. The Drafting Committee deemed some of these concerns unwarranted. [227] Others, if warranted, could be solved through some kind of in-Code accommodation.[228] At the end of a June 1996 meeting, the Drafting Committee voted, three to five, in favor of ending the exclusion.

Notwithstanding the arguments and votes against the exclusion, the Drafting Committee ultimately retained it.[229] They opted for the low-hanging fruit of eliminating the exclusion of health-care-insurance receivables. To the degree that the insurance exclusion is supported by simple incumbency, it should be clear that the status quo was not the result desired by those most thoughtfully involved in the drafting. The exclusion has serious negative effects for consumers and makes life insurance products less attractive, very likely harming the insurance industry in general. Acquiescence to change-averse industry lobbyists can no longer justify the life insurance exclusion.

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[226] UNIFORM COMMERCIAL CODE: CONFIDENTIAL DRAFTS, *supra* note 10, at 4-5.

[227] Harris & Mooney, *supra* note 48, at 1374-75 ("e.g., the concern that an insurer would need to consult the UCC filings before deciding whom to pay"). This concern is not warranted because the code allows such an obligor to pay the presumed obligee unless notice has been given of assignment.

[228] *Id.* at 1375 ("e.g., the concern that the insurer would be obligated to pay the secured party upon receipt of a notification of assignment").

[229] NAT'L CONFERENCE OF COMM'R ON UNIF. STATE LAWS, REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 9 (1997) ("The Drafting Committee recognizes that insurance policies can be important items of collateral in many other business contexts and that the "cash" or "loan" value of life insurance policies also can be a useful source of collateral for borrowing by individuals. Nevertheless, it decided that other law should continue to govern security interests in insurance policies.").

C. "SPECIAL" TRANSFERS OF INTEREST

Although an insurance exception was created in light of political pressures, the avowed purpose of the exclusion was given in the Official Comments. "Such transactions are often quite special, do not fit easily under a general commercial statute and are adequately covered by existing law."[230]

In what ways these transactions are special, and why they do not fit, is not explained by the Commenters.[231] Subsequent treatises have accepted the Comment without elaboration.[232] Although every transaction is no doubt quite special, in the same sense as every child is above average,[233] there is no good reason to credit this comment.

Some resistance to creating parity between insurance-backed loans and other loans is based on the once popular theory that issuer-policy loans from the insurer were not loans at all, merely advances on the proceeds.[234] This view holds that a policy loan carries no obligation on the part of the insured to repay the amount borrowed, but the insurer can cancel the policy if the loan value ever exceeds the cash value of the policy.[235]

Two textual considerations show why this idea of "advances against life insurance policy proceeds" cannot justify the policy exclusion: First, party-specific explications cannot defend a transaction-specific exclusion. As the Comments make clear, "transfer[s] of interests in . . . a

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[230] UNIFORM COMMERCIAL CODE: 1962 OFFICIAL TEXT WITH COMMENTS, *reprinted in* XXIII UNIFORM COMMERCIAL CODE DRAFTS 401 (Elizabeth Slusser Kelly ed., 1984). The Comments to the current draft of the U.C.C. do not explain the life insurance policy exclusion.

[231] Indeed, it is clear they had no idea either. *See infra* Part II.B..

[232] *See, e.g.*, 11 Lary Lawrence, Lawrence's Anderson on the Uniform Commercial Code § 9-109:29 (3d. ed. 2010).

[233] *See* GARRISON KEILLOR, LAKE WOBEGON DAYS (1985).

[234] *See, e.g.*, Ford v. Mut. Life Ins. Co., 13 So.2d 45 (Miss. 1943); COUCH, *supra* note 32, § 80:1; VANCE, *supra* note 156, at 645.

[235] VANCE, *supra* note 156, at 652. Yet this view warrants skepticism. It would imply that insurers violate no lending statutes when offering misleading terms and usurious interest rates, or loan money in a racially discriminating manner. Second, if a policy loan creates no obligation in the insured, then loan repayments constitute payments without obligation. As a result, the insurance company ought to pay taxes on income that did not constitute obligated loan repayments. Third, if policy loans constituted an advance on proceeds, the loan principal ought to be out of the reach of ordinary creditors, receiving the same immunity as the proceeds would. But insureds cannot draw down their insurance policies to live at a high standard while remaining judgment proof.

policy of insurance" are excluded because "such transactions" are special, not because the transactions' participants are quite special. Nor does the exclusion mention or emphasize the relationship between the transferor and the transferee.

Neither the text of the UCC nor the Comments intimate that the specialness is any greater or lesser when the creditor is the policy issuer. No explanation that defends the exclusion in terms of the relationship between the insured and the insurer, as opposed to a third party, can make sense of the text or its application in decades of transactions. Even if it could, it would only justify an exclusion of transfers from insured to insurer, partially validating the reform proposal advocated in this article.[236]

Second, the question of whether a loan from an issuer is really a loan, as opposed to some other transaction, takes away focus from the real problem – bad, non-uniform law – and cannot justify keeping the exclusion as it currently exists. The Article 9 exclusion does not distinguish between loans and "advances" or "setoffs." Instead, it applies to any "transfer of an interest in" of a policy of insurance. A given transfer may be a setoff and not a loan, but simply being a setoff does not make the transaction "special" and unable to fit within the general security statute. Article 9 makes adequate provisions for setoffs in deposit accounts.[237]

If insurance companies deserve special treatment by virtue their identity or the nature of the transaction, there is room to acknowledge these differences in the Code without exclusion. Consider the creditor-bank that doubles as the holder of a deposit account. Like an insurance company, it is in a privileged position to monitor the customer. Also like the insurance company, it has a dual role as creditor and debtor, mirroring the insurance company's role as policy loan-creditor and "debtor" of the ultimate proceeds.

The Code allows the bank to perfect interests in the deposit accounts by control.[238] Banks are afforded special treatment in virtue of their special role, but they still join the general structure of the Code. The

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[236] Even if the insurer's relationship is different enough to warrant an alternative perfection and assignment scheme, third parties would still deserve an efficient system vis-à-vis one another. The Code is so wholly superior to existing law that third parties must be allowed to avail themselves even if the text were somehow construed to allow a coherent account of insurance companies' specialness.

[237] U.C.C. §§ 9-109(d)(10)(A), 9-340 (2000) (including set-off rights in scope of Article 9).

[238] *Id*. at § 9-314. *See generally* Willa E. Gibson, *Banks Reign Supreme Under Revised Article 9 Deposit Account Rules,* 30 DEL J. CORP. L. 819 (2005).

Code acknowledges the dual role of the creditor-bank well enough without an exclusion, and it could do the same for insurance policies.

California has enshrined insurer's privilege, but done so within the ambit of the UCC.[239] There are flaws with the California approach that are severe enough to make the California approach inferior to full inclusion. California excludes only issuer loans, and third party interests in loans perfect only upon written notification to the insurer. Notwithstanding such problems, both California's approach and the UCC's treatment of deposit accounts show that UCC-inclusion can be accomplished a number of ways, not all of which should seem a radical departure. Either would be a marked improvement upon the status quo since either solution would eliminate the uncertainty about how security interests are granted and perfected.

D. STOLI

It may be mistakenly thought that this proposal will facilitate stranger-originated life insurance (STOLI, as it is often called). In a typical STOLI transaction, a speculator persuades a consumer to obtain a policy of insurance. The speculator will typically offer to pay the premiums for a period of time. In some STOLI transactions, the premium payments constitute a loan that will be secured by the policy, and the speculator becomes the owner of the policy after a period of time.[240] The consumer will either be promised some payment for their participation, or else be enticed by the offer of "free insurance," enjoyed in the years prior to transferring the policy to the speculator.

STOLI transactions are thought to be worrisome for a variety of reasons.[241] First, by enabling speculators to treat insurance as a mere investment, STOLI transactions misuse public subsidy of insurance. Incentives to hold insurance are intended to promote the core survivor-protection function of insurance, because society benefits when insurance

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[239] CAL. COM. CODE § 9312(b)(4) (West 2009) ("[S]ecurity interest in, or claim in or under, any policy of insurance, including unearned premiums, may be perfected only by giving written notice of the security interest or claim to the insurer."); *id*. 9310(b)(11).

[240] Absent other concerns, the period will usually be the contestability period. After that period, the insurance company must generally honor the policy.

[241] Eryn Mathews, Note, *STOLI on the Rocks: Why States Should Eliminate the Abusive Practice of Stranger-Owned Life Insurance*, 14 CONN. INS. L.J. 521 (2008). *See also* Anita Huslin, *Wealthy Engage in Controversial Re-Selling of Life Insurance Policies*, WASH. POST, Nov. 27, 2007, at D1. (Larry King victimized in a STOLI arrangement).

products replace lost incomes and relieve the government of burdens. [242] STOLI speculators enjoy these subsidies without any party contemplating income replacement.

Second, STOLI transactions are often marketed without adequate disclosure of their downsides to insureds, including taxes, fees, reduced eligibility for Medicaid and other programs, and difficulty obtaining new insurance policies after the transaction.[243] Third, they are intended to circumvent insurable interest law.[244] The law has found it worrisome what strangers might do with a financial interest in the insured's passing; even family members murder one another enough for insurance proceeds.[245] Perhaps more important was the general distastefulness of gambling on another person's life.[246] As a result, many legislatures passed statutes recognizing the common law requirement that only those with appropriate interests in the insured living could own insurance against her dying.[247]

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[242] *Tax Treatment of Single-Premium Life Ins. Before the Subcomm. on Tax'n and Debt Mgmt. of the Senate Comm. on Fin*., 100th Cong. 118 (1988) (statement of Dennis E. Ross, Deputy Assistant Secretary (Tax Policy), Department of the Treasury) ("In certain cases, life insurance may enable the surviving spouse and minor children to avoid becoming dependent on governmental assistance, thereby relieving the government of an obligation it otherwise would have to assume.").

[243] Bob Lotane, *STOLI – It's Not Dead Yet,* FLORIDA UNDERWRITERS MAGAZINE, Feb. 2010.

[244] *See generally,* 28 JOHN ALAN APPLEMAN, APPLEMAN ON INSURANCE § 174.02 (2d ed. 2009) ("The requirement that a person purchasing a life policy must have some interest, pecuniary or otherwise, in the continued life of the insured. . . .").

[245] Prudential Ins. Co. of America v. Athmer, 178 F.3d 473 (7th Cir. 1999) (wife murders husband).

[246] GEORGE J. COUCH, CYCLOPEDIA OF INSURANCE LAW § 24:117 (2d ed. 1984) ("The reason given for such rule is that a contract made [devoid of an insurable interest] is against public policy on the theory that the beneficiary would be more interested in the early death of the insured than in the prolongation of his life. The purpose . . . is to prevent wagering contracts on the life of another by one having no insurable interest therein"); *see also* Grigsby v. Russell, 222 U.S. 149, 156 (1911) ("[T]he ground of the objection to life insurance without interest in the earlier English cases was not the temptation to murder but the fact that such wagers came to be regarded as a mischievous kind of gaming.").

[247] *See, e.g.,* ARK. CODE ANN. § 23-79-103(c)(1) to (2) (West 2009) ("In the case of individuals related closely by blood or by law, a substantial interest engendered by love and affection [and i]n the case of other persons, . . . a lawful and substantial economic interest in having the life . . . of the individual insured continue . . . .").

STOLI policies contemplate circumventing these statutes to whatever degree possible.

This article should not be taken to endorse or ease the creation of STOLI transactions. Article 9's freedom of assignment will not invalidate efforts to prevent STOLI transactions. True, Article 9 will not abide policy provisions limiting transfers of the policy to third parties. [248] However, insurance policies may be rescinded for fraud, and almost all policy applications ask questions about intentions to transfer the policy to a third party. Insurers will be free to rescind policies that appear to have been fraudulently obtained, particularly during the contestability period.[249] And Article 9 is explicit that its assignment facilitation clause[250] will control only for the creation of security interests.[251] STOLI transactions involve absolute assignments of the entire policy; hence other statutes[252] and contract provisions can constrain these transfers. It is possible to distinguish STOLI from reform of life insurance securitization.[253] Many states have already taken action to bar STOLI[254] without taking a stand

[248] Franklin L. Best, Jr., *Securitization Of Life Insurance Policies*, 44 TORT TRIAL & INS. PRAC. L.J. 911, 929-30 (2009) (discussing drafting of policies to allow rescission).

[249] *See* 29 APPLEMAN, *supra* note 244, at § 178.03 (insurance statutes set a period of years after which insurance companies may generally not contest a policy's validity for reasons of fraud in acquisition).

[250] U.C.C. § 9-408 (2010).

[251] *Id*. comment 3.

[252] Section 9 of the NAIC Viatical Settlements Model Act provides that "[p]rior to the initiation of a plan, transaction or series of transactions, a viatical settlement broker or viatical settlement provider shall fully disclose to an insurer a plan, transaction or series of transactions, to which the viatical settlement broker or viatical settlement provider is a party, to originate, renew, continue or finance a life insurance policy with the insurer for the purpose of engaging in the business of viatical settlements at any time prior to, or during the first five (5) years after, issuance of the policy." NAIC VIATICAL SETTLEMENTS MODEL ACT § 9.

[253] SEC STAFF REPORT, *supra* note 52, at 12. *See also Life Settlements and the Need for Regulatory Transparency Before the S. Special Comm. On Aging*, 111th Cong. 1 (2009) (statement of Mary Beth Senkewicz, Deputy Ins. Comm'r, Florida Office of Ins. Reg.); Cory Chmelka, *Premium Financing: The Time Is Now*, CPA J. (Sept. 2009); Christina Pellett, *Life Settlements Poised for 'Natural Growth,': But Producers Still Lacking in Education*, AGENT'S SALES J. (Feb. 2010) ("While the two are often tied together in media coverage, life settlements are not the same as STOLI - though some STOLI arrangements do involve life settlements.").

[254] Best, *supra* note 248, at 917-27.

against life insurance related financial products, and even the life settlement industry generally opposes STOLI.[255]

E. INSURANCE INDUSTRY VITALITY

Any reform proposal must take into account the vitality of the insurance industry as a whole. As described above, increasing credit to insureds will reduce lapse.[256] The reduction in lapse will tend to be among the impaired policies, resulting in adverse selection (from the insurance company's perspective).[257] One may speculate that a general reduction in lapses by policyholders could lead to more payouts to insurance beneficiaries, and consequently increased costs for insurance companies. Insurance companies might pass on costs to other consumers,[258] or face a risk of insolvency.[259] Such results would decrease the utility of a competitive credit regime.

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[255] *Life Settlement Industry Opposes Stranger-Originated Annuities*, MARKETWIRE (May 5, 2010), http://www.marketwire.com/press-release/Life-Settlement-Industry-Opposes-Stranger-Originated-Annuities-1160433.htm.

[256] *See* LeBel & Tillinghast, *supra* note 33. *See also* Jim Connolly, *New Persistency Study Shows Lapse Rates Have Generally Declined*, NAT'L UNDERWRITER LIFE & HEALTH (May 4, 2008).

[257] Best, *supra* note 245, at 915.

[258] Hanming Fang & Edward Kung, *How Does Life Settlement Affect the Primary Life Insurance Market?* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 15761, 2010), *available at* http://econ-www.mit.edu/files/5329 ("[L]ife insurance companies, as represented by the Deloitte Report (2005), claim that the life settlement market, by denying them the return on lapsing or surrendered policies, increases the costs of providing policies in the primary market. They allege that these costs will have to be passed on to consumers, which would ultimately make the consumers worse off.").

[259] Perhaps this is why most life insurance companies oppose securitization of policies. Press Release, Am. Council of Life Insurers, *Statement of the ACLI Regarding Securitization of Life Settlements* (Feb. 3, 2010), *available at* http://www.secondaryinsurancemarketblog.com/files/aclipolicy.pdf. Statement of the ACLI Regarding Securitization of Life Settlements (Feb. 3, 2010) ("ACLI Statement"), *available at* http://www.acli.com/NR/rdonlyres/972B2B38-89F0-4683-B236-A01360544A9F/23344/STOLI_SecuritizationPolicyFinal_020310.pdf (The American Council of Life Insurers are a trade group for life insurance companies. They mainly oppose securitization out of fear that it will increase demand for fraudulent STOLI policies); *But see* Press Release, Institutional Life Markets Ass'n, ACLI Mixes "Apples and Oranges" to Mislead Customers (Feb. 4, 2010), available at http://www.lifemarketsassociation.org/documents/PR-

However, the SEC Life Settlements Task Force was not persuaded that lapse-reduction threatens the industry.[260] The Task Force noted that prudent pricing models involve conservative lapse rate assumptions.[261] At worst, certain insurance companies will suffer, but the industry as a whole will remain healthy. [262]

Moreover, reforms to the law of assignment are likely to be to the benefit of the insurance industry, for at least four reasons. First, these proposals are efficiency increasing, and insurance companies should be able to obtain some compensating share of the surplus. For example, legal reform will reduce costly litigation and confusion that currently is a cost for insurers too.[263]

Second, whatever wealth is transferred from insurance companies to creditors and investors is likely to find its way back to insurance companies anyway. Insurance companies are the ones with the best actuarial information and they are, theoretically and actually, the most likely third-party creditors against other insurance company's policies.

%20ACLI%20misleads.pdf; Press Release, Life Insurance Settlement Association, *Life Insurance Settlement Association Responds to Misleading ACLI Position on Life Settlements*, MARKETWIRE (Feb. 5, 2010), *available at* http://www.marketwire.com/press-release/Life-Insurance-Settlement-Association-Responds-Misleading-ACLI-Position-on-Life-Settlements-1113175.htm.

[260] SEC STAFF REPORT, *supra* note 52, at 20 ("the Task Force was told that the extent of this impact is likely to be small.") (citing Telephone Interview with Scott Hawkins, Conning Research & Consulting (Mar. 30, 2010); Michael Shumrak, *Life Settlements—A Window Of Opportunity For The Life Insurance Industry?*, REINS. NEWS, Feb. 2010, at 14 (only about 1% of life policies have been settled)).

[261] SEC, STAFF REPORT, *supra* note 52, at 20 (citing Christian Kendrick, *Special Report: Return of Premium Products*, TRANSAMERICA REINS. (Jul. 13, 2007), *available at* http://www.transamericareinsurance.com/Media/media_associateArticle.aspx?id=295); *see also* DELOITTE CONSULTING LLP & THE UNIV. OF CONN., THE LIFE SETTLEMENT MARKET: AN ACTUARIAL PERSPECTIVE ON CONSUMER ECONOMIC VALUE 12 (2005), *available at* http://www.quatloos.com/uconn_deloitte_life_settlements.pdf (a life settlements transaction "generally has minimal or no impact on the anticipated profitability of a life insurance contract because the persistency of an unhealthy policyholder is precisely what is assumed at the time of original pricing.").

[262] SEC STAFF REPORT, *supra* note 52, at 20.

[263] *See* Knippenberg, *supra* note 11, at 226 ("The long and the short of it is, there are risk and costs. . . to insurers who are driven to interpleader actions or, not infrequently, forced to justify as defendants the payment of proceeds to one or another of multiple claimants.") (citing Lincoln Nat'l Life Ins. Co. v. Brown Schools, 757 S.W.2d. 411, 414 (Tex. Ct. App. 1988)).

Much of what insurers lose in lapse-reduction will really represent a transfer from one insurance company to another, with the consumer as the incidental beneficiary.

Third, insurers may sometimes be pleased that their customers turn to third parties for credit. Policy loans disrupt insurer cash flow, and so their dynamics are of vital interest to insurers.[264] Since insurers may be required by law to offer policy loans[265] and may be limited by law in their ability to charge market interest rates, there may be times where insurers would prefer not to serve their customers' financing needs.

This result may be exacerbated by the inverse relationship between an insurer's ability to lend to their customers, and their customers' need for loans: policy borrowing is largely driven by emergencies,[266] so catastrophic events both induce borrowing and also accelerate maturity payments. Insureds resort to policy loans more often when other forms of credit are difficult to obtain, regardless of the market interest rate.[267] Rendering alternative financing more accessible may induce some insureds to borrow elsewhere. This will reduce unanticipated draws on the insurance company's balance sheet, even when statutory interest rate compares favorably with the market interest rate.

Fourth, a liberal secondary market allows insurance companies new ways to hedge risk. Actuarial technology gives insurers great power to

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[264]. Andre P. Liebenberg, James M. Carson, & Robert E. Hoyt, *The Demand for Life Insurance Policy Loans*, 77 J. RISK & INS. 651, 651 (2010).

[265] *See* ALASKA STAT. ANN. § 21.45.080(a) (West 2011); ARIZ. REV. STAT. ANN. § 20-1208(A) (2011); ARIZ. REV. STAT. ANN. § 20-1209(A) (2011); DEL. CODE ANN. tit. 18 § 2911(a) (West 2011); GA. CODE ANN. § 33-25-3(5) (West 2011); ME. REV. STAT. ANN. tit. 24-A, § 2510(1.) (2010); MASS. GEN. LAWS ANN. ch. 175, § 132(7) (West 2011); MINN. STAT. ANN. § 61A.03(g) (West 2011); MONT. CODE. ANN. § 33-20-131(1) (2010); NEB. REV. STAT. ANN. § 44-502(8) (2010); NEV. REV. STAT. ANN. 688A.110(1) (West 2011); N.J. STAT. ANN. § 17B:25-8 (West 2011); N.Y. INS. LAW § 3203(8)(A) (McKinney 2011); OHIO REV. CODE ANN. § 3915.05(G) (West 2011); OR. REV. STAT. ANN. § 743.186(1) (West 2011); 40 PA. CONS. STAT. ANN. § 510(h) (West 2011); S.C. CODE ANN. § 38-63-220(k)(1) (2010); S.D. CODIFIED LAWS § 58-15-15 (2011); VT. STAT. ANN. tit. 8, § 3731(7) (West 2010); WASH. REV. CODE. ANN. § 48.23.080(1) (West 2011); W. VA. CODE ANN. § 33-13-8(a) (West 2011). *See also* Metro. Life Ins. Co. v. Mass. Travelers Ins. Co., 471 U.S. 724, 728, (1985).

[266] Liebenberg, Carson & Hoyt *supra* note 264.

[267] A. Edward Day & Patric H. Hendershott, *Household Demand for Policy*, 44 J. RISK & INS. 441 (1977). *But see* J. David Cummins, *An Econometric Model of the Life Insurance Sector of the U.S. Economy*, 40 J. RISK & INS. 533 (1973) (arguing for both market interest rate and alternative funds hypotheses).

predict the time and extent of their liabilities, but insurers currently can do nothing to meet expected and liabilities except altering their asset mix. An insurance company that recruited heavily in the past may be able to predict substantial liabilities in a decade or so. But it faces the possibility that its cash-out date will be a depressed period for the investment market; an insurance company with significant fixed liabilities maturing in 2008 may have had more difficulty paying than one paying the same liabilities in 1998.

As it stands, an insurance company can respond to such risks by shifting from risky, illiquid assets (that may earn higher returns) into comparatively safer, liquid assets (that may earn less attractive returns). This is a method of mitigating risk, but it is a crude method and it sacrifices returns.

Insurance companies would do better if they could periodically update their inter-temporal diversification. [268] With a robust secondary market, an insurance company could buy policies due to mature at the same time as those they have issued. Then they would be due payments at the same time their own liabilities matured. Put simply, insurers could make sure that cash was flowing in to match the cash that was flowing out. The more robust the secondary market, and the easier to pool insurance-linked assets, the easier and cheaper for insurance companies to rebalance their portfolios. It is perhaps no wonder that the largest insurance policy securitization to date, and the only rated securitization, was internal to an insurance company. [269]

IV. CONCLUSION

The advantages of having a single commercial law govern secured transactions in every state were known to the drafters of the Code and have since been demonstrated to practitioners who may have been initially skeptical. Life insurance policies were excluded from the scope of Article 9 because of industry resistance, but that resistance rested on skepticism about the merits of Article 9.

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[268] *See* IAN AYRES & BARY NALEBUFF, LIFECYCLE INVESTING (2010) (describing the Samuelson Share, and methods for investors to achieve intertemporal diversification).

[269] Meg Green, *AIG Files First Rated Life Settlement Securitization*, BESTWEEK, Apr. 16, 2009 ($8.4 billion transaction internal to an AIG subsidiary); *see also* SEC STAFF REPORT, *supra* note 52, at 15-16 (discussing securitizations).

The time for skepticism is over. Importantly, the legal morass of the common law has become more of a problem since the time when the code was contemplated. Removing almost all other secured transactions to the Code has left insurance alone to develop the case law, leaving industry practices to exist in uncertain tension with the throwback common law.

The law governing perfection and surplus allocation is unclear and at odds with creditors' expectations. The reservation problem, too, stands as an impediment on securitization and resale, and a source of potential litigation.

All these problems would be solved by bringing interests in life insurance policies into the scope of the UCC. The nature of the inclusion can be debated. The simplest, clearest solution is for life insurance policies to be treated as general intangibles, but even if they are given their own rules within the UCC, as they are in California and Louisiana, the system will be much improved.

The path leading away from exclusion has ramifications for reform projects generally. In reform projects, compromises may sometimes be struck. But the transactions left unchanged because they are "good enough," do not remain good enough as the market grows in response to the reform.

Perhaps if Article 9 had not created a unified security regime, the disparate types of security agreements would have grown together organically, jurisdiction to jurisdiction, with life insurance policies lending among them. But the growth of non-UCC securitization has been isolated and localized life insurance policy collateral, stunting the growth and rationalization of the law of insurance-backed-lending.

Moreover, the success of Article 9 security agreements in other areas has led to a rise in successful securitizations. The market expects that assets can be used in sophisticated financing agreements and securitizations. Article 9 has created an expectation of, and appetite for, a high standard of efficiency and predictability in financing transaction. As it stands, life insurance policies cannot satisfy that appetite. Every reform compromise carries with it the possibility of regression, making the unreformed law even worse than before. For the life insurance policy exclusion, and other opportunities for reform, fuller reform is the better policy.