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THE RELATIONSHIP BETWEEN A LIFE INSURANCE COMPANY AND A POLICY HOLDER

THE LAW of insurance is said to be predicated upon the principles of contract, but the course of insurance litigation is marked by innumerable deviations from standard contract analysis.¹ Attempts to rationalize decisions indicate that the haphazard variations of the cases reflect the stresses engendered by a powerful, though unarticulated, clash of opposing forces. On one hand stands the legal doctrine embodied in the parol evidence rule.² A person is supposed to know the contract that he makes, and once he reduces his agreement to writing, he is bound; else all agreements are futile.³ On the other hand surge the folkways of insurance buying. Since insurance is intimately bound up with one of man's primary cultural motivations, the desire for security, its purchase is rarely transacted on a commercial level. No process of offer and acceptance by parties in approximately equal

1. See *e.g.*, *Satz v. Massachusetts Bonding and Ins. Co.*, 243 N. Y. 385, 393, 153 N. E. 844, 846 (1926).

2. RESTATEMENT, CONTRACTS (1932) §§ 237-249.

3. *Boylan v. Hot Springs R. R.*, 132 U. S. 146 (1889); *In re Millers' & Manufacturers' Ins. Co.*, 97 Minn. 98, 106 N. W. 485 (1906); *Metzger v. Aetna Ins. Co.*, 227 N. Y. 411, 125 N. E. 814 (1920); RESTATEMENT, CONTRACTS (1932) § 70.

bargaining positions obtains here. Contracts are invariably drawn by the insurer's expert attorneys; the insured, rarely resorting to legal advice, does not agree to the policies so much as adhere to them.⁴ Unusual, indeed, is the insured who at any time even reads his policy.⁵ The transaction, for him, is not one of bargain but of faith. This picture of the policy holder is silhouetted sharply against the harsh legal background of the doctrines of warranty and *uberrimae fidei*.⁶ While in theory the requirement of highest good faith presumably applies equally to insurer and insured, only the insured, in the process of making full disclosures during the pre-acceptance period, is called upon to exercise it.⁷ And once the policy is sold the requirement apparently disappears, leaving between company and policy holder, by the weight of authority, only the contract relation of debtor and creditor.⁸

Despite this general assertion, courts frequently have endeavored to protect the trusting policy holder from a severe contract result by invoking such verbalistic devices as waiver,⁹ estoppel,¹⁰ and public policy against forfeitures.¹¹ Reformation has also been freely granted, even where the insured has not read his policy.¹² This makeshift resolution of the conflict, while commendable in purpose, has produced great uncertainty in the prediction of legal consequences.¹³ And in cases where it has failed, the result has been great injustice to the policy holder. A re-analysis of the relationship between insurer and insured may afford a more realistic approach to the cases.

4. MOWBRAY, *INSURANCE* (2d ed. 1937) 46; Patterson, *The Delivery of a Life-Insurance Policy* (1919) 33 HARV. L. REV. 198, 222, n. 106.

5. VANCE, *INSURANCE* (2d ed. 1930) 215.

6. *Id.* at 74, n. 62, 452.

7. *Id.* at 69, 75. Historically the requirement of *uberrimae fidei* applied only to the duty of the applicant for marine insurance to disclose fully his knowledge of the risk. MOWBRAY, *INSURANCE* (2d ed. 1937) 55.

8. *Equitable Life Assurance Soc. of U. S. v. Brown*, 213 U. S. 25 (1909); *Coons v. Home Life Ins. Co. of New York*, 368 Ill. 231, 13 N. E. (2d) 482 (1938); *Uhlman v. New York Life Ins. Co.*, 109 N. Y. 421, 17 N. E. 363 (1888); see *Timlin v. Equitable Life Assurance Soc.*, 141 Wis. 276, 284, 124 N. W. 253, 256 (1910). *Contra*: (holding the relation to be one of trust) *Federal Life Ins. Co. v. Kerr*, 173 Ind. 613, 89 N. E. 398 (1909), *rehearing denied*, 173 Ind. 628, 91 N. E. 230 (1910); *United States Life Ins. Co. v. Spinks*, 29 Ky. L. Rep. 960, 96 S. W. 889 (1906); *Equitable Life Assurance Soc. v. Hardin*, 166 Ky. 51, 178 S. W. 1155 (1915); *Thomas v. Equitable Life Assurance Soc.*, 198 Mo. App. 533, 205 S. W. 533 (1918); *Ellinger v. Equitable Life Assurance Soc.*, 132 Wis. 259, 111 N. W. 567 (1907).

9. VANCE, *INSURANCE* (2d ed. 1930) c. 9, particularly p. 452.

10. *Id.* at 495 *et seq.*

11. *Mutual Life Ins. Co. v. Henley*, 125 Ark. 372, 188 S. W. 829 (1916); *St. Louis Mut. Life Ins. Co. v. Grigsby*, 10 Bush 310 (Ky. 1875); *Northwestern Mut. Life Ins. Co. v. Fort's Adm'r*, 82 Ky. 269 (1884); *Bruce v. Continental Life Ins. Co.*, 58 Vt. 253, 2 Atl. 710 (1885).

12. *Back v. People's Nat. Fire Ins. Co.*, 97 Conn. 336, 116 Atl. 603 (1922); *Lewitt v. Jewelers' Safety Fund Soc.*, 249 N. Y. 217, 164 N. E. 29 (1928).

13. See Langmaid, *Waiver and Estoppel in Insurance Law in California* (1931) 20 CALIF. L. REV. 1, 41.

The theory of the debtor-creditor relation had its origin at a time when the principles of life insurance were imperfectly understood. It was common belief that the entire premium paid by the policy holder was consumed in the purchase of a fixed service for the particular year, and that the company alone had an interest in whatever remained above costs, owing to the insured only a debt accruing upon a contingency.¹⁴ Now it is clear that only a part of the premium is sufficient to pay the yearly cost of operation, the rest being devoted to the accumulation of a reserve fund at a rate that on the average life expectancy will amount to the face value of the policy.¹⁵ Whatever the composition of the insurer, the furnishing of life insurance is essentially a mutual enterprise by the policy holders, with the company serving as administrative and investment manager for the funds accumulated from the premiums.¹⁶ And today the general interest of the insured in those funds is well established.¹⁷ It is manifest in the recognition of his right to a cash surrender value for his policy, to a guaranteed loan value, and to dividends¹⁸—which are not dividends at all in the popular sense of the word but merely the return to the policy holder of the excess by which his premium has been loaded over the amount necessary for current expenses and the reserve fund contribution.¹⁹ Functionally, then, the writing of life insurance is a means by which funds, in which the insured has at all times an interest, are entrusted to managers to invest, conserve, and return upon a contingency certain to occur.

In the leading case of *Uhlman v. New York Life Insurance Company*,²⁰ the New York Court of Appeals, seeking some familiar analogy to which it could liken the relationship between policy holder and company, concluded that it most closely resembled that between a depositor and a bank, *i.e.*, creditor and debtor. But, accepting the court's own analogy, if the depositor in question be a member of a mutual savings bank, the institution which functionally closest resembles an insurance company, the cases indicate that the relation created is not debtor and creditor, but *cestui* and trustee.²¹

14. See *United States Life Ins. Co. v. Spinks*, 29 Ky. L. Rep. 960, 967, 96 S.W. 889, 894 (1906).

15. See *United States Life Ins. Co. v. Spinks*, 29 Ky. L. Rep. 960, 967, 96 S.W. 889, 894 (1906); MOWBRAY, *INSURANCE* (2d ed. 1937) 394.

16. See (1932) 8 *ENCYC. SOC. SCIENCES* 97.

17. See *United States Life Ins. Co. v. Spinks*, 29 Ky. L. Rep. 960, 967, 96 S.W. 889, 894 (1906); MOWBRAY, *INSURANCE* (2d ed. 1937) c. 24.

18. See *Commissioner v. Illinois Life Ins. Co.*, 80 F. (2d) 280, 282 (C. C. A. 7th, 1935).

19. See *Coons v. Home Life Ins. Co. of New York*, 368 Ill. 231, 236, 13 N. E. (2d) 482, 485 (1938).

20. 109 N. Y. 421, 17 N. E. 363 (1888).

21. See *Savings Bank of Danbury v. Loewe*, 242 U. S. 357, 359 (1917); *Highfield v. First Nat. Bank of Rome*, 45 Ga. App. 431, 438, 165 S. E. 135, 139 (1932); *State v. People's Nat. Bank*, 75 N. H. 27, 30, 70 Atl. 542, 544 (1908).

Selection of one or the other of these labels does not entail a choice between concepts fundamentally at odds. Debtor-creditor and trustee-*cestui* are by no means polar designations. Trustees are in some respects only debtors, while debtors may be subjected to the fiduciary obligations of trustees. A debtor presumably may not be said to hold his debt in trust,²² but he is in a sense a trustee of his property, subject to a fiduciary duty not to make a transfer which is in fraud of creditors.²³ Creditors of an insolvent corporation may, at least under the "trust fund" theory, recover its assets from stockholders or preferred distributees.²⁴ Stockholders are commonly declared to be creditors of a corporation, and then only when dividends are declared.²⁵ Yet equity, in recognition of a fiduciary obligation in the directors, will compel the declaration of dividends when an abuse of discretion is shown.²⁶ Stamping the relation of insurer to insured as one of trust is less an alteration of basic philosophy than a change in emphasis looking to a redefinition of a standard of duty.

The general requisites of a trust are apparently present in the typical life insurance set up. The insurance company is the trustee; the funds contributed by policy holders constitute the *res*;²⁷ and the policy holder is at once settlor and *cestui*. In reality his status is very similar to that of the settlor of a living trust who names himself beneficiary for life with a remainder over to a designated person or to his estate.²⁸ Conceptually, the primary objection to this construction is the rule against the mingling of trust funds,²⁹ but there is nothing in the policy of this rule which forbids the *cestui* from consenting, directly or impliedly, to mingling.³⁰ Indeed, since the strength of insurance companies is derived from their ability to spread investment

22. See note 27, *infra*.

23. UNIFORM FRAUDULENT CONVEYANCE ACT §§ 9, 10. A further indication of this fiduciary obligation is the right of the bankruptcy trustee to demand an accounting of the affairs of an insolvent debtor. BANKRUPTCY ACT § 47a; 52 STAT. 840, 11 U. S. C. A. § 75 (Supp. 1938).

24. *Camden v. Stuart*, 144 U. S. 104 (1892); *Cole v. Millerton Iron Co.*, 133 N. Y. 164, 30 N. E. 847 (1892). The "trust fund" theory has been limited [*Hollens v. Brierfield Coal & Iron Co.*, 150 U. S. 371 (1893)] and criticized. *Hospes v. Northwestern Mfg. and Car Co.*, 48 Minn. 174, 50 N. W. 1117 (1892).

25. *Staats v. Biograph Company*, 236 Fed. 454 (C. C. A. 2d, 1916).

26. See *American Steel Foundries v. Lazear*, 204 Fed. 204, 210 (C. C. A. 3d, 1913); BALLANTINE, *MANUAL OF CORPORATION LAW PRACTICE* (2d ed. 1930) § 157.

27. See (1932) 8 ENCYC. SOC. SCIENCES 104. Theoretical difficulty is presented by the principle that an obligor may not hold his own obligation in trust [Legis. (1937) 50 HARV. L. REV. 511, 512], but this is obviated by looking directly to the reserve fund as the *res* and not to the obligation of the insurance company to pay on death of the insured. See Comment (1927) 36 YALE L. J. 394, 400.

28. See Leaphart, *The Trust As a Substitute for a Will* (1930) 78 U. OF PA. L. REV. 626, 628.

29. *Moore v. McKenzie*, 112 Me. 356, 92 Atl. 296 (1914); RESTATEMENT, TRUSTS (1935) § 179; 3 BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* (1935) § 596.

30. *Lannin v. Buckley*, 256 Mass. 78, 152 N. E. 71 (1926); RESTATEMENT, TRUSTS (1935) §§ 179(e), 227 (j).

risk, policy should encourage such practice. In recognition of the wisdom of this procedure, several states have specifically permitted insurance companies to mingle the funds of insurance trusts with their general assets.³¹ But the objection to the trust analysis most vigorously stressed by the courts is that upon trust theory, the right of the policy holder to an accounting of the method of distributing dividends will follow as a matter of course without the necessity of alleging fraud. It is feared that, as a consequence, insurance companies will be harassed by frivolous demands.³² This apprehension appears overstated, for even though the right to an accounting be recognized, the permissive extent of its application is still within judicial discretion.³³ Courts that have adopted the trust interpretation have shown a disposition to recognize the necessity of avoiding useless embarrassment and inconvenience to the company, circumscribing the right to an accounting by the limits of reasonableness.³⁴ Since the companies have to go through the process of determining dividends at stated periods regardless of demand, it is not unreasonable to require that their calculations be made available at such times to those properly interested.

Judicial treatment of fraternal insurance cases sustains a trust analysis, for courts have long regarded a benevolent association, incorporated or not, as the trustee of the funds contributed by its members.³⁵ Early cases justified the different treatment accorded policy holders in a benevolent association on the theory that the issuance of insurance was merely ancillary to the purpose of fraternal organizations, the plane of relationship being elevated above a debtor-creditor status by motives of benevolence and fraternity.³⁶ Whatever soundness this distinction may once have possessed, the fact remains that today the primary function of the great majority of benevolent associations has become the selling of insurance; they differ from the commercial companies only in the absence of the profit motive and the retention of the open contract provision.³⁷ Yet courts still treat the association as a trustee.³⁸

31. CONN. GEN. STAT. (1930) § 4193; MASS. GEN. LAWS (1932) c. 175, § 119A; PA. STAT. ANN. (Purdon, 1930) tit. 40, § 514; WIS. STAT. (1937) § 20b.39.

32. *Everson v. Equitable Life Assurance Soc.*, 68 Fed. 258 (W.D. Pa. 1895), *aff'd*, 71 Fed. 570 (C. C. A. 3d, 1896); *Peters v. Equitable Life Assurance Soc.*, 200 Mass. 579, 86 N. E. 885 (1909); *Uhlman v. New York Life Ins. Co.*, 109 N. Y. 421, 17 N. E. 363 (1888).

33. *Shaw v. Beaumont*, 88 N. J. Eq. 333, 102 Atl. 151 (1917).

34. *Equitable Life Assurance Soc. v. Hardin*, 166 Ky. 51, 178 S. W. 1155 (1915); *Miller v. New York Life Ins. Co.*, 179 Ky. 246, 200 S. W. 482 (1918).

35. *Die Gross-Loge Des Ordens Der Hermanns-Söhne Im Staate Colo. v. Wolfer*, 42 Colo. 393, 94 Pac. 329 (1908); *Kane v. Knights of Columbus*, 84 Conn. 96, 79 Atl. 63 (1911); *National Circle, Daughters of Isabella v. Hines*, 88 Conn. 676, 92 Atl. 401 (1914).

36. *Commonwealth v. Equitable Beneficial Ass'n*, 137 Pa. 412, 18 Atl. 1112 (1890); see *Northwestern Mutual Life Ins. Co. v. Wisconsin*, 247 U. S. 132, 140 (1918).

37. *Comment* (1938) 47 YALE L. J. 965, 970, n. 34, 972, n. 51, 52. But see *Comment* (1938) 33 ILL. L. REV. 281.

38. *Most Worshipful Grand Lodge of Ancient Free and Accepted Masons of Alabama (Colored) v. Callier*, 224 Ala. 364, 140 So. 557 (1932); *Donovan v. Danielson*, 271 Mass.

Stare decisis offers one explanation, but equally possible is the conclusion that the courts, free in the light of changed circumstances to adopt an independent construction, have selected the trust analysis.

The utility of the trust interpretation may be tested by its application to four types of cases. The duty of the insurer to forestall lapse of a policy if there be within its possession funds to maintain it is often asserted; yet courts proceeding on the usual contract theory frequently arrive at the harsh results demonstrated in *Williams v. Union Central Life Insurance Company*.³⁹ The insured failed to meet a premium payment on time, but a dividend had been declared by the company, which if applied in reduction of the amount advanced on the policy would have extended protection beyond the date of the death of the policy holder. The insurer, contending that since the insured failed to exercise any of the options in the policy the dividend was merely payable in cash, allowed the policy to lapse. This action was sustained by the United States Supreme Court. Despite the retention by the company of funds clearly owing to the insured and sufficient to protect his policy, his beneficiaries thus received nothing except the surrender value of the policy. Under a trust analysis, the company as the fiduciary of the insured would not only be privileged but bound to act in the insured's best interest, which would mean, almost without exception, the maintenance of the policy.⁴⁰

Petitions for reformation of insurance policies are frequently before the courts; but hazardous indeed is the prediction of the results in a particular case.⁴¹ Companies lean heavily on their salesmen in selling insurance, but they are careful to disclaim any responsibility for the representations of these agents. The first officially recognized communication between company and prospective insured occurs with the issuance of the policy. Thus the insurer, while reaping the benefits of pressure salesmanship, often avoids liability for the legal consequences of the agent's representations. This aspect of insurance law, now continually muddled by the unrealistic doctrine of mutual mistake,⁴² can be clarified by raising the insurer's standard of duty. Either the insurer should bear from the beginning of negotiations a fiduciary obligation to issue to the insured the policy its agent's representations have given him reasonable

267, 171 N. E. 823 (1930); *Shafran v. St. Nicholas Ruthenian Greek Catholic Sick and Death Ben. Soc. of Passaic, N. J.*, 117 N. J. Eq. 54, 175 Atl. 139 (1934).

39. 291 U. S. 170 (1934). See also *Moore v. Pilot Life Ins. Co.*, 86 F. (2d) 197 (C. C. A. 4th, 1936); *Coons v. Home Life Ins. Co.*, 368 Ill. 231, 13 N. E. (2d) 482 (1938), (1938) 32 ILL. L. REV. 744; Notes (1920) 6 A. L. R. 1400, (1927) 47 A. L. R. 452, (1934) 92 A. L. R. 702, 712 and cases cited.

40. Cf. *Finley v. Massachusetts Mut. Life Ins. Co.*, 172 La. 477, 134 So. 399 (1931) (disregards terms of policy to raise a duty to maintain policy).

41. Compare *Swede v. Metropolitan Life Ins. Co.*, 94 F. (2d) 124 (C. C. A. 5th, 1938) (denying reformation) with *Equitable Life Assurance Soc. of U. S. v. Saurman*, 126 Pa. Super. 184, 190 Atl. 422 (1937) (permitting reliance by insured on agent's representations).

42. See generally, VANCE, INSURANCE (2d ed. 1930) § 71.

cause to believe he was buying; or it should inform him adequately concerning the nature of the policy actually delivered.

The theory that insurer and insured stand merely in the relation of debtor and creditor is upon occasion employed to justify retention by the insurer of premiums paid on a non-insurable interest. In *Harse v. Pearl Life Assurance Company*⁴³ an agent had sold a policy by telling the plaintiff that he had an insurable interest in his mother's life. Although under well-settled law the policy holder had no such interest, the company accepted premiums from him, and upon his discovery that the policy was void, denied him a refund. Finding that agent and policy holder had both misapprehended the law, the court disallowed recovery of the premiums. It added that the plaintiff was bound unless he could show "a difference in the position of the parties which created a fiduciary relationship to the plaintiff, so as to make it inequitable for the defendants to insist on the bargain." Although the agent might have been in error, there can be no real doubt that the company was at all times fully aware of the true nature of the plaintiff's interest. It is equally clear that the policy holder knew, and commonly would know, only the law that the agent had told him. The difference in position between the parties to which the court referred is so generally evident that to demand its formal proof is superfluous. With the acceptance of a trust interpretation, the necessity of demonstrating the obvious is removed; for the fiduciary relation, under which retention of premiums by the insurer would be patently unjust, is automatically supplied.

The far reaching implications of the right to an accounting are illustrated by *Rhine v. New York Life Insurance Company*.⁴⁴ Plaintiff had purchased a combined life and disability policy. Owing to insufficient actuarial experience and numerous and successful depression-inspired attempts to "fake" disabilities, the company failed to charge enough for the disability risk, and a huge loss resulted.⁴⁵ To compensate for the deficit, the company thereupon decreased only the dividends payable to the holders of the combined policies. If dividends had not been curtailed, insolvency eventually might have ensued. The standard procedure is to spread any loss by deducting from the dividends of *all* policy holders, *pro rata*. But since a strong case can be made for restricting the loss to those who stood to benefit by reason of the disability clauses in their policies,⁴⁶ the propriety of the company's action is not here

43. [1904] 1 K. B. 558 (C.A.). The leading American case is *American Mut. Life Ins. Co. v. Mead*, 39 Ind. App. 215, 79 N. E. 526 (1906). *Contra*: *Metropolitan Life Ins. Co. v. Blesch*, 22 Ky. L. Rep. 530, 58 S. W. 436 (1900); *Interstate Life & Accident Co. v. Cook*, 19 Tenn. App. 290, 86 S. W. (2d) 887 (1935).

44. 273 N. Y. 1, 6 N. E. (2d) 74 (1936), Comment (1937) 50 HARV. L. REV. 790, (1937) 85 U. OF PA. L. REV. 541.

45. Comment (1937) 50 HARV. L. REV. 790, 792, n. 7, 10 (between 1920 and 1930 loss amounted to forty million dollars).

46. *Cf. Carpenter v. Pacific Mutual Life Insurance Company of America*, 10 Cal. (2d) 307, 74 P. (2d) 761 (1937), *aff'd sub nom. Neblett v. Carpenter*, 59 Sup. Ct. 170 (U. S. 1938), *rehearing denied*, 59 Sup. Ct. 359 (U. S. 1938).

questioned.⁴⁷ The major objection is that faced under a conventional analysis with the necessity of proving fraud in order to secure an accounting by which to challenge the insurer's conduct, the policy holder's task is almost insuperable. Under a trust interpretation, however, the policy holder could require as of right that the company, at a convenient time, justify its action before a court of equity.

The peripheral implications of a trust analysis may present additional conceptual difficulties,⁴⁸ but preponderantly in its favor is the fact that it expresses reality. A fiduciary attitude is the norm, and companies should be placed under a correspondingly higher duty to deal fairly with policy holders. Under a trust theory each case, instead of being subjected to the erratic application of the doctrines of waiver, estoppel, and policy against forfeiture, would be determined in the light of the fundamental proposition that insurer owes to policy holder the highest good faith, not only in selling him his policy but in protecting his interests in subsequent dealings. Certainly if the requirement of *uberrimae fidei* has legal validity, it should apply at all times to insurer as well as to insured.

47. Opposing arguments of equal cogency are available under the trust theory. If each class of policy holders be deemed contributors to a separate fund, it may be justly claimed that to exact contributions from one fund to balance a deficit in another is a breach of the first trust. But if all policy holders are considered as contributing to a common fund, it is presumably inequitable to burden only part of them with a loss.

48. If a trustee loses property without negligence, he is, unlike a debtor, excused from liability. Fear may arise that this would in some respects impair the security of the policy holders. Practically, however, this offers no real problem, for any loss honestly incurred is distributed throughout the entire company and rests on no single policy holder. Moreover, the higher standard of care demanded by a fiduciary relationship would be more than likely to compensate for possible disadvantages. See Comment (1926) 36 YALE L. J. 396, n. 4.

The fact that as between the insurer and insured the insurer is held to the fiduciary obligations of a trustee instead of merely the duties of a debtor has no necessary effect on the relations between the insured and third persons. However, even if attempts are made to apply all the conceptual concomitants that flow from a trust designation, no appreciable alteration in relationship should follow. Those interests which a creditor could reach if the insured's interest were purely legal, [VANCE, *INSURANCE* (2d ed. 1930) §§ 161, 162] are almost as available if the interest be deemed equitable. 1 BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* (1935) § 193. In some jurisdictions procedural restrictions may confine an action to equity, but in many states the interest of a *cestui* can be reached at law. 1 BOGERT, *op. cit. supra*, at 546. In the absence of express restriction or statute a *cestui* may alienate his interest as freely as he might a legal interest. 1 BOGERT, *op. cit. supra*, at § 188, n. 3.

In all events, designation of the insured's interest as equitable instead of legal should not change his relation to his beneficiary, or his beneficiary's status with respect to the insurer. VANCE, *op. cit. supra*, at § 146 (insured is a trustee of the insurer's promise for the use of the beneficiary); 1 BOGERT, *op. cit. supra*, at § 113, n. 36 (deeming it well settled that equitable interests may be held by trustees). See generally, Vance, *The Beneficiary's Interest in a Life Insurance Policy* (1922) 31 YALE L. J. 343.