

Notes

Peasants' Revolt: Why Congress Should Eliminate the Tax Benefits on Dead Peasant Insurance

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Corporate-owned life insurance ("COLI") is a form of insurance in which an employer takes out a life insurance policy on the life of one of its employees. COLI is legal under state insurable interest statutes because employers have a financial incentive in the continuation of certain "key employees." However, in the past two decades, use of COLI has increased as large corporations have begun to insure larger percentages of their workers, even low-wage employees. This widespread practice presents many public policy concerns: corporations profit by reaping the death benefits when an employee dies and federal tax law permits the corporations to exclude the proceeds from gross income. Congress attempted to curb COLI by limiting a corporation from insuring certain types of employees, but corporations continue to insure large percentages of their employees.

This Note argues that Congress should go further in eliminating COLI due to the dangerous incentives that it provides to employers in the event of an employee's death. In the modern employment context, all employees are replaceable and private businesses should not reap federal tax benefits from the death of its employees. This Note proposes changes to state insurable interest laws as well as the elimination of federal tax benefits for corporations.

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INTRODUCTION

In 2008, Irma Johnson mistakenly received a check for \$1.5 million from an insurance company following the death of her husband, Daniel

Johnson.¹ The check should have been sent to Wal-Mart, where Dan worked for only a couple months before being fired in 2001.² Wal-Mart had taken out a life insurance policy on Dan in 2001 and held the beneficial interest under the policy until his death.³ Wal-Mart's life insurance policy is an example of a "Dead Peasant" insurance policy, where an employer takes out a life insurance policy on a rank-and-file employee in order to receive tax-free death benefits.

Dead Peasant policies represent extreme forms of corporate-owned life insurance ("COLI"), a practice whereby an employer takes out a life insurance policy on a key employee who is integral to the company's success to protect the employer in the case of the employee's death. While some courts have invalidated such policies, modern COLI arrangements persist as large corporations continue to take out insurance policies on a large number of their employees. The question is whether these policies are legitimate protections against loss, or whether they represent a scheme that is coldly calculated to fill the coffers of private corporations. This Note argues that COLI should be limited because it rewards employers when their employees die quickly.

Courts and legislatures have already prohibited Stranger-Owned Life Insurance ("STOLI"), where an individual gambles on the life of a stranger. This Note argues that COLI represents a similar gamble and that legislatures and courts should prohibit it as they have prohibited STOLI policies. Additionally, although Congress has not restricted COLI, it has acted by limiting tax advantages that companies enjoy through COLI. This Note proposes that state and federal laws should go further in restricting COLI because in the modern employment relationship, employers do not need to be compensated following the death of an employee, even so-called "key persons."

Part I of this Note summarizes the history of the insurable interest requirement and outlines the differences between STOLI policies, viatical settlements, COLI, and Dead Peasant policies. Part II identifies several public policy concerns created by COLI and explains why such policies are dangerous. Part III summarizes congressional amendments that are designed to limit tax advantages of COLI and analyzes the current state of the law. Part IV proposes three possible legal solutions for preventing the abusive nature of COLI, and ultimately recommends

1. Claire Shipman & Chris Strathmann, *Are 'Dead Peasant' Life Insurance Policies Fair?*, ABC NEWS (Oct. 2, 2009), <http://abcnews.go.com/GMA/dead-peasant-life-insurance-policies-fair/story?id=8724327>.

2. *Id.*

3. *Id.* Filmmaker Michael Moore documented Irma's shock and subsequent realization that Wal-Mart would be collecting millions of dollars from her husband's death in Moore's 2009 film *Capitalism: A Love Story*. *Id.*

the elimination of all tax benefits to prevent the inherent dangers of such policies.

I. HISTORICAL BACKGROUND

A. HISTORY OF THE INSURABLE INTEREST REQUIREMENT

Prior to 1774, English courts permitted life-wagering contracts where one citizen would gamble on the death of another by taking out a life insurance policy on that person.⁴ It did not matter if the purchaser was related to or knew the insured.⁵ In 1774, however, the English Parliament enacted a statute requiring life insurance policies to contain an insurable interest, or an interest by the purchaser of the life insurance policy in the longevity of the insured.⁶ In other words, one who took out the policy must have had some incentive for the insured to continue living. The public policy rationale for enacting an insurable interest requirement in 1774 was that permitting a person to gamble on another's life could induce the gambler to kill the insured.⁷ Consequently, there had to be an incentive for the policyholder to want the insured to live longer to avoid the potential moral hazard.⁸

As the United States adopted English common law, states required an insurable interest for life insurance policies, either through statutes or common law.⁹ Under these statutes and court decisions, factors that could satisfy the insurable interest included "blood relation" and "love and affection" to the insured.¹⁰ The logic behind these factors was simple: if one loves or is related by blood to the insured, she would not be induced to kill the insured.¹¹ Additionally, statutes and common law decisions often

4. Peter Nash Swisher, *The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 *DRAKE L. REV.* 477, 481 (2005).

5. *See id.* Interestingly, many of the wagering contracts were taken out on a person accused of a capital crime and the gamble for the purchaser was whether the conviction and punishment would stand. *Id.*

6. *Id.*

7. Eryn Mathews, *STOLI on the Rocks: Why States Should Eliminate the Abusive Practice of Stranger-Owned Life Insurance*, 14 *CONN. INS. L.J.* 521, 542 (2008). Modern courts also cite prevention of murder as a rationale for the insurable interest requirement. *See, e.g., Hopkins v. Hopkins*, 614 A.2d 96, 98 (Md. 1992).

8. *Conn. Mut. Life Ins. Co. v. Schaefer*, 94 U.S. 457, 460 (1876) ("A man cannot take out insurance on the life of a total stranger, nor on that of one who is not so connected with him as to make the continuance of the life a matter of some real interest to him.").

9. *Id.* In *Schaefer*, Justice Bradley summarized how the insurable interest adoption gradually migrated from England to the United States: "In this country, statutes [requiring an insurable interest] have been passed in some of the States; but where they have not been, in most cases either the English statutes have been considered as operative, or the older common law has been followed." *Id.*

10. Mathews, *supra* note 7, at 543.

11. *Id.* at 542 (noting that the initial intent for the insurable interest requirement was deterring murder). The rationale assumed that blood relatives and persons bound by love and affection would

permitted a “substantial economic interest” as a basis for satisfying the insurable interest requirement.¹²

B. STOLI: A WAY AROUND THE INSURABLE INTEREST REQUIREMENT

1. *The Origins of STOLI*

STOLI transactions occur when an individual takes out a life insurance policy and transfers the policy to a stranger in exchange for money. STOLI transactions date back to the enactment of insurable interest statutes in England.¹³ A typical STOLI transaction is set up in this way: An elderly person is offered a sum of money in exchange for taking out a life insurance policy on her own life and transferring it immediately to an investor, who will fund the premiums.¹⁴ The investor holds the policy and receives the death benefits when the elderly person dies.¹⁵ Because the elderly person technically took out the policy on herself, the transaction is a way to evade the insurable interest statute because it permits the investor to gamble on the person’s life. As a result, American courts and legislatures began restricting the legality of such policies.

After the gradual state-by-state adoption of the insurable interest requirement in the United States, the Supreme Court heard the first case involving a STOLI transaction in *Warnock v. Davis* in 1881.¹⁶ In *Warnock*, Henry Crosser took out a \$5000 life insurance policy on his own life and immediately transferred his interest to a group of investors who agreed to pay the premiums and pay Crosser’s wife a ten percent (\$500) commission.¹⁷ The insurer argued that the contract was void for lacking an insurable interest; even though Crosser had an insurable interest in his own life, the formation and assignment of the contract was a sham that allowed the investors to obtain an illegal wagering contract.¹⁸ The Court invalidated the agreement for lack of an insurable interest because it was not transferred in good faith.¹⁹ Essentially, lack of good faith meant that Crosser only agreed to the policy to facilitate the transfer to the investors.²⁰ Therefore, good faith became the legal standard by which a transfer of a

not want to kill each other, but it is merely a theory. In reality, many blood relationships, from Cain and Abel to the pornographers and the Mitchell Brothers, have ended in familial homicide.

12. *Id.* at 543.

13. Maria Fleisher, Comment, *Stranger Originated Life Insurance: Finding a Modern Cure for an Age-Old Problem*, 41 CUMB. L. REV. 569, 570–71 (2011).

14. *Id.* at 570.

15. *Id.*

16. 104 U.S. 775 (1881).

17. *Id.* at 775.

18. *Id.* at 778.

19. *Id.* at 781–83.

20. *Id.* at 782.

life insurance contract to a stranger would be legal: if the individual took out the policy in good faith, any assignment of the policy would be valid. If the policy was not procured in good faith, it represented an attempt to evade the insurable interest requirement and the policy would be invalidated.

In subsequent cases, the Supreme Court refined the criteria for a life insurance contract to satisfy the insurable interest requirement. In *Connecticut Mutual Life Insurance Co. v. Schaefer*, the Court held that an insurable interest need only exist “at the time of taking out the policy.”²¹ The Court reemphasized that if an insured takes out a policy in good faith, it would be held valid.²² Therefore, as long as a policy was valid at its inception and later transferred, it satisfied the insurable interest requirement. In *Grigsby v. Russell*, the Court explained that because life insurance contracts should be given the “ordinary characteristics of property,” the policyholder retained the right to transfer it to a group of investors so long as the policy was taken out in good faith.²³

2. *The Viatical Settlement Market*

With the Supreme Court condoning the free transfer of life insurance policies so long as policyholders agreed to them in good faith, investors eventually found a way to profit by receiving the transfer of such policies. The transfer of a life insurance policy to pay for medical services for treatment of a disease is called a “viatical settlement.”²⁴ The 1980s, the height of the AIDS epidemic, saw the rise of a viatical settlement industry,²⁵ whereby individuals diagnosed with AIDS began transferring their life insurance policies to third-party investors for a sum of money.²⁶ The viatical settlement industry refers to the widespread practice of transferring life insurance contracts in exchange for cash.²⁷ At the time, AIDS frequently became fatal soon after diagnosis. As a result, those afflicted with the disease often needed fast cash for treatment.²⁸ Investors were happy to be on the purchasing end of the policies—AIDS patients

21. 94 U.S. 457, 462 (1876).

22. *Id.* at 460.

23. 222 U.S. 149, 156 (1911).

24. *Id.* at 286.

25. Some courts and scholars use the term “life settlement” rather than “viatical settlement.” For clarity, this Note uses viatical settlement, but the terms are interchangeable. See Sachin Kohli, *Pricing Death: Analyzing the Secondary Market for Life Insurance Policies and its Regulatory Environment*, 54 *BUFF. L. REV.* 279, 281 (2006) (“The transaction of selling one’s policy to a life settlement provider is referred to as either a viatical settlement or a life settlement.”).

26. *Life Partners, Inc. v. Morrison*, 484 F.3d 284, 287 (4th Cir. 2007).

27. *See id.*

28. Neil A. Doherty & Hal J. Singer, *The Benefits of a Secondary Market for Life Insurance Policies*, 38 *REAL PROP. PROB. & TR. J.* 449, 450 (2003).

had short life expectancies, which allowed investors to profit handsomely—and AIDS victims could take advantage of cash payments on policies that would not otherwise help them after their deaths.²⁹

The viatical settlement industry has grown rapidly in the past few decades, expanding to cover many diseases.³⁰ In 1989, life insurance contracts were worth an estimated total of \$5 million.³¹ In 1995, an estimated \$200 million worth of viatical settlements were sold.³² In 2005, that figure rose to an estimated \$13 billion.³³ Some experts predict that the total value of the viatical settlement industry could reach \$160 billion by 2030.³⁴ The growth of the industry has also led to the growth of STOLI transactions, probably because it is often unclear whether a life insurance policy was assigned in good faith. Therefore, STOLI policies disguise themselves as legitimate viatical settlements.

Viatical settlements, or any transfers of life insurance done in good faith, are legal on the basis that an individual may freely transfer his or her own property; however, some critics have called for regulation of the industry due to the disparity in bargaining power between a large company and a terminally ill individual in need of money.³⁵ Another concern might be that individuals could conceal an illness only to obtain a policy and flip it immediately to a group of investors. Critical evaluations of the viatical settlement industry are beyond the scope of this Note.

This Note describes the viatical settlement industry to highlight the problem of modern STOLI schemes, which grew out of the burgeoning viatical settlement industry. The key difference between viatical settlements and STOLI policies is that under a viatical settlement the insured originally agreed to the policy in good faith and intended to remain the beneficiary, whereas with STOLI transactions, the insured took out the policy in bad faith only for the purpose of transferring it to

29. *Id.* at 451 (“Policyholders benefit from improvements in the quality of their final days, and investors benefit by having the opportunity to invest in a previously inaccessible asset class.”).

30. Joy D. Kosiewicz, Comment, *Death for Sale: A Call to Regulate the Viatical Settlement Industry*, 48 CASE W. RES. L. REV. 701, 701–02 (1998).

31. Sec. & Exch. Comm’n v. Life Partners, Inc., 898 F. Supp. 14, 17 n.1 (D.D.C. 1995).

32. *Id.*

33. Holman W. Jenkins, Jr., *Life Insurers Face the Future, Grudgingly*, WALL ST. J., Aug. 9, 2006, at A11.

34. *Id.*

35. See Denise M. Schultz, *Angels of Mercy or Greedy Capitalists? Buying Life Insurance Policies from the Terminally Ill*, 24 PEPP. L. REV. 99, 110 (1996) (arguing for the codification of state viatical regulations because they “seek to ensure that viatical settlement companies do not take advantage of a viator’s vulnerability”); see also Miriam R. Albert, *Selling Death Short: The Regulatory and Policy Implications of Viatical Settlements*, 61 ALB. L. REV. 1013, 1031 n.92 (1998) (arguing that some regulations that allow the viator to rescind a contract within thirty days may set up a “bargaining game” that works to the viator’s disadvantage). See generally Kosiewicz, *supra* note 30.

an investor. While viatical settlements are valid under the law,³⁶ courts have construed STOLI policies as illegitimate contracts that evade insurable interest laws.³⁷ COLI policies also lack an insurable interest in the modern employment context.

3. Modern STOLI Arrangements

In the past decade, the litigation concerning STOLI policies has increased as investors have become more sophisticated in concealing STOLI schemes from insurers.³⁸ A federal district court in New Jersey recently summarized a typical modern STOLI transaction:

A typical STOLI transaction is structured as follows. An agent attempts to sell a life insurance policy to an elderly insurable candidate, and offers the candidate up-front cash in exchange for promising a future sale of the policy. The agent informs the candidate that the candidate will be able to obtain the policy at virtually no cost to himself, because the agent has secured non-recourse financing to purchase the policy. The candidate then acts as a “nominal grantor” of a life insurance trust that is used to apply for the policy. “At that time, the agent will tell the insured that, in all probability, the policy will be sold to investors for a price that will pay the loan and accrued interest, leaving a profit to split between the agent and the insured.”³⁹

The use of a trust to facilitate the transfer agreement is so common in STOLI transactions that many states have explicitly mentioned the use of trusts in their insurable interest laws.⁴⁰ Most cases involve a life insurance policy transferred by an individual to a group of investors and the cases normally turn on a finding of good faith.⁴¹ A policy is purchased in good faith when a person does not intend to transfer the policy at the

36. See Kosiewicz, *supra* note 30, at 701 (“Viatical settlements are available in all 50 states.”). For an example of a state viatical settlement statute, see CAL. INS. CODE §§ 10113.1–13.3 (West 2013).

37. See, e.g., *Pruco Life Ins. Co. v. Brasner*, No. 10-80804, 2011 U.S. Dist. LEXIS 156297, at *32–33 (S.D. Fla. Nov. 14, 2011) (invalidating a life insurance policy transferred without good faith and stating that it “amounts to an illegal wagering contract”); see also *AXA Equitable Life Ins. Co. v. Infinity Fin. Grp., LLC*, 608 F. Supp. 2d 1349, 1356–57 (S.D. Fla. 2009) (denying a motion to dismiss a claim against a bad faith transfer of a life insurance policy, stating: “Assuming the truth of the allegations of the amended complaint as true, as the court must at this stage, the procurement and the assignment of the policies was not done in good faith, but was part of a scheme devised by defendants to obtain interests in insurance policies . . . in which the defendants had no insurable interest”).

38. See Joseph J. Hasman et al., *Recent Developments in Health Insurance, Life Insurance, and Disability Insurance Law*, 47 TORT TRIAL & INS. PRAC. L.J. 247, 273–76 (2011) (summarizing recent developments of STOLI litigation).

39. *Lincoln Nat'l Life Ins. Co. v. Calhoun*, 596 F. Supp. 2d 882, 885 (D.N.J. 2009) (citation omitted).

40. See, e.g., CAL. INS. CODE § 10110.1(d) (“Trusts and special purpose entities that are used to apply for and initiate the issuance of policies of insurance for investors, where one or more beneficiaries of those trusts or special purpose entities do not have an insurable interest in the life of the insured, violate the insurable interest laws and the prohibition against wagering on life.”).

41. See, e.g., *Pruco Life Ins. Co.*, 2011 U.S. Dist. LEXIS 156297, at *23; see also *Lincoln Nat'l Life Ins. Co. v. Snyder*, 722 F. Supp. 2d 546 (D. Del. 2010).

policy's inception.⁴² If a transaction lacks good faith because the insured never meant to remain as policy beneficiary, then the contract is a STOLI transaction rather than a viatical settlement, and therefore violates the insurable interest requirement.

Nearly all U.S. jurisdictions have adopted the insurable interest requirement for life insurance contracts.⁴³ States differ, however, as to when an insurable interest is required to exist in order for a policy to be upheld. A minority of states have enacted strict insurable interest laws that require the insurable interest to exist at the time of the insured's death.⁴⁴ However, forty-four states allow an individual to freely transfer the policy so long as the contract was taken out and transferred in good faith.⁴⁵ Thus, most modern STOLI cases turn on a factual determination of whether the insured acted in good faith in procuring and transferring the policy.⁴⁶

C. COLI: A NEW FACE FOR AN OLD PROBLEM

I. The Emergence of COLI

COLI, also referred to as employer-owned life insurance ("EOLI"), is a form of a life insurance contract between an employer and employee.⁴⁷ The corporation or employer owns the life insurance policy on the employee, pays the premiums, and usually becomes the sole beneficiary under the contract. Therefore, the employer collects any death benefits when the insured employee dies. Many arrangements might include a small percentage payout for the employee's family.

COLI policies originally developed for the benefit of companies taking out so-called "key-man" or "key-person" life insurance policies on important employees whose deaths might result in financial loss to the company.⁴⁸ These types of policies "came to be accepted when [they] involved key personnel and bore a rational relationship to the costs or losses that might be expected to be incurred as a result of the death of the

42. See *Grigsby v. Russell*, 222 U.S. 149, 156 (1911).

43. Swisher, *supra* note 4, at 479.

44. Mathews, *supra* note 7, at 546.

45. *Id.* at 547.

46. For cases that turned on factual determinations of a good faith transfer, see *supra* note 41.

47. COLI is a bit of a misnomer because it applies not solely to corporations but to all profit-making companies such as partnerships, business trusts, and limited liability partnerships. Stephan R. Leimberg & Howard M. Zaritsky, *IRS Provides New and Substantial Guidance on Employer-Owned Life Insurance*, EST. PLAN., Aug. 2009, at 3, 4 n.3. While others use the term EOLI, for simplicity this Note will continue to use the term COLI.

48. See Mathews, *supra* note 7, at 544; see also Charity Rush, Comment, *Corporate-Owned Life Insurance (A/K/A 'Dead Peasant' or 'Dead Janitor' Policies): Has Texas Buried the Insurable Interest Requirement?*, 41 HOUS. L. REV. 135, 140 (2004).

person being insured.”⁴⁹ States that adopted this exception for key-person insurance usually required the consent of the insured employee.⁵⁰

The rationale behind key-person COLI policies is simple: a company will lose financially if the key employee dies. An extreme example of this would involve former Apple CEO Steve Jobs; prior to Jobs’ death, Apple would presumably have an interest in Jobs staying alive. Therefore, it would be in Apple’s best financial interest to take out life insurance on Jobs’ life. Allowing this type of life insurance contract satisfies two concerns: 1) Apple would not be incentivized for Jobs to die early, given his value to the company, and 2) Apple would avoid a financial loss in the case of Jobs’ death by being compensated through the policy’s death benefits.⁵¹

The main problem with this rationale is that it is difficult to determine which employees constitute key people to a company. While Jobs would certainly be considered a key person, would a high-profile manager of Apple retail stores who earns \$150,000 a year be considered a key employee? Would it matter if the employee owned part of the company and if so, how much would the employee have to own in order to be considered a key person? What about an employee who works in the Apple retail store but makes \$20.00 per hour? Would it matter if that same employee only made minimum wage? The answers to these questions are difficult and demonstrate the gray area created by allowing an employer to insure key employees.

Today, COLI policies are much broader and may extend to “any employee regardless of the length of employment or the value of the employee’s services.”⁵² Failing to comply with a state’s consent and notice requirements, rather than lacking an insurable interest, tends to be the only reason that COLI policies are invalidated. Some states, such as Georgia, allow employers to have an insurable interest in retired employees who do not currently work for the employer.⁵³

49. Stephan R. Leimberg & Albert E. Gibbons, *COLI, BOLI, TOLI and ‘Insurable Interests’*, EST. PLAN., July 2001, at 333, 333 (recognizing that under English common law no such prohibition existed).

50. *Id.* at 334.

51. There is no indication Apple collected on a life insurance policy following Jobs’ death. The hypothetical is used to demonstrate an extreme example of the rationale behind key-man insurance policies. It is possible that, given Jobs’ medical condition, an insurer would not ensure Jobs or that the premiums would be too high for Apple to take out such a policy.

52. *Am. Elec. Power, Inc. v. United States*, 136 F. Supp. 2d 762, 768 (S.D. Ohio 2001).

53. See GA. CODE ANN. § 33-24-3(d)(2) (2013) (permitting employers to have an insurable interest in any “employee,” which includes retired employees). Georgia’s prior insurable interest statute defined employee more broadly, including dependents of any employee. See George Steven Swan, *The Law and Economics of Company-Owned Life Insurance (COLI): Winn-Dixie Stores, Inc. v. Commissioner of Internal Revenue*, 27 S. ILL. U. L.J. 357, 371 (2003). As of 2006, Georgia’s legislature removed the term “dependent of any employee” from Georgia’s insurable interest statute. GA. CODE ANN. § 33-24-3(d)(2).

2. *Dead Peasant Insurance*

Dead Peasant policies are extreme forms of COLI, whereby an employer insures a large percentage of its employees, even rank-and-file employees who are unlikely to be integral to the company's success. In the 1990s and 2000s, employers began to expand the number and range of employees who they claimed to be key persons to include even those who made relatively small salaries.⁵⁴ In most cases, the employees did not know that they were being covered.⁵⁵

These policies are often pejoratively called "Dead Peasant" or "Dead Janitor" policies.⁵⁶ Interestingly, the origin of the term "Dead Peasant" comes from internal memos⁵⁷ of an insurance company that became part of the court's record in *Winn-Dixie Stores, Inc. v. Commissioner of Internal Revenue*, in which the United States Court of Appeals for the Seventh Circuit invalidated several COLI policies as "sham transactions."⁵⁸ Using the terms "peasants" or "janitors" emphasizes the unimportance of the employees covered and exposes the fact that many COLI policies run contrary to the original intent behind key-person insurance.

3. *Judicial Restraints on COLI*

One of the first cases to highlight the potential abusive nature of COLI policies involved the death of Felipe Tillman documented by the *Wall Street Journal* in 1992.⁵⁹ Tillman's company, Camelot Music Inc. ("Camelot"), purchased a COLI policy on Tillman and collected \$339,302 following his death.⁶⁰ Tillman was unaware of the policy, and his family only found out after his death.⁶¹ In an article about his death, Felipe's brother Anthony Tillman expressed shock that a company could profit off an employee's death without notice to the employee or his family: "If someone is going to use your name for something, even though you're an

54. Ellen E. Schultz & Theo Francis, *Companies Profit on Workers' Deaths Through 'Dead Peasants' Insurance*, WALL ST. J. (Apr. 19, 2002, 12:13 AM), http://online.wsj.com/public/resources/documents/april_19.htm.

55. *Id.*

56. Mike Myers, *How "Dead Peasant" Insurance Got Its Name*, CONTINGENT FEE BUS. LITIG. BLOG (Aug. 13, 2008), <http://www.contingentfeeblog.com/2008/08/articles/corporate-owned-life-insurance/how-dead-peasant-insurance-got-its-name>.

57. *Id.* (quoting the exact language in the memorandum as stating "I want a summary sheet that has . . . the Dead Peasants in the third column").

58. *Id.* ("Thus, the phrase 'dead peasant insurance' is not a creation of the media. It is a term used within the insurance industry to describe employees whose lives are insured by policies of corporate owned life insurance for an employer's benefit.").

59. Schultz & Francis, *supra* note 54.

60. *Id.*

61. *Id.*

employee of theirs, you should know what's going on in your name . . . [i]t isn't fair."⁶²

Years later, Tillman's estate sued Camelot under an Oklahoma statute that allows insurance proceeds to be recovered if an insurance contract did not contain an insurable interest on the insured's life.⁶³ On appeal, the United States Court of Appeals for the Tenth Circuit held that Camelot did not have an insurable interest in Tillman because it could not prove that Tillman's value to the company outweighed any potential gain from insurance proceeds following his death.⁶⁴ This Note argues below that most employees' insurance policies similarly lack an insurable interest because most employees are replaceable.

Mayo v. Hartford Life Insurance Co.,⁶⁵ a case involving a class action lawsuit against three large corporations, is perhaps the most famous case involving a Dead Peasant policy. In *Mayo*, Camelot, Transworld Entertainment Corporation, and Wal-Mart (collectively "corporate defendants"), challenging the death benefits received from COLI policies.⁶⁶ The class of plaintiffs included former employees and estates of deceased employees of the corporate defendants.⁶⁷ The corporate defendants had purchased COLI policies on a large number of their employees during the disputed time period: Camelot had purchased life insurance on every employee that worked more than twenty hours per week and Wal-Mart had purchased policies on every hourly employee.⁶⁸ The issue in the case concerned the validity of the policies under Texas insurable interest statutes and whether the corporate defendants could retain money collected as death benefits on the deceased former employees.⁶⁹

The portion of the case that involved Wal-Mart only concerned the validity of Wal-Mart's policy to insure all hourly employees. The plaintiffs argued that the corporate defendants' COLI practice violated the Texas insurable interest statute because the companies did not have a valid insurable interest in the employees.⁷⁰ Therefore, the company was not entitled to be a beneficiary of the policy or to keep any death benefits. Wal-Mart argued that it had a valid insurable interest in all of

62. *Id.*

63. *Tillman ex rel. Estate of Tillman v. Camelot Music, Inc.*, No. 02-0761, 2005 WL 3436484, at *1 (N.D. Okla. Dec. 14, 2005).

64. *Tillman ex rel. Estate of Tillman v. Camelot Music, Inc.*, 408 F.3d 1300, 1306-07 (10th Cir. 2005), *on remand*, 2005 WL 3436484, at *1.

65. 220 F. Supp. 2d 714 (S.D. Tex. 2002).

66. *Id.* at 722.

67. *Id.*

68. *Id.* at 722-24.

69. *Id.* at 722.

70. *Id.* at 724.

its employees' lives because "'as a group' all employees were 'important to the company's profitability and to the continuing functioning of its business.'"⁷¹

The District Court rejected Wal-Mart's argument and held that Wal-Mart's practice of insuring all hourly employees violated the insurable interest requirement.⁷² The court reasoned that the COLI policies were against public policy because Wal-Mart could not prove that it did not have an incentive in procuring the early death of its employees.⁷³ The decision reemphasized the original policy arguments for creating the insurable interest requirement: the policyholder should not have an interest in the speedy death of the insured in order to reap a lucrative payout.⁷⁴ Part II.B of this Note points out several ways an employer might be incentivized to accelerate the death of its employee.

Tillman and *Mayo* represent cases in which extreme forms of COLI—or Dead Peasant policies—were invalidated due to a lack of an insurable interest under a specific state statute. These cases demonstrate that there are limits to a company's abuse of the COLI system with extreme policies that cover nearly all rank-and-file employees. However, as this Note argues in Part II, COLI policies create policy concerns in general. These extreme cases are not the only types of policies that courts and legislatures should be concerned with because many modern day insurance policies lack an insurable interest.

II. POLICY CONCERNS FOR COLI

Aside from courts, scholars have often criticized Dead Peasant policies as being against public policy.⁷⁵ Most of this criticism has focused on the fact that the policies have often lacked consent and notice.⁷⁶ However, COLI policies create several other public policy concerns: 1) the policies lack a legitimate insurable interest because there is often an arbitrary connection between the employee's value to the company and the financial gain that an employer can make from the employee's death; 2) the policies create an improper incentive for employers to accelerate the deaths of their employees; 3) the policies are funded by American taxpayers for the benefit of both the employers and insurance

71. Rush, *supra* note 48, at 149 (quoting *Mayo v. Hartford Life Ins. Co.*, 220 F. Supp. 2d 794, 801–03 (S.D. Tex. 2002)).

72. *Mayo*, 220 F. Supp. 2d at 737–38.

73. *Id.*

74. *Id.*

75. See, e.g., Susan Lorde Martin, *Corporate-Owned Life Insurance: Another Financial Scheme That Takes Advantage of Employees and Shareholders*, 58 U. MIAMI L. REV. 653, 676–77 (2004).

76. *Id.* (“It is unseemly for businesses to benefit from the deaths of their employees, some of whom may have been terminated many years before, without the employees' having agreed to the arrangement or, in fact, having known about it.”).

companies; and 4) the policies are morally reprehensible as a form of life-wagering similar to STOLI policies.

A. COLI LACKS A LEGITIMATE INSURABLE INTEREST

Charles de Gaulle is credited with the famous phrase: “The cemeteries of the world are full of indispensable men.”⁷⁷ As callous as it sounds, there is truth to the quote in the modern employment relationship. Most large companies are able to replace key employees without being subject to financial ruin. If all employees are replaceable, then all COLI policies lack a legitimate insurable interest. Even for employees who are perceived as valuable to a company, a life insurance payout is not adequate to compensate the company for the loss. Even Jobs, who might have been one of the people most indispensable to his company, was arguably replaced with relative ease by Apple, and even if this were not the case, a life insurance payout would be inadequate to compensate for the loss of Jobs to the company.⁷⁸

While many claim that Apple has thrived because Jobs has left the company in great shape to succeed,⁷⁹ it is apparent that Apple would not have benefitted from an insurance payout upon Jobs’ death in the long term. Any money paid out by the policy would have only added extra lining to the company’s profits. In order to remain competitive over time, many believe that Apple must remain a leading innovator.⁸⁰ In other words, to the extent that Jobs was irreplaceable for his ability to

77. Steve Lohr, Op-Ed., *One Day You’re Indispensable, the Next Day . . .*, N.Y. TIMES, Jan. 18, 2009, at WK3.

78. Art Levinson replaced Jobs as Chairman of the Board and Tim Cook became CEO and both were highly qualified to fill in. Levinson served as CEO of Genentech for fourteen years, wrote or co-wrote over eighty published scientific papers, and was named as inventor on eleven U.S. patents. Philip Elmer-DeWitt, *The Man Who Replaced Steve Jobs as Chairman of the Board*, CNN MONEY (Nov. 16, 2011, 11:01 AM), <http://tech.fortune.cnn.com/2011/11/16/the-man-who-replaced-steve-jobs-as-chairman-of-the-board>. *Institutional Investor* named him “America’s Best CEO” in biotech for four straight years, and *Businessweek* named him one of the best managers in 2004 and 2005. *Id.* Cook served as Apple’s Chief Operating Officer for seven years and had over twelve years of executive experience working at Compaq and IBM. Steven Musil, *A Look at Tim Cook, the Man Replacing Steve Jobs*, CNET NEWS (Aug. 24, 2011, 4:30 PM), http://news.cnet.com/8301-13579_3-20096918-37/a-look-at-tim-cook-the-man-replacing-steve-jobs. In the year following Jobs’ death, Apple continued to thrive. In 2011, the company held a market capitalization worth \$629.4 billion and put out the iPhone 5, which sold between six and ten million units within two weeks. Jon Swartz, *Year After Jobs’ Death, How High Can Apple Fly?*, USA TODAY, Oct. 5, 2012, at A1. At one point in 2012, Apple stock shares were up over eighty percent from the time of Jobs’ death. David Goldman, *Apple’s Post-Steve Tipping Point*, CNN MONEY (Oct. 5, 2012, 9:08 AM), <http://money.cnn.com/2012/10/05/technology/apple-steve-jobs/index.html>. The Apple stock price has declined since 2012, but is still well above the below \$400 a share that it was trading for when Jobs died. Balaji Viswanathan, *Why Is Apple Stock Falling Down?*, FORBES (Feb. 13, 2013, 12:07 PM), <http://www.forbes.com/sites/quora/2013/02/13/why-is-apple-stock-falling-down>.

79. Swartz, *supra* note 78.

80. *Id.*

innovate, a cash payment from a life insurance policy would not have helped Apple stay on top of the tech market. This analogy is simplified to illustrate that even employees who are seen as integral to a company's success are replaceable to some extent.

The Apple example highlights the fact that employers, especially large corporations, do not need insurance proceeds to serve as protection against the possibility of losing important employees. Companies especially do not need tax breaks for the proceeds from such policies.⁸¹ A true insurable interest does not exist in the modern employment relationship; employees have become dispensable and companies have learned to cope with the loss of any employee, even the most highly paid officer.

The primary rationale behind life insurance is to make sure that a family is not left destitute in the case of a family member's death. While this rationale might exist for some small businesses, it does not exist for large corporations. Thus, the modern employment context resembles a famous exchange between James Bond and his nemesis Auric Goldfinger in the 1964 movie *Goldfinger*:

Goldfinger [Speaking to Bond, who is about to be cut in half by a laser]: "There is nothing you can talk to me about that I don't already know."

Bond: "Well you're forgetting one thing. If I fail to report, 008 replaces me."

Goldfinger: "I trust he will be more successful."⁸²

As challenging or difficult as any job may be, a corporation will not be left destitute simply due to the death of one employee. Modern day employers can survive the loss of an employee without reaping federal tax benefits.

B. ACCELERATING THE DEATH OF THE EMPLOYEE

Due to the lack of an insurable interest, the COLI system creates a scenario by which an employer is incentivized for her employee to die quickly. This rationale formed the basis for the court's conclusion in *Mayo*. But even if some courts invalidate extreme forms of COLI or Dead Peasant policies, this improper incentive will usually exist in the context of COLI unless the employer has a true insurable interest in a key employee.

The incentive that one might have to accelerate the death of the insured formed the basis for the insurable interest requirement. COLI

81. For a discussion on the tax breaks afforded to companies who collect profits on COLI, see discussion *infra* Part II.C.

82. *GOLDFINGER* (Eon Productions 1964).

policies create the same incentive for an employer: An employer could overwork an employee or become less concerned about dangerous working conditions. A company could place insured workers into more dangerous jobs or spend less money on safety accommodations. Additionally, COLI policies may have contributed to the decisions that several companies have made to refuse to provide employees with health care plans.⁸³

While some of these scenarios might seem extreme, it is not difficult to imagine a large corporation employing many of these tactics. Even small businesses might be susceptible to some of these problems; although not necessarily acting maliciously, the insurance policy might be a factor in the company's decision to provide the employee with fewer accommodations. For example, if a company of forty workers is choosing whether to provide health insurance to its employees, it may be persuaded not to do so if it also happens to have a life insurance policy out on every employee. The small company may not actively want its employees to die, but may be incentivized enough by the death benefits and tax advantages that come from failing to provide health insurance. Moreover, the larger a company is, the stronger these incentives will be. Although it is impossible to know whether employers have purposely taken risks to ensure the accelerated death of their employees, with the COLI system the possibility exists for companies to exploit any possible advantage to increase profit.

C. TAXPAYERS FUND COLI

Additionally, COLI policies are problematic because they are expensive for taxpayers. Given that the policies lack a legitimate insurable interest, companies should not be able to profit at the expense of taxpayers.

Employers and insurance companies can reap profits from COLI policies due to the tax benefits afforded to life insurance proceeds. Prior to 1996, companies benefitted from two distinct tax advantages: 1) the ability to deduct interest on loans taken out to finance COLI policies ("deductibility of interest advantage"); and 2) excluding death benefits received on policies from gross income when reporting federal taxes

83. As of October 2005, only forty-four percent of Wal-Mart's 1.3 million workers in the United States were provided with health insurance. See Aaron Bernstein, *A Stepped-Up Assault on Wal-Mart*, BUSINESSWEEK (Oct. 19, 2005), <http://www.businessweek.com/stories/2005-10-19/a-stepped-up-assault-on-wal-mart>. Under the Affordable Care Act, companies with more than fifty employees will be required to provide health insurance for employees and dependents starting in 2014. See I.R.C. § 4980H (2011). However, under new rules promulgated by the Internal Revenue Service pursuant to the Affordable Care Act, employers will not be subject to any penalties for failure to provide coverage if family coverage is unaffordable to those employees. See Robert Pear, *Employers Must Offer Family Care, Affordable or Not*, N.Y. TIMES, Jan. 1, 2013, at A13.

(“death benefits exclusion”).⁸⁴ The deductibility of interest advantage was eliminated by Congress through the enactment of the Health Insurance Portability and Accountability Act of 1996.⁸⁵ The death benefits exclusion remains in place although Congress limited it through Congressional amendments to the Pension Protection Act of 2006 (“PPA”). Because the death benefits exclusion is still in place, this Note primarily focuses on that tax advantage.

Under the Internal Revenue Code (the “Code”), any money received on the payout of a life insurance policy is excluded from gross income and not subject to federal income taxation.⁸⁶ Therefore, the beneficiary of a policy collects any money received tax-free when an insured dies.⁸⁷ The PPA narrowed the type of employees whose death benefits could be excluded from gross income.⁸⁸ Part III of this Note analyzes the amendments to the PPA and the current state of the law and argues that the amendments have not removed all the tax benefits an employer enjoys, especially the benefits for large corporations, with the result that Dead Peasant policies have continued to thrive.

Mayo demonstrates how larger companies can exploit the death benefits exclusion: the larger the company and the number of employees insured, the greater the likelihood that the company will profit. Wal-Mart’s scheme—at issue in *Mayo*—was calculated: it insured every hourly employee, knowing that enough would die to allow Wal-Mart to turn a profit. This type of scheme benefits larger companies: with more employees, a company could be more confident that enough death benefits could accrue to help the company. Given that it is extremely unlikely that Wal-Mart considers every employee to be irreplaceable, the policy to insure all hourly employees is a statistical method of taking advantage of the tax benefits from COLI. Moreover, the case demonstrates how COLI policies might be more profitable if taken out on lower-income workers. Life expectancy is negatively correlated with income—the less money an individual makes the more likely that individual will die at an early age.⁸⁹

84. See generally Craig E. Behrenfeld & Erica Good Pless, *Employer-Owned Life Insurance After the Pension Protection Act of 2006*, 83 FLA. B.J. 47, 47–48 (2009).

85. *Id.*

86. I.R.C. § 101(a)(1).

87. See *In re CM Holdings, Inc.*, 254 B.R. 578, 581 (D. Del. 2000), *aff’d*, 301 F.3d 96 (3d Cir. 2002); *Dow Chem. Co. v. United States*, 250 F. Supp. 2d 748, 756 (E.D. Mich. 2003).

88. See discussion *infra* Part III.A.

89. The first famous international study of this correlation was conducted by Samuel H. Preston when he created the so-called “Preston Curve,” which analyzed rich and poor nations comparatively. See Samuel H. Preston, *The Changing Relation Between Mortality and Level of Economic Development*, 29 POPULATION STUD. 231, 231 (1975). More recent studies demonstrate that the correlation between income and life expectancy in the United States has grown in the past couple of

Companies and insurers both profit from the tax system created by the death benefits exclusion. Because an employer can gain large sums of money by excluding death benefits from its reported income, it can take on more risk in purchasing policies on an employee, which allows insurance companies to profit through premiums. Due to the fact that insurers are not required to disclose anything about profits from issuing COLI policies, it is impossible to determine how much insurers profit. However, some data suggest that COLI insurance is more profitable than other types of insurance for the big insurers. For example, in the first nine months of 2002, Money Group Inc.'s sales of life insurance to companies increased by 128% to a total of \$124 million, while all other life insurance sales fell three percent.⁹⁰ Therefore, employers were not the only entities to abuse the system created by the death benefits exclusion—insurance companies continued to issue COLI policies even under circumstances where the insurance might not be for key employees.

The death benefits exclusion creates a public policy concern because taxpayers are funding COLI policies for large corporations and insurance companies. Tax revenues that would otherwise be collected are given back to the companies rather than taxpayers. The federal government could spend tax money gained by an elimination of the death benefits exclusion on fiscal programs or give it back to individuals in the form of tax credits. Even if COLI policies were rationally justified as key-man policies (this Note argues they are not), it is still problematic that the public must fund the tax breaks gained from the payout on these policies. The system created is one in which money flows from the taxpayers to support a gamble that allows insurance companies and large corporations to profit. Even if other public policy concerns were not present, at the very least corporations and insurers should have to take risks without the benefit of taxpayer money.

D. MORAL REPREHENSIBILITY OF LIFE-WAGERING

In addition to the other policy concerns outlined in this section, gambling on employees' lives is morally wrong. A modern rationale that lies behind the insurable interest requirement concerns "the immorality

decades. See Sabrina Tavernise, *Life Spans Shrink for Least-Educated Whites in U.S.*, N.Y. TIMES (Sept. 20, 2012), <http://www.nytimes.com/2012/09/21/us/life-expectancy-for-less-educated-whites-in-us-is-shrinking.html>; see also Paul Krugman, *Live Long and Prosper*, N.Y. TIMES THE CONSCIENCE OF A LIBERAL BLOG (Aug. 13, 2010, 2:36 PM), <http://krugman.blogs.nytimes.com/2010/08/13/live-long-and-prosper-2>.

90. Ellen E. Schultz & Theo Francis, *How Life Insurance Morphed into a Corporate Finance Tool*, WALL ST. J. (Dec. 30, 2002), http://online.wsj.com/public/resources/documents/dec_30_one.htm.

inherent in gambling on the life of another human being.”⁹¹ Courts have applied this rationale, which dates back to nineteenth-century common law, when invalidating modern STOLI policies.⁹²

In the modern employment arrangement, many employees do not know the owners of the company that employs them. Therefore, COLI policies create parties that are as unfamiliar to each other as those of STOLI policies. Only in a small business context would the purchaser of a policy be well acquainted with an individual. Even in such a context, an employer holding COLI on its employees should be forced to prove it has a valid insurable interest; otherwise the policy is tantamount to a wagering contract on a human being's life.

III. ANALYZING THE CONGRESSIONAL RESPONSE

COLI and Dead Peasant policies continue to thrive as the death benefits exclusion remains in place. While Congress has acted to limit some of the profits employers and insurers can reap from the COLI system, the congressional response has not eliminated COLI. In fact, congressional action has created additional problems for the COLI system. This Part first summarizes two congressional responses created by the PPA: 1) the death benefits exclusion; and 2) the consent and notice requirements. This Part then analyzes the changes in the law, summarizing the current state of COLI and criticizing the inadequacy of congressional action.

A. CONGRESSIONAL RESPONSE CREATED BY THE PPA

I. *The Narrowing of the Death Benefits Exclusion*

With the spotlight on Dead Peasant policies following *Mayo*, Congress set its sights on reforming COLI to end the practice of Dead Peasant policies. Prior to 2006, most companies benefitted from the death benefits exclusion, even after Congress ended the ability for companies to deduct interest on loans taken out to purchase COLI with the passage of the Health Insurance Portability and Accountability Act in 1996.⁹³ However, early legislative attempts specifically designed to address the problems of COLI failed.⁹⁴ In 2006, Congress passed reform

91. Robert S. Bloink, *Catalysts for Clarification: Modern Twists on the Insurable Interest Requirement for Life Insurance*, 17 CONN. INS. L.J. 55, 60 (2010).

92. “A policy, obtained by a party who has no interest in the subject of insurance, is a mere wager policy.” *Kramer v. Phoenix Life Ins. Co.*, 940 N.E. 2d 535, 539 (2010) (quoting *Ruse v. Mut. Benefit Life Ins. Co.*, 23 N.Y. 516, 523 (1861)).

93. See discussion *supra* note 85.

94. In 2002, Congressman Gene Green (D-Tex.) introduced a bill requiring notification to employees for COLI policies, but the bill died in committee. See *Rush, supra* note 48, at 161 n.190.

through amendments to the Code as part of the PPA.⁹⁵ The act primarily addressed employee pension plans, but the revisions to the Code were specifically designed to prevent the abuse of Dead Peasant policies.⁹⁶

The Code section 101(a)(1) provides the general rule for excluding insurance benefits from total income: “Except as otherwise provided in . . . subsection (j), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.”⁹⁷ Because of this exclusion, individuals or companies can receive a payout on a life insurance contract without having to pay any federal income tax.

The PPA amendments, which added section 101(j), limited this exclusion by shielding COLI policies from exemption under the general income provision.⁹⁸ Therefore, a widow, for example, could continue to exclude death benefits received from her husband’s death on a policy in which she is a beneficiary under 101(a)(1). On the other hand, a company generally cannot exclude death benefits on a policy it took out on its employee under 101(j).

However, Congress also created an exception to the exception; in other words, the 101(j) exception only applies to certain COLI plans, while others are still subject to the 101(a)(1) exclusion. Section 101(j)(2)(A) effectively allows a company to continue to exclude death benefits from total income in the following situations: 1) the insured under the policy was an employee within twelve months of the insured’s death; 2) the insured was a director; or 3) the insured was a “highly compensated employee,” defined as within the thirty-five percent of income-earners at the company.⁹⁹ These limitations comport with the original rationale behind key-person COLI policies by not allowing employers to gain advantage of the death benefits exclusion for plans involving employees who are not integral to the company’s success. In sum, the PPA attempted to eliminate Dead Peasant policies by narrowing the range of employees

Senator John Edwards (D-N.C.) and Congressman Rahm Emanuel (D-Ill.) introduced similar bills in 2003, but they never passed. *Id.*

95. Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780.

96. For a summary of the provisions of the PPA specifically addressing COLI policies, see generally Behrenfeld & Pless, *supra* note 84.

97. I.R.C. § 101(a)(1) (2012).

98. *Id.* § 101(j)(1).

99. *Id.* § 101(j)(2)(A). The full text of subsection (A) states, “[e]xceptions based on insured’s status: Any amount received by reason of the death of an insured who, with respect to an applicable policyholder—(i) was an employee at any time during the 12-month period before the insured’s death, or (ii) is, at the time the contract is issued—(I) a director, (II) a highly compensated employee within the meaning of section 414(q) . . . or (III) a highly compensated individual within the meaning of section 105(h)(5), except that ‘35 percent’ shall be substituted for ‘25 percent’ in subparagraph (C) thereof.” *Id.*

eligible for an employer to claim death benefits tax-free, but still allows an employer to exclude such benefits for current or important employees.

2. *Consent and Notice requirements*

The PPA also amended the Code by requiring employers to obtain the consent of and give notice to employees before being eligible to claim the 101(a)(1) exclusion of gross income. Section 101(j)(4), which outlines notice and consent requirements, reads as follows:

The notice and consent requirements of this paragraph are met if, before the issuance of the contract, the employee—

(A) is notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued,

(B) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and

(C) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.¹⁰⁰

Therefore, in order for the 101(a)(1) exclusion to be triggered, an employer must obtain consent from the employee, even if it was not limited by the 101(j) exception. For example, a company would have to obtain the consent of its CEO even if she was the highest paid person in the company in order to claim the death benefits exclusion upon that CEO's death. While the consent and notice requirements apply to all employees, Congress most likely enacted consent and notice requirements in response to the highly publicized Dead Peasant cases, such as that of Felipe Tillman.¹⁰¹

B. ADDITIONAL PROBLEMS CREATED BY CONGRESS

I. *Unanswered Questions Under the PPA*

While the congressional amendments are significant in limiting COLI, the current law does not go far enough in preventing the dangers of COLI outlined in Part II. First, the law leaves important questions unanswered, allowing large companies to utilize loopholes and continue to abuse COLI. Secondly, the law focuses too heavily on consent and notice but fails to consider the insurable interest requirement in COLI policies.

The first problem not addressed by the PPA is the ability of large companies to exploit tax advantages. The new law creates a one-size-fits-all standard for allowing companies to claim tax benefits under COLI

100. *Id.* § 101(j)(4).

101. *See* discussion *supra* notes 59–64.

policies because the statute does not distinguish between big and small businesses. The exceptions to the exception (or the provisions in section 101(j)(2)(A) that re-trigger the death benefits exclusion) apply regardless of the size of a company.¹⁰² Therefore, a company of any size may insure any employee within the top thirty-five percent of income-earners of the company and collect tax-free death benefits at a later date.

By failing to distinguish between company sizes, the advantages for big companies to abuse COLI remain in effect. For example, suppose a small business insures all forty of its employees under a life insurance plan. After the employee passes away, the small business would be denied the tax-free benefits for twenty-six of those employees and be able to collect tax-free benefits on only fourteen of the employees. In contrast, Wal-Mart, who has approximately two million employees,¹⁰³ would be able to collect tax-free death benefits on 700,000 employees. This discrepancy is problematic because it is not difficult to imagine how all forty employees for the small business might be integral to the company's success, whereas a large percentage of the 700,000 Wal-Mart employees are likely to be easily replaceable. Therefore, there is no need to compensate Wal-Mart in the case of the death of those employees because Wal-Mart does not have a legitimate insurable interest in the employees.

Another important point not addressed by the PPA concerns how long an employee has to work at the company in order for the company to claim tax-free benefits. Part of what made Dan and Irma Johnson's story¹⁰⁴ seem so egregious to viewers of Michael Moore's film, *Capitalism: A Love Story*, was the fact that Dan Johnson had only worked for Wal-Mart for a couple of months.¹⁰⁵ Under the PPA, the ability of Wal-Mart to insure Dan would continue so long as he was compensated in the top thirty-five percent of the company or employed within the last twelve months before his death.

This problem could have been easily fixed by the new law. For example, Congress could have enacted a provision requiring a year's worth of service as a reasonably low bar for an employer to claim tax-free benefits. Requiring a certain amount of time would ensure that the employee is valuable to the company. One counterargument might be

102. The COLI amendments under the PPA do not distinguish between companies based on size. In comparison, the Affordable Care Act is an example of a law that distinguishes between large and small companies. *See* discussion *supra* note 83. Under that law, large companies comprise those with more than fifty employees and those large companies are subject to requirements to provide health insurance for employees.

103. Loren Berlin, *Walmart's How Big? What the Huge Numbers Really Mean*, DAILYFINANCE (May 28, 2011, 9:00 AM), <http://www.dailyfinance.com/2011/05/28/walmarts-how-big-what-the-huge-numbers-really-mean>.

104. *See supra* notes 1–3.

105. *See supra* note 1.

that a newly-hired CEO would not be eligible for the gross income exclusion under this type of law. Therefore, the best way the law could be written is to create a length of time requirement that varies depending on the type of employees. Highly-compensated employees and directors could be subject to a very short time period such as one week, whereas rank-and-file employees could be subject to a longer requirement such as one year.

2. *Over-Focusing on Consent and Notice*

One potential reason that the above concerns were left unaddressed might be that Congress figured that requiring consent and notice solved most of the problems that lay behind Dead Peasant policies. After all, many of the popular stories documenting the abuse of COLIs taken out on rank-and-file employees involved people who did not consent and were not given notice to such policies.¹⁰⁶ Some scholars predicted that the 101(j)(4) requirements would standardize notice and consent across the insurance industry,¹⁰⁷ but issues concerning whether consent was properly obtained still persist despite these requirements.¹⁰⁸

Congress should turn its focus to amending the PPA in a way that is consistent with the insurable interest requirement by forcing employers to demonstrate a true insurable interest in the life of the employee under the COLI policy before they gain any tax advantages. The prior amendments ultimately fail to restrict the ability of companies to take out COLI on employees. While Congress might have thought that the limitation for policies on employees within the top thirty-five percent of income-earners brought the tax breaks in line with the insurable interest requirement, this is an inadequate measure to ensure the policies have a valid insurable interest. The focus of Congress should turn toward strengthening the limitations to provide that a company may only enjoy tax breaks if the policies have a valid insurable interest. Such a requirement would ensure that employers would not be incentivized to have their employees die early. This would preserve the public policy rationales for the insurable interest requirement in the employment context.

106. The policies taken out on Dan Johnson, see *supra* notes 1–3, and Felipe Tillman, see *supra* notes 59–64, lacked notice and consent.

107. See, e.g., Behrenfeld & Pless, *supra* note 84.

108. For example, Irma Johnson's lawsuit against Amegy Bank alleged that the bank knew that Johnson was cognitively impaired when he signed forms to comply with state consent requirements. Ashby Jones, 'Dead Peasant' Policies: The Next Big Thing in Insurance Litigation, WALL ST. J. (Feb. 24, 2009, 10:24 AM), <http://blogs.wsj.com/law/2009/02/24/dead-peasant-policies-the-next-big-thing-in-insurance-litigation>.

Additionally, consent might not be a difficult barrier for Dead Peasant policies, especially in a poor economy. If a worker has been unemployed for more than one year and is offered a job so long as she consents to a life insurance policy, it is doubtful that the employee would withhold consent. It is hard to imagine a minimum-wage employee at Wal-Mart withdrawing consent for a life insurance policy, especially if consent to the policy is a precondition to a job offer.

More importantly, obtaining consent has no bearing on the insurable interest question; simply because an employee agrees to an insurance policy does not change the interest the company has in the longevity of the employee. Giving proper consent and notice might make the policy seem less reprehensible in cases where the employee was never notified and never agreed to the policy, such as Dan Johnson's policy. But the focus around consent and notice fails to address the central problem with COLI policies, which is the circumvention of the insurable interest requirement. The lack of consent and notice to an employee is not the greatest danger of Dead Peasant insurance; rather, the incentive a company might have to accelerate the death of its workers is the gravest policy concern.

C. CURRENT STATE OF COLI: DEAD PEASANT POLICIES ARE NOT DEAD

Although the 2006 congressional amendments attempted to weaken the practice of Dead Peasant policies, there are indications that companies continue to exploit the death benefits exclusion. It is difficult to determine the extent to which companies are purchasing life insurance on their employees primarily because most companies are not required to disclose such information.¹⁰⁹ Only banks are required to disclose ownership of Dead Peasant policies.¹¹⁰ While it is unknown how many COLI policies are being purchased by companies, the amount that banks have purchased indicates that COLI remains a profitable investment for companies.

Banks continued to take out millions of dollars in insurance premiums on their own employees after 2006. In the first quarter of 2009, Bank of America held \$17.3 billion in life insurance on its workers; Wachovia held \$12 billion; JPMorgan Chase & Co. held \$11.1 billion; and Wells Fargo held \$5.7 billion.¹¹¹ At the end of 2008, banks had \$122.3 billion in life insurance on their employees.¹¹² This figure was double what banks had at the end of 2004,¹¹³ demonstrating that the 2006 amendments had little effect on the total money banks held in life

109. Schultz & Francis, *supra* note 54.

110. *Id.*

111. Ellen E. Schultz, *Banks Use Life Insurance to Fund Bonuses*, WALL ST. J., May 20, 2009, at C1.

112. *Id.*

113. *Id.*

insurance on their employees. Consultants estimate that over the coming decades, banks will receive \$400 billion in total death benefits.¹¹⁴

The continuation of Dead Peasant policies is not solely limited to banks. It is unclear how much money other companies have spent on life insurance for employees. However, the *Wall Street Journal* identified companies that still held substantial COLI assets in 2009 including Fannie Mae, Freddie Mac, American International Group Inc. (“AIG”) and Tyson Foods Inc.¹¹⁵ If the figures that show the total amount of money banks hold are an indication of the benefits of COLI, it is likely that several other large corporations continue to collect billions of dollars in death benefits from COLI.

Companies do not need taxpayer-funded death benefits to cover the loss of any of their employees and COLI policies should be viewed as illegal wagering schemes that evade the insurable interest requirement. Each state and Congress should act immediately to eliminate or weaken COLI. The need for action is heightened by the fact that the practice of abusing COLI has continued despite the 2006 amendments.

IV. POSSIBLE SOLUTIONS

Three possible legal solutions exist to deal with eliminating or weakening Dead Peasant policies: 1) States can amend insurable interest statutes to explicitly block an employer from insuring its employees; 2) Congress can amend the Pension Protection Act by eliminating section 101(j) entirely and remove the tax-free benefits enjoyed by companies for their COLI policies; or 3) Congress can amend the PPA less drastically by distinguishing between large and small companies and addressing other problems with the law that are discussed in Part III above. The first solution would be the most robust way to eliminate the abuse of COLI policies, but is extremely impractical since each state would have to amend its insurable interest laws separately. The second solution is the strongest way for the federal government to deal with the issue but might be politically unpopular. The third solution is the most practical, but would also be less effective than the other two options.

A. AMENDING INSURABLE INTEREST STATUTES STATE BY STATE

The first solution is for each state to eliminate the ability of an employer to insure its own employees. States could remove any language such as “substantial economic interest” from the insurable interest statutes or explicitly mention that an employment relationship is not enough to satisfy the insurable interest requirement. However, there may be

¹¹⁴ *Id.*

¹¹⁵ *Id.*

situations other than employment where a substantial economic interest qualifies for an insurable interest. Therefore, the best option is for each state to specifically address COLI policies. Most states have already enacted insurable interest statutes that are designed to address modern-day STOLI arrangements. Therefore, states could easily add a section to the same set of statutes to eliminate COLI specifically while retaining the language for “substantial economic interest.”

This solution is impractical because it would have to be enacted on a state-by-state basis; it is difficult for the federal government to alter insurance law. Insurance law has traditionally been regulated by the states.¹¹⁶ Technically, the federal government under the McCarran-Ferguson Act can preempt state insurance law if the legislation specifically mentions that it intends to regulate insurance.¹¹⁷ However, it might be difficult to persuade Congress to pass a sweeping law that would alter the states’ insurable interest statutes.

Absent federal legislation, all fifty states would have to eliminate COLI in order for this solution to be effective. If one state refuses to adopt this kind of insurable interest statute, then a large company could incorporate itself there in hopes of continuing the practice of insuring its employees.¹¹⁸ Although it is not clear whether the lure for favorable COLI laws would prompt a business to incorporate in certain states, this solution leaves room for companies to exploit favorable laws from states that have failed to enact laws to combat COLI.

B. CONGRESS SHOULD ELIMINATE SECTION 101(J)

The most effective solution is for Congress to amend the provisions of the Code to eliminate life insurance proceeds as being exempt from gross income for COLI policies. Congress has already specifically

¹¹⁶ For a comprehensive history of the development of state insurance regulation and issues of federalism around insurance regulation, see generally Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625 (1999).

¹¹⁷ 15 U.S.C. § 1012(b) (2012) (“No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance.”).

¹¹⁸ The decision of a company to re-incorporate in a different state to obtain favorable laws is not an uncommon phenomenon. For example, companies have re-incorporated in Delaware due to favorable corporate law and tax advantages. See John W. Edwards II, *Busy Bees and Busybodies: The Extraterritorial Reach of California Corporate Law*, 11 U.C. DAVIS BUS. L.J. 1, 3–5 (2010) (discussing the advantages companies gain from Delaware corporate law); see also Leslie Wayne, *How Delaware Thrives as a Corporate Tax Haven*, N.Y. TIMES (June 30, 2012), <http://www.nytimes.com/2012/07/01/business/how-delaware-thrives-as-a-corporate-tax-haven.html>.

addressed COLI policies in the 2006 amendments to the PPA.¹¹⁹ Here, Congress would be eliminating the practice entirely.

This solution has numerous advantages. First, it would completely thwart the ability of large corporations to carry Dead Peasant policies. Companies would be greatly restrained in their efforts to profit from taxpayer funding through the death benefits exclusion on their COLI policies. Second, this solution would reinforce the insurable interest requirement. Any investor who accepts the transfer of a life insurance policy must still prove an insurable interest—employment would no longer be a basis for doing so. Third, because Congress is amending the law, employers in all states would be forced to abide by it.

One counterargument against this solution might be that an elimination of section 101(j) is too drastic because it would thwart small companies from being able to insure their own employees. However, because employers in a modern age should be ready to replace any employee, there is no need for small companies to insure their own employees. Furthermore, eliminating the death benefits exclusion does not prevent a company from insuring its employees; it would only thwart the ability of that small company to claim any death benefits tax-free. If a company of ten people relies on all ten people and would be greatly hurt if any employee died, the company may still insure all ten employees. Under this solution, the company would merely lose the ability to claim death benefits tax free.

Given that Dead Peasant policies are objectionable because companies profit from employees' deaths, eliminating tax benefits would eliminate most of the public policy concerns associated with COLI. This solution naturally hurts bigger companies more because they are the ones who rely on the tax benefits in order to turn a profit. Large companies may still choose to insure CEOs or other highly compensated employees. Eliminating the tax benefits would likely lead to the gradual elimination of the practice and at least taxpayer money would not be supporting the practice.

A disadvantage of this approach is that it may not be politically popular. The counterarguments raised above might be used to dismiss the solution and it may be seen as a drastic solution. Therefore, this Note proposes one final argument to fix the law with a more nuanced, less drastic congressional approach.

C. CONGRESS SHOULD AMEND THE PPA

The final solution is for Congress to amend the PPA by leaving the death benefits exclusion in place but limiting its application. This

¹¹⁹. See discussion *supra* Part III.A.

solution accounts for the questions that are unanswered by the PPA identified in Part III, *supra*.

First, the law should distinguish big companies from small companies. The one-size-fits-all nature of the law should change so that large companies cannot continue to exploit the profits available from Dead Peasant policies. Congress could amend the law in several different ways: 1) placing a cap on the number of employees whose death benefits might be claimed as exempt from gross income; 2) placing a cap on the total dollar amount of life insurance a company may take out; or 3) creating a system where the larger a company is the more restricted it is in claiming death benefits.

The third option outlined above would weaken the ability of companies to take out Dead Peasant policies because large corporations would face restrictions on how many rank-and-file employees they could insure. The restrictions could include higher barriers for the exceptions already in place. For example, the law could require that all companies with more than 500 employees can only claim an exception for highly compensated employees if the employee is in the top ten percent of income-earners, rather than the top thirty-five percent. Alternatively, the law could restrict companies of more than 500 employees from claiming death benefits for current employees. A number of options could be explored, but taking account for the size of the company and restricting the tax benefits for larger companies would erode the ability of companies to abuse COLI.

Second, the law should require an employee to have worked a certain length of time before a company could claim death benefits on an employee. As currently written, an employee could work for a company for two days and if a life insurance policy were taken out, the company could still claim death benefits in the case of death so long as the income, consent, and notice requirements were met. The law should require an employee to work for a company for a given time period, such as one year. Imposing a length of time requirement is consistent with the insurable interest requirement because it is reasonable to require that the employee work for the company for a certain period of time.

Finally, the law should abolish or limit section 101(j)(2)(A)(i), the provision that exempts policies for current employees or employees who worked for the company within twelve months of their death. Companies should not be able to insure employees and collect tax benefits merely because the employee currently works for the company. Simply because an employee works for a company does not establish whether the company has an insurable interest. If Wal-Mart decides to insure a minimum-wage employee, the mere fact that the employee died while working for Wal-Mart does not establish a valid insurable interest. More

likely, large companies would insure these employees as a way to profit. At the very least, the statutory provision for claiming employees who died less than a year after leaving the company should be abolished.

Though this Note has proffered some possible limitations, the precise time length, income percentage, or company size that would best eliminate the policy concerns of COLI policies can be determined by Congressional studies. While many of the time periods and figures proposed here may seem arbitrary, Congress needs to change the law to eliminate the public policy consequences associated with COLI. Congressional studies and fact-finding could help determine what figures and time periods would be acceptable to amend the law in the fairest way. This Note simply points out that distinguishing between large and small companies, imposing a length of time requirement for employees, and abolishing the exceptions for current employees and employees who worked at a company within a year of their death are all options that would fix the problems with the current law. Ultimately, as argued above, abolishing the death benefits exclusion is a more robust option, but this solution provides a more realistic, less drastic way for Congress to amend the law.

CONCLUSION

Life insurance on rank-and-file employees, or Dead Peasant insurance, abuses COLI. The practice is not consistent with the insurable interest requirement and amounts to a way for companies to profit off of employees by gambling on their lives. Courts and legislatures have already recognized the illegality of STOLI and should analyze COLI in the same way. States should abolish the ability of employers to insure employees under their insurable interest statutes.

Congress has already shown itself willing to curb COLI abuse, but its efforts have been largely ineffective. The 2006 amendments to the PPA that target COLI do not adequately address the public policy concerns of COLI and create additional problems that give advantages to larger companies. Moreover, Dead Peasant policies persist as banks and other companies have continued to pour billions of dollars into the profitable enterprise. Congress should abolish the exception in the Code under section 101(j) which permits an employer to exempt COLI death benefits from gross income. At the very least, Congress should amend the law to take account for its flaws by distinguishing between company size, abolishing the provisions that allows companies to insure current employees, and imposing a requirement for length of time an employee must work at a company before being insured.
