INSURE POLICY PLUS SERVICES (P) LTD. V. LIFE INSURANCE CORPORATION OF INDIA: CAN LIFE INSURANCE POLICIES BE TRADED?

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Beginning with an analysis of the 2007 Mumbai High Court ruling in Insure Policy Plus Services (P) Ltd. v. Life Insurance Corporation of India, this paper goes on to discuss its implications in the Indian scenario. The authors also elucidate on the economic benefits and legality of assigning life insurance policies to third parties without an insurable interest in the life of the policyholder. The paper also goes on to examine life insurance policy trading in the secondary market, as prevalent in the West, where it is a flourishing business and tries to ascertain whether India will be receptive to the same.

I. INTRODUCTION

On March 22, 2007, the Division Bench of the Bombay High Court held that life insurance policies can be freely assigned to corporations for the purpose of trading,[1] giving rise to speculations and apprehensions in the mind of the common man. The fundamental and major purpose of a Life Insurance Policy is financial security and protection of the family. Upon death of the insured or maturity of the policy, a value becomes payable to his representatives and nominees. Leaving aside the operation of expected perils and subject to insured's compliance with terms and conditions of the policy, the insurer is bound to pay the sum assured at a pre-determined future date. A Life Insurance Policy is also regarded as a property under the law. Credit institutions lend money on the security of policies up to a certain percentage of their cash value. On the death of the insured, his personal representatives can collect the assured sum, which forms part of the insured's estate in the same way as any other debt due to the insured. Creditors can also attach the policy in execution, like any other property belonging to the insured. The

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1 Insure Policy Plus Services (India) Pvt Ltd. v. Life Insurance Corporation of India and the Insurance Regulatory and Development Authority, 2007 (109) Bom LR 559, [2007] 79 SCL 583 (Bom.).

holder of the policy can deal with it like any other property, by way of sale, mortgage or create a trust out of it or bequeath it.[2] As has been observed by Justice Holmes, life insurance has become one of the best-recognized forms of investment and self-compelled saving and should have all the required features of a property.[3]

The right to assign is also one of the rights attached with the notion of property. Life insurance policies can be assigned by the policy holder in favour of a third party, with or without consideration, whereby the assignee continues paying the premium and enjoys all the benefits attached with the policy, once it matures.[4] Thus, life insurance policies are very similar to properties like stock certificates, corporate bonds or other actionable claims, with the exception that it is not a negotiable instrument and so cannot confer more rights to the assignee than what the assignor himself possesses. Now, as per the ruling of the Bombay High Court, life insurance policies can be used as tradable commodities whereby a third party, with no insurable interest[5] in the life of the policyholder will get the benefits of the policy. The major concern that arises is whether it is feasible in India and hence, the Supreme Court decision on the issue is eagerly awaited.

In the first section of this paper, a detailed analysis of pertinent judicial pronouncements along with a discussion of the relevant law shall be provided. The next part shall examine the secondary market of life insurance policies as prevalent in foreign jurisdictions along with the regulatory environment. Finally, in conclusion, we shall ascertain the viability of such a secondary market in India and the future implications of the Bombay High Court decision.

II. BACKGROUND OF THE CASE

A. LEGAL BACKGROUND

The Indian law regarding assignment of insurance policies, prior to the enactment of the Insurance Act, 1938 (*hereinafter* referred to as the Act) was contained in Sections 130 to 132 and 135 of the Transfer of Property Act, 1882. As per these provisions, the transfer of an actionable claim could be affected by an instrument in writing signed by the transferor and thereupon, all rights and remedies would vest upon the transferee. An assignee of life insurance policy could not sue in his own name and upon the death of the assignor, his representatives would be a necessary party to a suit by the assignee. Section 38 of the Act now

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[2] AVTAR SINGH, PRINCIPLES OF INSURANCE LAW 488 (2002).

[3] Grigsby v. Russel, 223 US 149 (1911) as quoted in AVTAR SINGH, PRINCIPLES OF INSURANCE LAW 488 (2002).

[4] *See* § 38 of the Insurance Act, 1938.

[5] The concept of insurable interest has been explained in the later part of this paper.

governs such transfer.[6] It lays down an exclusive method of effecting assignment of life insurance policies. It endorses any kind of transfer – sale, mortgage, pledge, gift or assignment of a life policy, be it absolute or conditional.[7] Such transfer can be made to any person, who is not legally disqualified to be a transferee and law has put no restriction in this issue.

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[6] § 38 - (1) A transfer or assignment of a policy of life insurance, whether with or without consideration, may be made only by an endorsement upon the policy itself or by a separate instrument, signed in either case by the transferor or by the assignor or his duly authorised agent and attested by at least one witness, specifically setting forth the fact of transfer or assignment.

(2) The transfer or assignment shall be complete and effectual upon the execution of such endorsement or instrument duly attested but except where the transfer or assignment is in favour of the insurer shall not be operative as against an Insurer and shall not confer upon the transferee or assignee, or his legal representative, any right to sue for the amount of such policy or the moneys secured thereby until a notice in writing of the transfer or assignment if and either the said endorsement or instrument itself or a copy thereof certified to be correct by both transferor and transferee or their duly authorised agents have been delivered to the insurer:

> *Provided* that where the insurer maintains one or more places of business in India, such notice shall be delivered only at the place in [India] mentioned in the policy for the purpose or at his principal place of business in India.

(3) The date on which the notice referred to in sub-section (2) is delivered to the insurer shall regulate the priority of all claims under a transfer or assignment as between persons interested in the policy: and where there is more then one instrument of transfer or assignment, the priority of the claims under such instruments shall be governed by the order in which the notices referred to in sub-section (2) are delivered.

(4) Upon the receipt of the notice referred to in sub-section (2), the insurer shall record the fact of such transfer or assignment together with the date thereof and the name of the transferee or the assignee and shall, on the request of the person by whom the notice was given, or of the transferee or assignee, on payment of a fee not exceeding one rupee, grant a written acknowledgment of the receipt of such notice; and any such acknowledgment shall be conclusive evidence against the insurer that he has duly received the notice to which such acknowledgment relates.

(5) Subject to the terms and conditions of the transfer or assignment, the insurer shall, from the date of the receipt of the notice referred to in subsection (2), recognise the transferee or assignee named in the notice as the only person entitled to benefit under the policy, and such person shall subject to all liabilities and equities to which the transferor or assignor was subject at the date of the transfer or assignment and may institute any proceedings in relation to the policy without obtaining the consent of the transferor or assignor or making him a party to such proceedings.

(6) Any rights and remedies of an assignee or transferee of a policy of life insurance under an assignment or transfer affected prior to the commencement of this Act shall not be affected by the provisions of this section.

(7) Notwithstanding any law or custom having the force of law to the contrary, and assignment in favour of a person made with the condition that it shall be inoperative or that the interest shall pass to some other person on the happening of a specified event during the lifetime of the person whose life is insured, and an assignment in favour of the survivor or survivors of a number of persons shall be valid.

[7] Conditional Assignment is the kind of transfer, whereby, on the happening of a specified event, which does not depend on the will of the assignor, the assignment will be suspended or revoked wholly or in part. Absolute Assignment is the kind of transfer, whereby all the rights, title and interest which the assignor has in the policy passes on to the assignee without reversion to the assignor or his estate in any event.

On assigning the policy, the assignor i.e. the assured or the policyholder loses his right over the policy and the assignee becomes its owner. The assignee can further re-assign the policy and he also has a right to sue under the policy. A valid assignment once made cannot be cancelled. It is only by another valid assignment that the earlier assignment gets cancelled. In all cases, assignment automatically cancels the nomination. Under conditional assignment, if the conditional assignee dies, the benefit under the policy goes back to the life assured if surviving. Otherwise, the benefit goes to policyholder's nominee. Under absolute assignment, if the absolute assignee dies, the benefits under the policy go to the legal heirs of the assignee.[8]

B. THE FACTUAL BACKGROUND

Insure Policy Plus Services (*hereinafter* also referred to as IPPS) is a company, which carried out the business of assigning life insurance policies, issued by Life Insurance Corporation of India (*hereinafter* also referred to as LIC), to buyers after acquiring them from the policyholders for a consideration. When policyholders became unable to continue paying the premium, they could either surrender it to the LIC after the lapse of a minimum of three years for a surrender value,[9] or assign it to someone else for a consideration. IPPS paid a better consideration than the surrender value and thus acquired the policies. The company then assigned the same to a third party, who would pay the entire premium and upon maturity, get the insured amount, including tax-free interest.

As per Section 38, all duly assigned life insurance policies have to be notified to LIC for its records. All assignments by IPPS were recorded by the LIC till January-February 2003, when several branches of LIC in Nasik division refused to accept notices of assignments lodged by IPPS. On October 22, 2003, LIC issued a circular directing that assignment in favour of companies trading in policies should be declined. A similar Circular was again issued on March 2, 2005. IPPS filed a petition before the Bombay High Court, seeking a declaration, that the Insurance policies issued by LIC are tradable and assignable freely in accordance with the provisions of Insurance Act, 1938 and that the Circular dated October 22, 2003 and/ or March 2, 2005, and the actions of LIC in refusing to register the assignment of life insurance policies in favour of the company are illegal, null and void, being violative of the provisions of the Insurance Act, 1938 and *ultra vires* Article 14 and 19(1)(g) of the Constitution of India.

C. THE ARGUMENTS OF THE PARTIES

The case made out by IPPS is that policy is a movable property and the policyholder has an absolute right to deal with it in any manner whatsoever. Section 38 of the Act permits assignment of insurance policies in favour of any person, with

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[8] AVTAR SINGH, PRINCIPLES OF INSURANCE LAW 489 (2002).

[9] *See infra* note 27, for a discussion on Surrender Value.

or without consideration. Presence of an insurable interest is required at the time of issuing of the policy and not during subsequent transfer. Moreover, LIC was only required to record the instances of assignment, which was already valid by virtue of Section 38(1). Considering LIC permits assignment of life policies in favour of banks and financial institutions as a security, there is no ground why it should not be allowed in case of companies for the purpose of trading them. It is a widely known practice in US, where the market is estimated at 134 billion dollars and the UK where the size of business is 2 billion sterling pounds.

In their reply, LIC contended that insurable interest is a requirement, which should be present throughout the subsistence of the life insurance contract. Insurable interest is a pecuniary interest arising from the relationship of the party obtaining the policy, either as creditor or from ties of blood or marriage, as will justify a reasonable expectation of advantage or benefit from the continuance of life or a loss arising out of the extinction of such life.[10] In the absence of such an interest, the contract of insurance becomes a wagering contract, as it will create a desire for the event against which the insurance has been sought, and so should be condemned as violative of public policy. Such contracts are also null and void as per Section 30 of the Indian Contract Act. Assignments of life insurance policies in favour of banks as a collateral security is accepted by LIC since it has an insurable interest in the continuance of the life of the assured as the responsibility of paying premium continues with the policyholder and the security remains valid and enforceable for the entire duration of the policy. Moreover, the insurance scenario in India cannot be compared with that of UK or US, since in India, life insurance policies are a measure of social security for family members of the assured. Any trading in such policies amounts to gross affront to the value of life. The western countries have a well-developed social security system and hence the dependence on life policies is not significant. The policy issued by LIC is governed by the terms and conditions set out therein and a lapsed policy can be revived only by the procedure mentioned, at the sole discretion of the insured only. The impugned Circulars were issued by the LIC with the sole objective of protecting the interest of the policyholders and in discharge of the statutory obligation of implementing public policy.

Hon’ble Justices F. I. Rebello and Anoop V. Mohta, constituting the Division Bench of the High Court of Bombay gave their decision after a detailed examination of the issues as enumerated in this part. They unanimously upheld the view that a life insurance policy is a property of the holder, since it represents a right to recover certain sums of money from the insurance office in the eventuality of a certain event, and the premium may be considered as an investment with assured returns. Thus, the policyholder is free to deal with it, in any manner as he thinks fit, and that includes assigning it to a third party for a consideration.

[10] K.S.N. Murthy And Dr. KVS Sharma, Modern Law Of Insurance 55 (2002).

D. THE ISSUES RAISED AND DECIDED UPON

1. WHETHER LIFE INSURANCE IS A MEASURE OF SOCIAL SECURITY

The Life Insurance Corporation Act was enacted in 1956 with the purpose of nationalization of the business of life insurance and to provide for regulation and control of the business of LIC. The Statement of Objects and Reasons set out therein state that it was to ensure absolute security to the policyholder in the matter of life insurance, to spread insurance widely and in particular, to rural areas and also as a further step of effectively mobilizing public savings.[11] The Bench further went into the scheme of the Act and examined its different provisions as well. An amendment to the Act vide Act 41 of 1999 introduced Section 30A, whereby the exclusive privilege of carrying on life insurance business given to LIC, ceased from the commencement of the Insurance Regulatory and Development Authority Act, 1999 (*hereinafter* also referred to as IRDA Act). LIC, which was carrying on life insurance business in accordance with the provisions of the Insurance Act, 1938, ceased to have monopoly on Life Insurance business. Various private companies entered the business of issuing life insurance policies and are regulated by the Insurance Regulatory and Development Authority, (*hereinafter* also referred to as IRDA) established under the IRDA Act.

The benefits awarded by LIC like exemption of the principal amount and the sum allocated as bonus or interest from income tax under Section 10(1) (d) of the Income Tax Act, exemption of money payable under life insurance policy of the judgment debtor from attachment and sale during execution of any decree in a Civil Court under Section 60(kb) of the Civil Procedure Code are also provided by the private corporations, carrying on the business of providing life insurance. Therefore, even if the effect of a life policy has social benefits, it cannot be called solely a measure of social security. After the entry of private corporations in the insurance market, the act of issuing life policies by the LIC is also a business, carried in accordance with the existing laws.

This finding of the court is no doubt exemplary keeping in view the present commercial development of India. Insurance is no longer considered the mechanism of security but as a sound investment with assured returns. The economically emerging Indian market has to be competitive in all respects, so as to derive the best results out of all the players. Gone are the days when LIC could claim to have been the only institution in the insurance business, delivering social security, just because it has the financial backing of the government. In the present era of globalization, India cannot sit with her eyes closed to all possible business avenues in the name of social security.

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[11] *See* Statement of Objects and Reasons, Life Insurance Corporation Act, 1956.

2. WHETHER ABSENCE OF INSURABLE INTEREST MAKES THE POLICY A WAGERING CONTRACT

LIC contended that there must be insurable interest, at the time the policy is taken and also at the time of subsequent assignment. If there is no insurable interest throughout the subsistence of the contract of insurance, it would amount to wager and such contracts would, therefore, be against public policy. Wagering contracts are void under Section 30 of the Indian Contract Act. To locate the law relating to wagering contracts, the Bench referred to *Gherulal Parekh v. Mahadeodas Maiya,*[12] where the Supreme Court held that wagering contracts are those, where performance is not demanded but only a difference in price is predicated on happening of an event. There should be common intention between the parties to the wager that they should not demand delivery of the goods but should take only the difference in prices on the happening of an event.[13]

However, the argument of LIC that what is void, can also be dubbed as illegal, does not hold water since it is settled jurisprudence that no taint of illegality can be attached to something which is void, or in other words, unenforceable under the law.[14] The Bench of the Bombay High Court traced the law of wager in India and England and concluded that contracts of wager have never been struck down on the ground of illegality. While considering the law of insurable interest in the US, the Bench discussed some judgments to get a clear picture. In *Aetna Life Insurance Company v. David France and Lucetta*[15] and *Basil F Warnock v. George Davis,*[16] the issue under consideration was whether there is a lack of insurable interest during assignment of a life policy and whether it makes the same a wagering contract. The Supreme Court stated in *Basil Warnock* that "in all cases there must be a reasonable ground to expect some benefit or advantage from the continuance of the life of the assured, otherwise the contract is a mere wager, by which the assignee is directly interested in early death of the assured. Hence, the assignment of a policy to a party not having an insurable interest is as objectionable as taking out a policy without insurable interest."

The judgments in *Aetna* and *Basil Warnock* came up for consideration before the US Supreme Court in *Grigsby v. Russel,*[17] whereby the Court observed that life insurance policies have become one of the best recognized forms of

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[12] AIR 1959 SC 78.

[13] The Supreme Court in Gherulal Parekh also quoted Sir William Anson with approval, the definition of wager "as a promise to give money or moneys worth upon the determination or ascertainment of an uncertain event".

[14] The Supreme Court in Gherulal Parekh again quoted Sir William Anson and observed that "the law may either actually forbid an agreement to be made, or it may merely say that if it is made, the courts will not enforce it. In the former case, it is illegal; in the latter it is only void. Illegal contracts are also void but void contracts are not necessarily illegal."

[15] P 94 US 1876.

[16] 104 US 771.

[17] 222 US 149.

investment and so far as reasonable safety permits, it is desirable to give them the ordinary character of property. To deny the right to sell except to persons having such an interest is to diminish appreciably the value of the contract in the owner's hand. It was conclusively held that though there has to be an insurable interest when the policy is taken out, there is no requirement of insurable interest at the time of transfer or assignment, since it acts as a hindrance to the policyholder's right to deal with his property. The law laid down in *Grigsby* that insurable interest is not required at the time of assignment, has been followed in other cases as well. Since it was found to be the settled position of law in UK also, the Bombay High Court decided this issue against LIC and held that insurable interest does not play any role in validating an assignment.

3. WHETHER SECTION 38 OF THE ACT IS A SUBSTANTIVE PROVISION

LIC contended that Section 38 of the Insurance Act is merely a procedural provision and cannot control substantive right of policyholders of the life assured. A policy, which has lapsed, can be revived only in accordance with the terms of the policy, and revival is at the sole discretion of LIC. The Bench went into a thorough reading of the provision[18] while answering this issue. Sub-section (2) sets out that once a transfer or assignment is made in the manner prescribed by Sub-section (1), it is complete and effectual on the execution of the endorsement or by a separate instrument in writing. However, such transfer or assignment is not binding as against the insurer until and unless intimation in writing is delivered. Once the notice is received, by Sub-section (4), the insurer is bound to record the fact of transfer or assignment along with details of the transferee. Sub-section (5) mandates that the insurer recognize the transferee or assignee as the only person entitled to receive the benefits under the policy and such a person would be subject to liabilities and equities. It is the transferee who can institute any proceedings without obtaining the consent of the transferor or making him a party to it.

The Bench agreed that assignment amounts to complete novation of the contract but also pointed out that it is permissible under law. Under Section 38, the insurer is bound to acknowledge the assignment and cannot question the right of the insured to transfer his interests in the policy. Moreover, once the assignment is effected once and for all, it is the assignee who is considered the policyholder. Thus, Section 38 was held to be a substantive provision under which all benefits are transferred to the assignee, and it becomes binding upon the insurer upon taking notice of it. We believe that the terminology of the provision makes it amply clear that it is a substantive law. The phrase "…the insurer *shall*, from the date of the receipt of the notice recognize the transferee or assignee named in the notice as the only person entitled to benefit under the policy…" [emphasis added] leaves no doubt that the insurer is bound to record such transfer made by the policyholder.

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[18] *See supra* note 4, for the provision.

The Bombay High Court also struck down the Circulars issued by LIC as violative of the mandatory provisions of the Act. It was of the opinion that as long as there are no terms and conditions to the contrary in the contract of insurance, no such embargo can be put by issuing Circulars by LIC. Hence, the Bombay High Court held that free trading in insurance policies is permissible under Indian law, prompting LIC to move to the Supreme Court vide a Special Leave Petition. This matter is presently before a Bench headed by Justice S.H. Kapadia in the Supreme Court.[19] Now, it is upon the Apex Court of the country to give its decision on the issue of policy trading in India, which will form the basis for future implications. The latest verdict from the Supreme Court came in May 2008, where it directed the Reserve Bank of India (RBI) to formulate guidelines on whether a lapsed life insurance policy could be revived by a third party for pecuniary benefits.[20]

III. POLICY TRADING: THE PROCESS, BENEFITS AND THE REGULATORY ENVIRONMENT

Investment and insurance are usually considered to be inversely proportional and mutually contrary to each other. This is mainly because insurance is meant to cover one's life. So, even if insurance products may not offer higher returns, it always makes sense to have such a cover. On the other hand, investment is viewed as a vehicle for multiplication of one's money. Therefore, one always discusses investment in terms of returns offered.[21] However, Insurance Policy trading or life settlements market offers opportunities for investment on insurance policies. The secondary market for life insurance came to prominence in the early 1990s, when terminally ill individuals, especially those living with AIDS, began selling their life policies to third parties to finance their medical expenses.[22] Such transactions were called viatical settlements.[23] Despite the benefits, the popularity of viatical settlements led to the establishment of a number of Ponzi Schemes.[24]

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[19] *See LIC in SC over Policy Trading*, available at http://sify.com/finance/insurance/fullstory.php?id=14439807 (Last visited on January 10, 2009).

[20] *See generally*, DH News Service, New Delhi *SC to go by RBI Norms on Lapsed PolicyTrade* available at http://www.deccanherald.com/Content/May122008/national 200805116746 9.asp (Last visited on January 10, 2009).

[21] Jayant Pai, *The Changing Face of Insurance* available at www.rediff.com/money/2007/apr/03insure.htm (Last visited on January 12, 2009).

[22] Michael Quint, *Pre-Death Cash: A Business Grows,* New York Times (New York), November 14, 1998 at D1, as cited in Sachin Kohli, *Pricing Death: Analyzing the Secondary Market for Life Insurance Policies and its Regulatory Environment* available at www.ssrn.com/papers/2396587.pdf (Last visited on January 11, 2009).

[23] The name 'viatical' derives from the Latin viaticum, meaning 'provisions for a long journey'. Michael Cavendish, *Policing Terminal Illness Investing: How Florida Regulates Viatical Settlement Contracts,* Fla. B. J. Feb. 2000, 10.

[24] In 1997, it was discovered that Personal Choice Opportunities (PCO), a viatical settlement business collected over $95 million from investors to pay back old investors, instead of purchasing life insurance policies. In the process it defrauded more than 1600 investors. *See California Man Admits to Viatical Fraud,* LA Times (Los Angeles) November 14, 1997, as cited in Kohli, *supra* note 22.

Ultimately, the fraud-induced negative stigma surrounding the viatical industry and medical advances in AIDS treatment prohibited the growth of the secondary market for viatical settlements and policyholders moved towards the more positive life settlement market.[25]

A. UNDERSTANDING THE PROCESS

A life settlement market can generally be defined as the purchase of an existing life insurance policy by a third party for investment purposes.[26] This market is usually a secondary market, i.e. life settlements can occur only after a buyer who had purchased a life insurance policy previously, later decides that the policy in question is no longer necessary and trades it away. The original life insurance product purchase is therefore imperative for resale in a life settlement transaction. For many years, life insurance policies were considered as an illiquid asset because it was used for providing security and not for resale. Historically, if a policyholder could no longer afford or no longer wanted his life insurance policy, his only options were to either (1) let the policy lapse or (2) surrender the policy back to the life insurance company for either no value or a minimal surrender value, known as the Cash Surrender Value (CSV).[27] In case of a lapsed life policy, the policyholder who could no longer afford premium payments simply lost his insurance coverage and received nothing in return. In the case of surrender, the policyholder could recover few portions of his investment. In recent years, the traditional understanding of life insurance and its liquidity has undergone a sea change.[28] With the rise of the life settlement market, the policy owner now has a third option, the sale of the policy to a third party investor at a market determined price. The policy owner exercises this third option only if he receives incremental value for the policy over and above the CSV offered by the insurer for the surrender of the policy.[29]

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[25] *Investing in Death: Insurance Traders Gamble on Mortality of Terminally Ill,* CHARLESTON GAZETTE, April 24, 1994, as cited in Neil A Doherty & Hal J Singer, *Benefits of a Secondary Market for Life Insurance Policies* 38 REAL PROP. PROB & TR. J 449 available at http://fic.wharton.upenn.edu/fic/papers/02/0241.pdf (Last visited on January 15, 2009).

[26] Life Settlements focus on individuals with slightly impaired health and who are not expected to live to their full life expectancy. Fliegelman, *supra* note 26.

[27] Cash Surrender Value or CSV, is a contractual right that is required by insurance law and regulation as a minimum level of payment to a terminating policy-owner. This minimum value is paid to the policyholder regardless of the reason for the policy's cancellation. For example, the Jeevan Pramukh Insurance Plan of LIC offers the guaranteed surrender value of 30% of the total amount of premiums paid excluding the first year's premium and the extra premiums, if any. *See LIC Jeevan Pramukh*, at http://www.licindia.com/high_worth_002_benefits.htm (Last visited on January 17, 2009).

[28] *See* M Bryan Freeman, *Life Settlements Enter the Mainstream,* NAT'L UNDERWRITER LIFE & HEALTH, September 19, 2005, 20, discussing how the secondary market gives policies liquidity similar to that of familiar tradable commodities like the stocks, bonds and residential mortgages.

[29] Kohli, *supra* note 22.

For instance, Person A has a life insurance policy, and has been paying premiums for a few years. However, there may come a time of exigency when he is in need of excess cash. In such a case, he can assign his policy to Person B, who will pay him more than the surrender value of his present policy. Now, Person B becomes the beneficiary of the policy. So while the policy continues in the name of Person A, Person B is the one paying the premium. On maturity, or the demise of Person A, whichever is earlier, Person B is entitled to receive all the benefits. The return depends on the seller's life expectancy or the maturity period of the policy.[30]

With the advent of a robust secondary market, players like life settlement firms have entered the field, which introduce the policyholder to investors and generally act as an intermediary. There are two main transactions in the life settlement industry. The first transaction, also known as the back-end transaction involves firms and how they finance the purchase of life policies. Initially, they are capitalized by institutional investors.[31] Moreover, these firms have also started securitizing their life settlement portfolios.[32] These firms pool together their in-force life insurance policies which they purchase and sell fractional interests thereof to institutional investors. Collectively, these policies are expected to generate payout of certain amounts of money over a period of time. Since there are diverse policies in a pool, the payout expectations generally hold true on an average.[33] Essentially, this is a resale of the policies, gains of which are used to buy more life policies. The other main transaction in the life settlement industry is the front-end transaction, which involves the policyholder selling his policy to a firm with the help of a broker. Once a policyholder decided to sell his policy, the broker submits the policy to the life settlement firms requesting for quotes on how much they would pay given the profile of the insured. After the firms have done their legal, financial and actuarial due diligence, they submit an offer to the policyholder.[34] Upon receipt of all offers, the broker and the holder evaluate and select the offer that suits them the most. The policyholder then assigns the policy to the firm and is relieved of any obligation to pay any more premiums on the same.

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30 Pai, *supra* note 21.

31 For example, in 2002, a subsidiary of Warren Buffet's Berkshire Hathaway invested $400 million into a life settlement firm for the purpose of buying life insurance policies from elderly policyholders. See John Hoogesteger, *Berkshire Unit Lends $400 million to Startup,* available at http://twincities.bizjournals.com/twincities/stories/2002/02/04/story1.html (Last visited on August 8, 2008).

32 For example, Deutsche Bank and Nomura Securities have an interest in securitization of life settlements. *See* Sarah Mulholland, *Deutsche Bank builds Life Insurance Portfolio*, Asset Securitization Report, November 29, 2004, 12, as cited in Kohli, *supra* note *22.*

33 Emmanuel Modu and AM Best, *Life Settlement Securitization Methodology,* available at http://www.ambest.com/debt/lifesettlement.pdf (Last visited on August 8, 2008).

34 Carol Fiedler, *Get Smart with Life Settlements,* available at http://lifesettlementmag.com/articles.php?int_id=16 (Last visited on August 20, 2008).

B. BENEFITS OF A SECONDARY MARKET FOR LIFE INSURANCE POLICIES

Microeconomic theory reveals that an efficient secondary market for a particular good or asset improves the value of that good or asset in the primary market. When resale is possible, the price that the consumers are willing to pay for durable good depends on both the value of the good during the period the consumer owns it and the resale value at the end of the period.[35] In the case of a whole-life policy, earlier premiums are greater than necessary to compensate for the low-death risk in the early years. As a result, the whole-Life Insurance Policy builds up a surplus from which future premiums can be subsidized.[36] So, if it is assumed that the policies are priced in a fair manner, then the value of the payment by the insurance company to the policyholder's beneficiaries can be projected to precisely equal the total expected value of the premium payments made by the policyholder. Rather, the policyholder earns a margin as returns on the policy according to the competitiveness of the market.[37]

Prior to the emergence of life settlement firms, the only buyer for a policy in the secondary market was the life insurance company that had issued the policy in the first place. It paid the policyholder a surrender value, which roughly equalled the amount by which the payments made to the insurer company exceeded the actuarial fair cost of the policy. Thus, life insurance companies wielded monopsony power over the repurchase of their own policies. [38] The insurance companies have thus, historically earned economic rents on the repurchase of impaired policies.[39] Hence, the policyholder, while surrendering his policy was not in a position to bargain effectively over the surrender value due to the presence of no other potential buyer for such policy. In these circumstances, the policyholder would be forced to either accept an amount that would be substantially less than the true economic value or elect not to surrender the policy. However, if there are competitive players in the secondary market in the form of life settlement firms, which offer better value for an impaired policy, the insurer company loses its ability to set a fixed price in the market.[40] The surrender value would also rise to a competitive level, giving the policyholder different prices to choose from.

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[35] Dennis Carlton & Jeffrey Perloff, Modern Industrial Organization 485 (2000).

[36] Neil A Doherty & Hal J Singer, *Benefits of a Secondary Market for Life Insurance Policies*, 38 Real Prop. Prob & Tr. J 449 available at http://fic.wharton.upenn.edu/fic/papers/02/0241.pdf (Last visited on January 15, 2009).

[37] *Id.*

[38] The term 'monopsony' refers to a firm that is the only purchaser of goods or services in a given market. *See* Carlton & Perloff, *supra* note 35, 105.

[39] Doherty & Singer, *supra* note 36.

[40] It follows from the economic principle that a monopolist loses its price-setting ability with the entry of competition. *See* William Baumol & Alan Blinder, Economic Principles And Policy 272 (1994).

A secondary market for life insurance policies would thus erode the ability of insurance companies to extract monopsony rent from policy terminations. An insurance company would be forced to either compensate a policyholder for the surrender of his/her policy according to the market value, or face the prospect of the policyholder assigning it to a third party, whereby its liability deriving from that policy would remain intact. A number of reasons may prompt a sale of life insurance policies in the secondary market. Life settlements are sometimes used to fund long-term healthcare or when the policyholder has outlived his beneficiaries. Companies with 'key-man'[41] or 'group employees' policies prefer to assign them to life settlement firms once they are no longer necessary.[42] Financially strained companies may find life settlement transactions a viable solution, whereby they can sell their life insurance policies to satisfy creditors' demands. On the other hand, a solvent company may sell a life policy to repay debt or buy back stock from a shareholder.[43] The reason why life settlement firms are purchasing life insurance policies is primarily owing to the opportunity for profit and the characteristics of the investment itself. The benefit to the third party investor is that he gets substantial return from the policy, with a limited amount of risk. Moreover, unlike other investments, performance of a life settlement investment is almost completely independent of the fluctuations in interest rates, inflation rates and other economic factors. Therefore, investors have an opportunity to diversify away the common risks associated with most of their investments.[44]

C. THE REGULATORY ENVIRONMENT

The secondary market for life insurance policies needs a strong and effective regulatory environment because of the number of players involved. Hence, it is imperative to develop a healthy regulatory environment catering to balance diverse interests. In the US, which has a thriving secondary life settlement market, it is governed by a patchwork of state and federal laws. In 1996, the Securities and Exchange Commission's bid to regulate viaticals under the federal securities law was rejected by the DC Court of Appeals in *SEC v. Life Partners Inc*.[45] Even though

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[41] Often, lenders require a small enterprise to purchase life insurance on the promoter or the main operator of the business. This mitigates the risk of the lenders by ensuring payment of the debt with the proceeds of the life insurance policy if something were to happen to the 'key-man'. See Diane E. Lewis, *Minimizing Crisis's Impact: Contingency Plans Such as 'Key-Man Life Insurance can help Firms Survive Disaster,* BOSTON GLOBE, October 14, 2001 as cited in Kohli, *supra* note 22.

[42] Valerie Greenberg, *Life Settlements: New Value in Old Policies,* MICH. B.J. September 2003, 32.

[43] Hoogesteger, *supra* note 31.

[44] Kohli, *supra* note 22.

[45] 87 F.3d 536 (DC Cir 1996).

they were not considered as securities under the federal law, many states[46] classified viatical settlements as securities and regulated their sale to investors.[47] However, due to lapses in such regulations, there have been a number of instances involving fraudulent sale of these policies to individual investors or fraudulent acquisition of new policies for resale to unscrupulous firms.[48]

Interestingly, life settlement markets in both the United States as well as in the European Union are flourishing and are becoming increasingly institutionalized. American International Group, Inc. and Berkshire Hathaway Inc. are two very well known investors that have both publicly commented upon their substantial ownership interest in life settlements.[49] Institutional ownership of these instruments has become so widespread that the Financial Accounting Standards Board (FASB) is currently working on a project to develop an improved accounting methodology for these investments.[50] In the United Kingdom, for instance, insurers are required by law to inform policyholders surrendering a contract that higher offers might be available from independent third parties. Such laws add to the institutionalization of secondary insurance markets. However, no similar requirement exists in the U.S. when a policy is surrendered to an insurer.[51] Thus, it can be seen that there is a need for sensible regulation of the life settlement market, mainly to inspire investor confidence in a still-emerging market. Unless it is effectively regulated, the secondary market for life settlements will face immense hardships in any jurisdiction.

IV. CONCLUSION

Throughout the paper, we have contended that the accordance of a formal status to insurance trading would make the market more competitive by bringing in more players, thereby making it possible for policyholders to obtain fair market value of their policies. This market price would be fixed by the interplay between demand and supply of insurance policies in the secondary markets. This

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46 For example, in 2001, Ohio enacted a law for the regulation of viatical firms modeled after the National Association of Insurance Commissioner's (NAIC) Model Viatical Settlement Act. The NAIC Model Act was first adopted in 1993 to address the viatical settlement industry's growth in response to the AIDS epidemic. The original NAIC Model Act did not address life settlements until December 2000, when the NAIC expanded the definition of 'viator' to include individuals who are not terminally-ill, thereby including life settlements within the scope of the Act. In addition to the NAIC Model Act, the NAIC has adopted model regulations. The NAIC Model Act and Model Regulations mainly focus on protecting the seller in a life settlement transaction by enacting disclosure and pricing requirements. *See* Fliegelman, *supra* note 26.

47 Carol Ostrom, *A Warning about Fraud in Death-Benefit Sales*, SEATTLE TIMES, February 27, 2002, B1 as cited in Doherty & Singer, *supra* note 36.

48 *Id.*

49 See Hoogesteger, *supra* note 31.

50 See http://www.fasb.org/project/life_settlements.html (Last visited on January 20, 2009) for more information on the FASB's current project status for the reporting of ownership of life settlements.

51 Fliegelman, *supra* note 26.

would, in turn have a positive effect on the demand for life insurance in the primary market, since the secondary market for life insurance effectively removes restriction on resale. Thus, the beneficiaries of the secondary market are not limited to consumers in the secondary market, but also include consumers, insurance agents and life insurance companies in the primary market for life insurance as well.[52] A competitive secondary market for life insurance policies improves the welfare of both new and existing policyholders. The development of the life settlement market therefore, reflects increasing level of efficiency by which insurance policyholders might exercise their policy options.

We maintain that the actions of life insurance companies to oppose life settlement firms, represents an effort to maintain monopsony over their customers in the purchase of policies that are likely to be surrendered. The assignability of a life insurance policy is a benefit that a consumer acquires when he becomes a policyholder, which is being interfered with by the life insurance companies.[53] Life insurance companies argue on the other hand, that their efforts to impede policyholders' legal exercise of their assignability benefits will actually improve consumer welfare. This argument is supported by the erroneous contention that entry into the secondary market makes consumers worse off. The High Court of Bombay has however rejected all such arguments and has legalized life insurance trading. All over the world, the life settlement market is currently in its early stages of development. However, market efficiency and optimization of the value embedded in insurance policies is likely to grow over time. Secondary markets will develop with third-party investors eager to purchase these instruments at values attractive to both the buyer and the seller.

The landmark ruling of the Bombay High Court has opened up a vista of new possibilities for the Indian insurance market. Its decision in favour of IPPS has pointed out to all, that life insurance policies can also be viewed as objects of investment. Policies, which were used only as an instrument of security in adverse times till a few years ago, now have emerged as a sure method of reaping monetary benefits. Implications of this judgment could be manifold. It will increase the number of investors/investor companies such as IPPS, since the ambiguity pertaining to the legality of such transactions has been comprehensively dispelled. We may also see a spate of renewal of lapsed policies by the insurer companies themselves. Life insurance and the way the same has been typically viewed will continue to change over the coming years. The early development of a secondary market for life insurance policies and the benefit it has brought to policyholders and investors illustrates the want and need for such a market. The emerging secondary market of India is ideal and viable for healthy trading in life settlements. Indian markets are perfectly receptive of such new opportunities[54] and the decision of the Bombay High Court goes a long way to encourage such growth.

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[52] Doherty & Singer, *supra* note 36.

[53] *Id.*

[54] For example, Carbon emission trading has become a huge hit among industries in the commodities market in India.

The present social mindset of the Indian consumers with respect to life insurance policies as the only tools of social security however needs to be changed. As discussed by the learned bench of the Bombay High Court, life insurance has now become a business with the entry of private players and hence it should be allowed to flourish in the secondary market also. Indian consumers should be educated in the various opportunities available to them, once they no longer wish to continue with their policies. Third-party investors also need to wake up to the great potential offered by life policies as investment instruments. However, it is often argued by the traditionalists that this would lead to criminal methods being adopted to ensure quicker returns on the life of the insured. In other words, investors may try to 'speed up' the process of claim generation by resorting to criminal means. While, this fear cannot be waived as being completely unfounded, it should be viewed more as an exception than a rule.[55]

The K.P. Narasimhan Committee[56] appointed by the IRDA suggested amendments to Section 38 of the Act to make the law clearer on the moot issues raised in the proceedings before the Bombay High Court. It also suggested empowering the IRDA to restrict or moderately regulate instances of assignment to prevent misuse of legal provisions.[57] Over and above these steps, a complete guideline consisting of rules and regulations should also be drafted in order to facilitate trading in life policies. Lastly, it should be remembered that the whole legal scenario now rests upon the forthcoming decision of the Supreme Court. We support the legal reasoning provided by the Bombay High Court because it suitably and correctly explains the present legal position in India. Given proper legislative attention, the secondary market can become a great source of value to the everyday life insurance consumer, even more so than it is today.

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[55] Pai, *supra* note 21.

[56] K.P. Narasimhan Committee Report available on http://www.irdaindia.org/kpncommittee/kpncommittee.pdf (Last visited on January 14, 2008).

[57] Deboy Sen Gupta, *Policy Trading: Free or Macabre* available at http://economictimes.indiatimes.com/Money_Matters/Insurance/Analysis/Policy_Trading_Free_or_Macabre_/articleshow/1818375.cms (Last visited on January 11, 2009).