

The Murder of the Insured By the Beneficiary: Attempting to Quantify One Moral Hazard Relating to Life Insurance Contracts⁺

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Summary

Moral hazard exists in the making of a contract when there is asymmetry of knowledge between the parties. If the performance of duties under a contract extends over a period of time after its making, moral hazard exists until performance is completed. Murdering the insured with the intention of collecting death benefit proceeds is one of the most dramatic moral hazards relating to the life insurance contract. Yet nearly all of the published literature concerning this hazard consists of case histories rather than statistical analysis. This paper addresses how this hazard could be quantified and managed by life insurers.

Moral Hazards Relating to the Life Insurance Contract

Both parties to a life insurance contract bear moral hazard risk. The

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insurer's risk selection (underwriting) process is its primary defense against incorrect or incomplete information provided by the applicant although the insurer also enjoys limited contractual defenses against moral hazard. The applicant also assumes moral hazard risk in selecting an insurer, although of a more limited nature, primarily because of the strong regulation of the life insurance business in the United States.¹ Strong regulation protects the solvency of insurers by limiting the ability of insurers to write business at inadequate rates and by reducing opportunities for corrupt personal enrichment by employees and directors of insurers. Nevertheless, "back up" coverage by most state guarantee funds has limitations, so the possibility exists that a contract owner or beneficiary might fail to receive full contract performance from the insurer and "back up" guarantee fund. In addition, both parties to the life insurance contract bear limited forms of "novation" risk, i.e., the insurer may reinsure its obligations or the owner may create third-party interests by sale, gift, assignment, or irrevocable beneficiary designation.

The process of applying for a life insurance contract clearly involves the moral hazard of misrepresentation by the applicant. The contestability provision of the life insurance contract is the primary defense of the insurer against this moral hazard, although its operation is limited by statute to two years except in the case of fraud (e.g., substitute sent to undergo medical examination). The suicide provision of the life insurance contract is the primary defense of the insurer against the moral hazard that the applicant may seek insurance to enrich his designated beneficiaries through self-destruction, although its operation is also limited by statute to two years (in most jurisdictions).

By way of contrast, the operation of the rule of common law that a murderer may not share as a beneficiary in the proceeds of life insurance on his victim is not similarly limited in its operation.² Even after the contract has become incontestable, the homicidal beneficiary cannot share in the proceeds of life insurance on his victim. However, the operation of the common law contractual defense against the homicidal beneficiary is constrained by the ability of the insurer and of law enforcement authorities

1. Strong regulation of life insurance companies has had some failures — witness the looting of the Thunor Trust companies by Martin Frankel. By way of contrast, the secondary market for life insurance contracts in the United States (often called the viatical settlement business) has been rife with corruption in the early years of its development. Some sham operations have defrauded investors without obtaining real assets in the form of viaticated policies. Other operations have fraudulently obtained policies on severely impaired individuals by "clean sheeting" applications. See note 40 for a more extended discussion of moral hazard in the viatical settlements business.

2. The common law rule is made statutory in some jurisdictions. An excellent summary of "slayer statutes" can be found in Gary Schuman's paper, "Life Insurance and the Homicidal Beneficiary: The Insurer's Responsibilities Under State Slayer Laws and Statutes" at www.thefederation.org/public/Quarterly/Spring01/schuman.htm.

to prove the beneficiary's probable involvement in the crime.³

Insurable Interest and Consent

The requirement that valid insurable interest exist in order for a life insurance contract to be effected is probably the strongest protection against the contract's being placed in force for the express purpose of realizing financial gain by murdering the insured. The insurer's underwriters will examine the relationship of the applicant, the proposed insured and the beneficiaries to determine if valid insurable interest exists. The evaluation will include not only the relationship of the parties to the proposed insurance contract, but also the appropriateness of the amount of insurance applied for. While the statutory requirement is limited to the existence of valid insurable interest at the inception of the contract, insurers are subject to post-claim lawsuits claiming damages for failure to ensure that such an interest existed at inception.⁴

The general underwriting principle is that no one should be worth more dead than alive. The statutory rule is generally that every person has an unlimited insurable interest in his own life. In effect all insurers impose limits not only on the amount of life insurance they will issue on their own books, but also on the total amount of life insurance in force and applied for in which they will participate on a given life.⁵ Longstanding benchmarks, such as five times earnings, have been challenged in recent years, both for personal and business insurance. Ross Morton cites one recent standard for personal insurance: sixteen times gross earnings plus six times net worth plus \$1 million.⁶ Section 3207 of New York state insurance law contains limits on the amount of insurance that can be written on minors under the age of 14 years six months. However, such statutory provisions are relatively uncommon.

Many insurers have also historically required the consent of the

3. Most jurisdictions recognize a lesser standard of proof for civil actions relating to homicidal beneficiary disqualifications than the "beyond reasonable doubt" standard applying for proof of murder. A good exposition of the rigorous standard required for criminal conviction can be found in the Sept. 30, 1994, ruling of the Vermont Supreme Court in *State v. Durenleau* [93-1658; 163 Vt. 8; 652 A.2d 981] at: http://dol.state.vt.us/gopher_root1/000000/supct/163/state_v_durenleau.93-168.

4. Meyer (1976, pp. 151-152) cites a noted case where a child was insured by an aunt-in-law, who subsequently murdered the child for the insurance proceeds. The child's father recovered damages in an action against the insurer.

5. Most automatic life reinsurance agreements contain a so-called "jumbo limit" on the total amount of insurance in force and applied for. Applications involving coverage in excess of the "jumbo limit" must be handled on a facultative, rather than an automatic, basis.

6. See Ross Morton, "Two Hymn Books Again" (at: http://marketingoptions.com/momail_sample4.htm) for an illuminating discussion of issue limits for business and personal insurance.

proposed insured (or of the parent or guardian in the case of a minor) in order to effectuate insurance. Meyer comments:

The requirement of consent protects the insured against homicide more effectively than the sound and well-established rule of public policy that a beneficiary who murders the insured cannot collect on the insurance policy on his life. The latter rule does not protect the insured adequately since the wrongdoer may not know of the rule or may expect or hope to conceal his crime (Meyer, 1976, p. 150).

In some jurisdictions, a married person can contract for life insurance on his spouse without express spousal consent. There is also jurisdictional variation as to whether employers have an insurable interest in their employees and whether the consent of the employee is necessary to effectuate such insurance.

Neither insurable interest nor consent are required to exist except at the inception of the contract. The insured who is not also the owner of a contract insuring his life has limited recourse in the event that he subsequently determines that the existence of the insurance constitutes a threat to his continued survival. Such cases arise infrequently when spouses or business partners become alienated after the inception of the insurance contract. Meyer comments:

However, if the insured petitioned a court to order the termination of the policy and presented evidence that his life was endangered by the continuation of the policy the court might issue such an order. It would seem that a court of equity would have power on public policy grounds to order the termination of a life insurance policy or a change of beneficiary if the insured offers proof that the existence of the contract endangers his life. No reported case on this point is known (Meyer, 1976, p. 151).

Homicide in the General and Insured Population

The National Center for Health Statistics reported 16,889 deaths by homicide and 97,860 deaths by accident in the United States in 1999 distributed by race as follows: