

Michigan Law Review

Volume 62 | Issue 2

1963

The Regulation of Specialty Policies in Life Insurance

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Recommended Citation

Spencer L. Kimball & Jon S. Hanson, *The Regulation of Specialty Policies in Life Insurance*, 62 MICH. L. REV. 167 (1963).

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MICHIGAN LAW REVIEW

Vol. 62

DECEMBER 1963

No. 2

THE REGULATION OF SPECIALTY POLICIES IN LIFE INSURANCE

*Spencer L. Kimball** and *Jon S. Hanson***

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I. INTRODUCTION

EVERY entrepreneur is vitally concerned with selling methods. Success depends upon sales. Sales depend upon desire for the product. Desire for most products, including life insurance, is not

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** Member of the Wisconsin Bar.—Ed. The basic research for this article was done by Mr. Hanson. Robert E. Dineen and Robert W. Ninneman of the Northwestern Mutual Life Insurance Company, for which Mr. Hanson worked one summer, made the resulting accumulated material available to the authors, relinquishing all control over the data. The authors wish to thank the Northwestern Mutual, and especially Messrs. Dineen and Ninneman, for valuable assistance in the initial research; at the same time, however, they must be absolved from all responsibility for the views expressed, which are solely those of the authors. Since the summer of 1962 further work on the project has been financed by the W. W. Cook Endowment of the University of Michigan, to which the authors also express appreciation. The Cook Endowment, too, is free from responsibility for the views expressed.

inherent but is created by the efforts of the entrepreneur. In the case of life insurance, an effective job of creating the desire, *i.e.*, of selling, is usually necessary to convince a prospective insurance buyer that over a long period he should allocate a significant portion of his income to the purchase of an intangible such as life insurance.

In the constant effort to improve marketing methods in selling life insurance, there has been a tendency in recent years to place special emphasis on an investment theme. Many companies have been selling life insurance as an investment akin to stocks or bonds rather than as insurance as such. In the "affluent society," even people in modest circumstances wish to share in what seems to them to be irreversible, long-range appreciation in values which characterizes the world of finance. Any sales message that promises them unwonted participation in the money-making activities of the community, while simultaneously discharging an obligation to their dependents, falls on receptive ears. A typical sales presentation of this kind may begin as follows:

"My company is interested in entering into a business relationship with you that can be very profitable both for you and for my company. Life insurance is a part of the program, but I didn't come here to talk to you about that. Let's forget the life insurance and consider only the making of money.

"This is a sample policy and here is a page of coupons. They are colored green to look like money because they actually represent money. You can clip them out just like bond coupons, and exchange them for cash. Better yet, these coupons can be left on deposit with the company, which guarantees to pay you not less than 3 1/2 percent interest. With the miracle of compound interest working for you, you would then receive in twenty years \$3,500, which is almost \$1,000 in excess of the face value of the coupons.

"Now let's come to the most significant part of the contract. You will share in every dollar the company earns. Not only do you receive the usual dividend arising from the participating business, but you also share in the profits generated by the nonparticipating business. Let me ask you this. If you were to invest \$400 with complete safety, what would you consider a fair rate of return on your investment? [After receiving the typical response of five or six percent, the agent continues.] Naturally four to six percent would be excellent, but of course it would be taxable. However, last year our board of directors declared a profit-sharing bonus of 12.5 percent, and that was tax-free. . . . Not only is this return extraordinary, but it will

almost certainly increase for you. This contract is sold only to a limited number of charter members, who get in on the ground floor where they can help the company grow. As the company expands, the profits increase. Meanwhile, the number of charter policyholders decreases through deaths and lapses. Doesn't it figure that with a limited and decreasing number of charter members sharing in ever increasing earnings, your share should increase every year?

"In the usual life insurance contract two things build equity for you—cash values and participating dividends. These charter-investment contracts have both of these ordinary sources of gain, but they add to them the guaranteed coupon accumulation plus profit-sharing in all of the company's business.

"Furthermore, if you apply your coupons, your profit-sharing dividends, and your regular participating dividends to the reduction of premiums, in about ten years you reach a point where there will be no more costs. That is, the balance due on the premium payments is reduced to zero. In short, as the company's earnings continue to increase after that, the company will pay you to own the insurance policy. You have a good life insurance policy. You receive annual dividend checks. You pay no more premiums. How can you beat that?"

How can one fail to be impressed? Insurance is included as a bonus in connection with a foolproof and lucrative investment. Here is an opportunity for the prospect to discharge his moral obligation to provide insurance protection for his dependents, and yet share in the investment opportunities of an affluent society. This seems a once-in-a-lifetime opportunity to get in on the ground floor. For once the prospect will not be on the sidelines watching others make money; this time he will be one of the insiders. The sales pitch abbreviated here is made, and successfully made, many times each day. But the investment theme is not the only one used in the modern marketing of insurance. Other appeals may be added:

"Now most insurance companies are paying less than they should when you die. You know, don't you, that your insurance policy is in part a savings account, and that there are cash values in it, *i.e.*, if you cash it in, you can get an amount of cash that keeps increasing year after year. Every insurance company is required by law to pay you this cash if you want to end your policy, or to lend the money to you if you want to keep your policy. The reason is that it is *your* money. Now

you would think that when you die, the insurance company would pay you the cash value of the policy as well as the insured sum. After all, you are paying annual premiums for insurance protection, but the company is only paying you in insurance the difference between the face of the policy and the cash value. Now our policies are different. Not only do you get the face value of our policy, but if you die in the tenth year, or the fifteenth, or the twentieth, you will also get back your accumulated premiums. We don't think anything less is fair."¹

A. *The Common Specialty Provisions*

1. *Tontine policies*, or more accurately semi-tontine policies, provide for the accumulation of dividends by the company for a specified period. When the period expires, those policyholders who have survived and have not lapsed or surrendered their policies share in the accumulated fund, to the exclusion of those who have died or have lapsed. The foregoing hypothetical specialty policy did not contain a tontine feature.

2. *Profit-sharing policies* are participating policies promising the policyholder not only a share in the surplus created by this particular class of policies, but also in surplus generated by some other classes. Typically, profit-sharing policies share in the surplus generated by the nonparticipating business, but occasionally they share in surplus created by a separate class of participating policies which are not profit-sharing.

3. *Charter policies* are sold at the beginning of a company's career, and are issued with an assurance that they will be sold only to a limited number of persons or for a limited total amount. The charter policies themselves, or statements about the charter feature made in the sales presentation, represent that the charter policyholder will receive a special advantage not available to persons

¹ These sales talks are fictitious but have been constructed from ones actually in use and from a written sales presentation in our files prepared by a company for use by its agents. Except for its brevity, the presentations are not unrepresentative. Of course not every specialty policy has all of these features in one contract, but some have a good many. See *Equitable Life & Cas. Ins. Co. v. Lee*, 310 F.2d 262 (9th Cir. 1962), for a case which throws light on the nature of the sales presentations often used.

There are numerous variations on the themes adumbrated here. A well-known one used in Indiana goes (in part): "You have been nominated—If you are an influential citizen in your community, it is possible that you may someday be 'nominated' by some life insurance company An opportunity to make a fine return on your money—perhaps ten or twenty times the ordinary rate of interest on any other type of investment or savings plan" The use of the expression "nominated" bears the mark of genius. It is hard to imagine it failing to produce results.

holding later policies issued by the same company. Most often, the special advantage is a profit-sharing feature; such charter policies form a subclass of profit-sharing policies.

4. *Coupon policies* contain a series of coupons in combination with an insurance contract. The coupons vary in their provisions, but typically they mature in successive years, entitling the policyholder to a specified sum in cash, or to various alternative benefits. Sometimes passbooks, resembling those in use by savings banks, are used instead of coupons. There seems to be little difference in principle between coupons and passbooks.

5. *The return of premium provision* promises to pay to the beneficiary all of the premiums paid up to the time of the insured's death in addition to the face amount, if the insured dies within a specified period. This is merely a form of increasing term insurance.

6. *The return of cash value provision* is closely analogous to the return of premium provision. It promises to pay to the beneficiary the cash value of the policy instead of the amount of premiums paid in addition to the face amount, if death occurs within a specified period. It, too, is a form of increasing term insurance.

7. *The sight draft (immediate cash draft) provision* is a feature which promises to pay the beneficiary a certain percentage of the face value of the policy if the insured dies within a specified period. Characteristically it is paid quickly, with virtually no formalities. It is merely a form of level term insurance.

As one may see from the above list, the specialty policies now being sold, mostly by relatively small companies,² consist basically of standard components of life insurance, such as ordinary life, pure endowments, and various forms of term insurance. For example, the coupon provision is actuarially an endowment, while the return of premium, return of cash value, and sight draft provisions, are forms of term insurance. They are founded upon sound actuarial methods, with reserves meeting minimum legal requirements. In opposing new insurance department regulations, some of these companies point to the orthodoxy of their policies. But by combining the traditional components in new ways and using un-

² Although one specialty policy company has assets of over \$4 billion, with more than \$10 billion of insurance in force, the vast majority of specialty policy companies, numbering in excess of 200 as nearly as we can ascertain, operate on a much smaller scale. Most of them have less than \$10 million in assets, thirty have less than \$1 million, while one hundred have less than \$5 million. Further, the overwhelming majority of these companies have less than \$100 million of insurance in force, more than twenty-five have less than \$10 million, and almost another fifty have less than \$25 million. About half of these companies are less than ten years old.

orthodox and often misleading selling methods, that which is essentially traditional insurance coverage appears to be something "special." While to the *cognoscente* the contract is merely a combination of usual components, the agents of the company may succeed in giving the average prospect quite a different impression. Complaints filed with state insurance departments illustrate what the prospect is led to believe:

"If we didn't draw out the dividends they would be so large we wouldn't have to work."

"When the agents sold me these policies I was sold with the idea that they were stock as well as protection and that within ten years my return would exceed 400% and that I could draw out the premium money at any time."

"We were told it was an investment, the life insurance policy just an incidental."³

Characteristically the effect of the sales presentation of specialty policies is to give the prospect the impression that he is buying into a profit-making opportunity rather than merely purchasing insurance. It is the possibility of deception rather than objection to the actuarial characteristics of specialty policies that has led several state insurance departments to promulgate rules regulating them. Thus the Missouri regulation expresses its concern for "References to a policy as being an 'investment,' 'investors', or 'profit-sharing' policy, or the use of similar designations in such a manner as to misrepresent the true nature of a life insurance policy . . ." or "references to any policy or contract in such a manner as to misrepresent its true nature . . ."⁴

The objective of this article is to explore the various specialty policies which are being used in American life insurance today, to ascertain what problems are created for the public by the use of such policies, and to ask whether they should be forbidden or regulated and, if the latter, in what ways regulation can best be worked out. We will examine first the reasons why life insurance companies issue specialty policies, next the public policy objectives that are of relevance to this subject, then the problems raised by each major kind of specialty in succession, and finally we will present some general conclusions from the entire study.

³ Excerpts from letters and statements attached to a circular letter issued by the Neb. Dep't of Ins., March 20, 1962. See also *Stegman v. Professional & Business Men's Life Ins. Co.*, 173 Kan. 744, 252 P.2d 1074 (1953).

⁴ Mo. Div. of Ins. Order No. XII-9, §§ 1, 2, Jan. 19, 1962.

II. WHY SOME LIFE INSURANCE COMPANIES WRITE SPECIALTY POLICIES

The life insurance business has long been extremely competitive, not only in price but in other ways.⁵ But since life insurance is sold, not bought, the key factor in life insurance competition has been the agent. In the past, competition more frequently has led to an increase in agency commissions than to a decrease in the price to the policyholder, but in this century, and particularly since the Armstrong investigation, a larger part of the competitive struggle between insurance companies has tended to center either upon the initial premium, or upon the net cost to the policyholder. Hence, one of the reasons that many small companies give for issuing specialty policies is that they are allegedly unable to compete on the basis of initial premiums or net cost. For example, one spokesman for companies issuing specialty policies said:

“For the smaller company to meet low-cost competition head-on with the same plan always places them in a tough position. This should be avoided, if possible, by the use of unique plans which do not permit comparison with the low-cost Ordinary life policies”⁶

In the attempt to compete in a market in which buyers are increasingly price-conscious, two general approaches have been employed, separately or in combination, in the preparation of specialty policies. First, many of the policies supplement orthodox insurance protection with investment features and other attractions in order to provide a maximum marketing appeal despite admittedly high costs. Second, various orthodox insurance coverages are combined in such a way that the benefits vary greatly, and cost comparison with the more traditional policies becomes impossible. In either of these two ways, the specialty company may shift the competition from price to another basis.

The endeavor to succeed in selling life insurance in a highly competitive market is laudable, even though it may sometimes lead to shabby practices. But that is only one of the more praiseworthy motives for the sale of specialty policies. Another motive is the

⁵ For extensive discussions of the history of life insurance with indications of its competitive nature, see KELLER, *THE LIFE INSURANCE ENTERPRISE, 1885-1910* (1963); STALSON, *MARKETING LIFE INSURANCE* 264-68, 342-45, 485, 582, 609 (1942).

⁶ Comment made by Mr. Ritter, Assistant Secretary of the Lincoln National Life Insurance Company of Fort Wayne, Indiana, participating in a forum, *1957-1958 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE* 52, 56. See also *id.*, 366.

provision of a favorable climate for the sale and manipulation of stock, *i.e.*, the sale of specialty policies is sometimes an aspect of a stock promotion. An article in the *Chicago Tribune* describes the *modus operandi* of such a scheme as used in Illinois:

"When the first 'public' issue runs out, a second one is floated at a higher price, then a third at a still higher price if the market will bear it, and so on.

"After a few such flotations, each at a higher price than its predecessor, a secondary market is likely to develop that is sufficiently strong to enable the 'founders,' if they wish, to unload their original stock at a profit of several hundred percent.

"At this stage the initial promoter or team of promoters, who of course are among the holders of founders' stock, may do just that and pull out of the organization to go elsewhere and do likewise.

"When they do, they leave behind no broken laws but a lot of publicly held stock in an insurance company which, tho actually operating, has yet to earn—or demonstrate that it could ever earn—the accolades bestowed upon it in the course of the stock promotion

"A promoter or team of promoters comes into town . . . and sets about lining up a dignified name or two carrying weight locally on which to prop the projected company's reputation. . . . Nothing illegal is proposed or contemplated. A life insurance operation actually is organized and set in business. Those who are attracted into the organization as backers at the outset are issued founders' stock at a very low price a share, perhaps \$1 or less. Then a second stock issue is brought out for sale to the public at a higher price. Nothing essentially is wrong with that. The 'founders,' who do the work of organizing the business and theoretically take the greatest risk, probably deserve to acquire some equity at lower cost than the general public."⁷

The sale of specialty insurance is resorted to in connection with the promotion because it is the quickest and surest way to put business on the books and to produce rapid increases in premium income, thus enhancing the likelihood of profitable stock flotation. Where the founders of a company are mainly interested

⁷ Clark, *New Illinois Law Hobbles Insurance Stock Promoter*, *Chicago Tribune*, Jan. 27, 1960, pt. IV, p. 7, cols. 3, 4. "[T]here have been a number of new companies that have started with low priced stock, put what appeared to be a substantial amount of business on the books, manipulated the stock, and then cashed in quickly." Probe, Jan. 22, 1959.

in the promotion rather than in the insurance enterprise, they are likely to move from state to state, forming a chain of companies one after another. Some of the companies may live and some may die; which they do matters little to the promoters.

There is no simple way to ascertain the extent to which specialty policies are issued in order to sell stocks. If there were adequate demonstration that the sale of specialty policies is crucial to such stock promotions, and that the unavailability of specialty policies would suffice to prevent speculative stock promotions, that might be reason enough to forbid the use of all specialty features. In the absence of such a demonstration, which cannot be made now, specialty policies must largely stand or fall of their own weight, not merely because they are or may be used in connection with questionable promotional schemes. Their utility in that connection is certainly an argument for their prohibition, however. Control of stock promotion abuses must then be treated as a separate problem, outside the scope of this article.⁸

The extent to which insurance companies issue specialty policies is uncertain and probably could not be ascertained even with great effort. However, investigation shows that out of almost 1500 life insurance companies operating in the United States, approximately 200 issue policies containing one or more of the specialty features.⁹ Some of these companies are to be found in every state except New York, the greatest concentration, however, being in the South and Southwest. A few states in the Midwest also seem hospitable to specialty insurance. These companies constitute over

⁸ The flotation of insurance stock issues is sometimes within the control of the Securities and Exchange Commission, sometimes of the state securities commissioner, and sometimes of the state insurance commissioner. The subject is too complex to be treated briefly in a footnote, but it is a subject that would repay careful exploration.

⁹ *BEST'S LIFE INS. REPORTS* (1962 ed.). In supplying information to the publisher, some companies mentioned special features. Moreover, if a company in either its summary of operations or in its liability statement listed coupons or coupon accumulations, it was counted as a coupon policy-issuing company. Of course, some companies that issued coupon policies in the past but no longer do so, still have to report coupon accumulations in financial statements. Thus a number of companies may have been included which once were specialty companies but are no longer. With respect to profit-sharing policies, companies having profit sharing only in connection with pension plans were not counted. With respect to charter policies, the company was included if *Best's* reported it as issuing a policy with a name like "Founders," "Charter," etc. Some such policies may be misnamed but the error is not likely to be significant. The authors also know from miscellaneous sources that a number of companies issuing special policies did not show up in the above ways. There may also be other companies which provided no indication in *Best's* and were not otherwise known to the authors. Nor does *Best's* include the most recently formed companies. It is clear that the authors' lists are subject to a variety of errors, but they do not all work in the same direction, and most of them tend to lead to a conservative enumeration.

thirteen percent of the total number of life insurance companies (although by no means thirteen percent of the insurance written), and touch an appreciable portion of the insurance buying public. The fact that nearly thirty states have recently reacted to the use of specialty policies with some form of regulation is also some indication of their widespread use.

It is difficult to state with certainty that small new companies must avoid direct price competition in order to survive. In a regime of free contract, this question does not often arise as a concern of the legislator, for one begins with the assumption that an entrepreneur should be free to vary his product as he likes in order to compete effectively. Freedom of competition, freedom of contract, and freedom of access of new entrepreneurs to the market are different aspects of a value which ranks high in our system. Whether a competitive judgment is wise is not generally a question for the law but for the entrepreneur himself. However, the present article will discuss weighty considerations which have been urged in favor of restriction or prohibition of specialty policies. No reliable judgment can be reached on the question of whether to regulate or prohibit until one studies the probable consequences of such action. One must ask whether direct price competition would really be fatal to small companies, as is often alleged. If it would be fatal, a desire to preserve free access to the market should lead the legislature to be cautious in instituting controls which would seriously handicap new companies; if it would not be fatal, it should be less reluctant to impose controls. The following paragraphs deal briefly with this question.

The net cost of an insurance policy depends upon three elements—the cost of mortality, the rate of return on invested assets, and the level of the expenses of the company. It is difficult to see why the small company should be at any competitive disadvantage with respect to mortality costs. Given equally careful underwriting, mortality experience should be essentially independent of the size of the company.¹⁰

So far as return on investment is concerned, although an important part of the investment market is closed to the small company with relatively small amounts to invest, there is no reason to suppose that a well-managed investment program for a small company cannot net approximately the same return as that for a larger one.¹¹ A more significant difference in the net cost of insurance

¹⁰ See 1957-1958 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 55.

¹¹ "These smaller companies have historically earned a higher net return on their

policies has been said to arise from differences in operating expenses. Thus one official of a large company pointed out that "... the trend is more and more toward mechanization, and the larger companies are first to take advantage of this. Also, the smaller company generally pays higher commissions"¹² But the advantage of mechanization is easy to overemphasize. Small companies may be able to use service bureaus that provide mechanical or electronic devices for a rental fee.¹³ In addition to the advantage of utilizing mechanical means for the handling of office routine, the large company with a tried and proven product and an established name is in an advantageous position in the competitive search for good agents. It is difficult to build a first-class agency force for a new and unknown small company. Some strong inducements are said to be necessary, hence it is common to rely upon higher commissions and the issuance of specialty policies having great marketing appeal in order to counteract the advantages of the big well-established companies in seeking agents.¹⁴ The new small companies apparently are forced to accept somewhat less-qualified persons as agents than do the larger companies. They also generally limit their portfolio to a small number of attractive policies, confine preparatory instruction to the fundamentals, and then often provide the new agents with a "canned" sales talk for the one or two policies they will sell.¹⁵

investments in the past. This has been a most helpful subsidy to their growth." Bensten, *Small Companies—Lemons or Lemonade?*, 1960 GENERAL PROCEEDINGS: AMERICAN LIFE CONVENTION 238, 242. "As to interest, can a smaller company make more selective investments and gain a higher interest rate? Probably not, but they might be able to equal that of a larger company." 1957-1958 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 55.

¹² *Ibid.* A recent study of costs throws much light on this question. Owsley, *Cost Factors in Life Company Management*, The Insurance Field, Sept. 13, 1963, p. 24.

¹³ "The Service Bureau Corporation . . . is equipped economically to provide special services of the type most Life companies need. Small companies which feel that they cannot afford IBM installations of their own would do well to investigate their use." Lindon G. Hughen, Comptroller of National Equity Life of Little Rock, Arkansas, as quoted in Leslie, *Means and Methods of Expense Reduction in Smaller Companies*, 1957-1958 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 64, 78. "Within . . . [recent] years smaller companies have been finding good, efficient use for computers [T]he use of service-bureau computers has given smaller companies which do not have sufficient volume a chance to profit from computers." William Smith, of International Business Machines Corporation, while participating in a forum, 1957-1958 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 87, 91. "The automation of lower volume companies is well on the way to solution. We are even led to hope that mass production of the smaller computers will lead to a cost basis for these machines that will give us comparable cost ratios with the largest computers." Bensten, *supra* note 11, at 240.

¹⁴ Borchardt, *Agency Contracts and Financing Plans*, 1957-1958 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 39.

¹⁵ *Id.* at 39-40. Borchardt goes on to say that "the nucleus of an excellent agency organization can be built up of such inexperienced men." *Ibid.*

It is not clear how far the advantages of size extend. It is easy to overemphasize the economies of scale, and we suspect there are also disadvantages to great size. The ten largest companies have a smaller percentage of the market now than they had in 1950.¹⁶ In any case, the difficulties of starting a company have not been so substantial as to prevent the formation of many new ones; the number of legal reserve life insurance companies operating in the United States doubled during the 1950's, and not all of these new companies sold specialty policies.¹⁷ A more important factor than size in the success of any company is the quality of management and other top personnel. Much of the inherent advantage of large size can be reduced by intelligent and economical operation of the beginning company, especially as manifested by the choice of an unsaturated market as a starting point. The large companies have no monopoly on either management or sales talent, and even in straight price competition small companies need not be left behind.^{17a} Nor is price competition necessarily decisive. One life insurance executive feels that "price competition can be weak competition. Many of the best agents do not even carry a rate book. Salesmanship is still the key to real success in our business . . . and it is here that the younger companies have been leading the way."¹⁸

Indeed, not only is it possible for a small company to compete without specialty policies, as is demonstrated by the success of many of them in so doing, but there is some doubt whether such policies contribute to the ultimate success of a new company.¹⁹ Dissatisfied policyholders will lead to lower persistency, which will detract from

¹⁶ N.Y. Times, May 13, 1962, § 3, p. 1, col. 2. See also figures provided in [1963] LIFE INS. FACT BOOK 18; 68 LIFE INS. COURANT 66 (April 1963); 56 LIFE INS. COURANT 56 (April 1951).

¹⁷ Our survey of *Best's* revealed many new small companies that apparently do not issue the specialty policies discussed in this paper. Moreover, there seem to be small companies that make it a point of pride to succeed while using only traditional forms. See also *Transcript of Hearing, In the Matter of Consideration of Adoption of a Proposed Rule Ins. 2.08 of the Wisconsin Administrative Code* 82 (Jan. 1962). But see Brief for General Life Insurance Corporation in Opposition to Proposed Rule Ins. 2.08, p. 35.

^{17a} For example, the following are actual premiums for a nonparticipating ordinary life policy for \$10,000, for a male, at age 35:

New or small company # 1	\$190.70
New or small company # 2	\$207.50
New or small company # 3	\$190.60
New or small company # 4	\$187.70

The average premium of five large, well established stock companies is \$191.20.

¹⁸ See 1957-1958 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 55.

¹⁹ See, e.g., Mr. Farrant, Vice-President and Actuary of British Pacific Life Ins. Co., 1960-1961 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 55-59.

the competitive position of the company. If the purchaser of a specialty contract is oversold and is disappointed, the company's public relations will grow weak as the policy grows older. Moreover, agents recruited to sell specialty policies are not inclined to stay with the company if it shifts to more conservative practices.²⁰

But whether or not the advantages of a specialty policy outweigh its disadvantages, many small companies treat the specialty policy as the key to success and insist upon trying it out. In the absence of persuasive considerations urging the regulation of specialty policies, the small company should be free to try whatever measures it thinks will improve its position. Freedom in the marketplace is still a value in our society which receives and should receive substantial weight. But it is not an absolute; it must be weighed against other relevant values which urge restriction upon freedom of contract. This leads to a consideration of the important values which are thought to be implicit in insurance law, and to which the law regulating specialty policies must adjust.

III. THE PUBLIC POLICY CONSIDERATIONS UNDERLYING REGULATION

At the 1962 Annual Meeting of the National Association of Life Companies (NALC),²¹ attention was focused upon the increasing number of states regulating, or proposing to regulate, specialty policies. There were many expressions of protest that these regulations were being used by the larger companies to exclude the

²⁰ "A specialty-type salesman, as a rule, is an individual who will drift from company to company." Raymond Strong, consulting actuary, participating in a forum, 1960-1961 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 59. William K. Robinson, consulting actuary, said in another meeting of the same organization, "Whatever the circumstances are, at some time in the company's future there must be a change to the orthodox plans of insurance. This may come as a very drastic change and affect the agency force to a great extent. Companies have done quite well selling a 'founders' contract but have found their men woefully untrained and completely inadequate when attempting to sell the orthodox plans. The result has been a very substantial drop in volume." 1956-1957 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 144.

²¹ The National Association of Life Companies was originally organized in Atlanta, Georgia in January 1955, under the name "National Institute of Life Insurers." It consisted of approximately one hundred southern life insurance companies. In February it changed its name and enlarged its membership to about 160 companies. One important reason for the formation of this association was to resist the anti-tontine bill sponsored by the National Association of Life Underwriters (NALU) and to defend the use of specialty policies by small companies. See note 46 *infra*. See the National Underwriter, Life Ed., Jan. 14, 1955, p. 1, and Feb. 18, 1955, p. 14; Insurance Advocate, Jan. 15, 1955, p. 31, and Feb. 19, 1955, p. 26; United States Review, Jan. 15, 1955, p. 24; The Eastern Underwriter, Jan. 14, 1955, p. 1; The Spectator, March 1955, p. 28. The NALU bill may be seen at two stages of maturity in Life Ass'n News, Nov. 1954, p. 147, and May 1955, p. 86. See note 46 *infra* for the final text.

smaller companies from the market. Ellis Arnall, Chairman of Coastal States Life Insurance Company and Chairman of the NALC, declared:

"Little business in every field asks nothing of big government or big business except fair play. Little business, as represented by nearly 1,000 small, growing, vigorous life companies, asks nothing except the application of the same rules to them and their large competitors."²²

The meeting passed a resolution which admonished

". . . NALC member companies to take cognizance of and prepare to fight the 'stringent restrictions' which are being enacted by several states against certain special policies. The association feels that these restrictions are prejudiced in favor of the larger companies and that it has an equal right to compete freely insofar as its conduct is not injurious to the public."²³

Joseph J. McCaffery, President of State Life of Montana, issued a call to battle:

"[The association] has resisted the tidal wave of opposition [to specialty policies]. . . . [T]his encroachment on the right of free competition must be eradicated. . . . The determination of the boundaries of 'public interest' should be established by policyholder demands and not by departmental regulation made without consideration accorded to individual or group needs and desires for protection."²⁴

Whether there should be regulation or even prohibition of specialty policies, and if there should be regulation, what kind it should be, depends on the public policy objectives which our society decides are important and seeks to implement. It is necessary here to sketch briefly the principal objectives of insurance law applicable to this problem.²⁵

The most important public policy objective of insurance law is the preservation of the solidity of the insurance company. However, this objective has little importance in the present context, for the specialty policy offers no particular threat to solidity. In general, it is actuarially sound. A second important objective of insurance

²² The National Underwriter, Life Ed., Aug. 11, 1962, p. 15, col. 3.

²³ *Id.* at 21, col. 1.

²⁴ *Ibid.*

²⁵ See generally Kimball, *The Purposes of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 MINN. L. REV. 471 (1961).

regulation is, however, to ensure that in the relations between the policyholders and the insurance companies there will be reasonableness, equity and fairness. A good deal of insurance law and regulation consists of efforts to police the insurance transaction and the relationships created by it, mainly for the protection of the policyholder in these respects. This important objective justifies and explains a great deal of intervention in the insurance transaction, and is relevant in any discussion of specialty policies.

The foregoing goals or purposes of insurance law are related to the effective functioning of the insurance institution itself. Without solidity and *æquum et bonum*, or "purity of the market" as one might call the congeries of related goals mentioned above,²⁶ the insurance institution does not perform its basic social function. But in addition, various general aims of our society impinge upon the insurance institution as overriding goals. Some of them lead to more legal intervention in the insurance enterprise; some lead us to eschew intervention. Some of the objectives are related to our political values; some are social and economic; some are moral. The whole range of goals having impact on insurance law has been studied in detail elsewhere;²⁷ here they are described only so far as is important for present purposes.

A goal that operates to limit and restrict intervention is the goal of liberty, by which is meant the absence of governmental interference in private relationships and private transactions. In the field of contracts especially, private autonomy is a value that has been and should be given great weight in our society. It reflects an underlying judgment that a central bureaucracy cannot, in general, make decisions which primarily affect only individuals as wisely as can the individuals themselves. Under the name "freedom of contract" this value reached its zenith in the latter part of the nineteenth century as one aspect of the translation of the doctrines of economic liberalism into law. To a considerable extent, the value of freedom of contract even became imbedded in the Constitution as one facet of the due process clause of the fourteenth amendment. In this century, however, there has been a substantial reduction in the value accorded to freedom of contract. Its constitutional protection has all but disappeared. But even if it no longer has the status of a constitutionally protected right, it is still a factor of importance in deciding whether to enact specific regulatory or pro-

²⁶ There is no suitable expression for this related group of objectives; they have been designated collectively as *æquum et bonum*, for want of a better term. *Id.* at 486.

²⁷ See Kimball, *supra* note 25.

hibitory proposals. It is here asserted that freedom of contract is a value so weighty that there should be regulation or prohibition of a freely contracted agreement only after a persuasive case has been made for such intervention. This value creates a presumption against government intervention in the private autonomy of freely contracting parties. This is true even if the contract in question is a contract of adhesion, so long as the market is competitive in the sense that, although there is no practical possibility for an individual policyholder to negotiate terms with an insurer, there is at least the opportunity for him to shop around in a market in which a variety of products is available.

Another value of American society that sometimes puts restrictions upon the intervention by the legislature and the courts in the insurance business, but at other times demands it, is the value of freedom of access to the insurance market for new entrepreneurs. This is related to the freedom of the individual insurance company, once admitted to the market, to compete without artificial restrictions upon the market by monopolistic controls. But neither freedom of contract, nor freedom to enter the market, nor freedom from domination of the market by self-appointed private guardians of the public weal is an absolute value. All are values only to the extent that they contribute to the welfare of the community. The justifications for a competitive economic system are (1) that it presumably produces higher quality and lower cost products than can be produced under any other and (2) that it provides a more congenial climate for political and social freedom (which come close to being absolute values). Control by government is cumbersome, difficult, and of uncertain consequence, and should be engaged in only so far as its effects are demonstrably good. The regulator himself has no monopoly on wisdom, and the facts upon which he must act are seldom clear. However, it is impossible to oppose regulation or prohibition directed at the prevention of fraudulent, deceitful, or grossly misleading practices, particularly if the form of intervention is mild. Interference that merely assures policyholders the power to make an informed choice when they purchase insurance does not really decrease economic freedom; in a real sense it enlarges it. Competition can work well only if the purchaser is "able and willing to discriminate between articles offered by different competitors"²⁸

²⁸ PATTERSON, *THE INSURANCE COMMISSIONER IN THE UNITED STATES* 246 (1927). In his special message to Congress on March 15, 1962, President Kennedy said: "Misleading, fraudulent or unhelpful practices . . . are clearly incompatible with the efficient and

One makes part of the case for intervention in life insurance by pointing to the complexity of the contract. The average buyer of life insurance is nearly helpless in considering the elaborate, technical, and varying policies available in the market. This helplessness is more evident when there is completely unrestrained freedom, because the life insurance contract, at best difficult to understand, can then appear in any number of variations.²⁹

The proponents of specialty life insurance policies have usually framed the issue as one of struggle between the old, giant, established insurance companies and the new, small, imaginative companies seeking to find a place in the market and to create a more competitive environment. The theoretical justification for free enterprise is that a competitive climate provides incentive to produce new and better products. If it is true that the regulation or prohibition of specialty policies is a weapon of established companies, utilized to keep new companies out of the business and to parcel out the market, then of course there should be great reluctance to impose such regulation or prohibition. On the other hand, there is a mystique about the idea of competition which can be and is used in an effort to justify many questionable practices. At the present time, few uninterested persons could be found to proclaim the merits of competition altogether unrestrained by law. New entrepreneurs have no natural right to have access to the market on any terms they may choose. The basic right is the right of the policyholder and of society rather than of the entrepreneur. It is legitimate to place limits upon the competitive freedom of both new and old companies for good reasons, and the problem is only to determine what limits are desirable to impose.

The question can best be formulated in these terms: Are the circumstances under which specialty policies are now issued in the American life insurance market such that the public interest would be served by regulation or prohibition of these policies, taking into consideration both the desirability of reasonableness, equity, fairness, and transparency of the market on the one hand, and freedom

equitable functioning of our free competitive economy." N.Y. Times, March 16, 1962, p. 16, col. 8. "[The consumer has the] right to be informed—to be protected against fraudulent, deceitful, or grossly misleading information, advertising, labeling, or other practices, and to be given the facts he needs to make an informed choice." *Id.*, col. 2.

²⁹ "It is hard enough for the layman to understand the workings of the life insurance contract. It is the duty of the insurance industry in the public interest to simplify the phraseology and provisions, not to add that which intends to confuse and complicate." Testimony of Arthur Gordon, of the International Union of Life Insurance Agents, *Hearing Before the Wis. Dep't of Ins. on Proposed Rule Ins. 2.08*, p. 104 (Jan. 1962).

of access to the market and freedom to contract without government intervention on the other? Are the dangers of deception in specialty policy marketing so substantial and so deleterious that freedom of entrepreneurs must be restricted to prevent the deception? If so, can effective methods of control be devised which do not limit freedom unnecessarily, or is prohibition the final solution? The answer will not necessarily be the same for each kind of specialty provision; the question must be answered separately for each set of circumstances. It seems quite conceivable, although perhaps not likely, that one solution would be best in New York and another in South Dakota, or that one answer would be justified in 1925 while the circumstances of 1963 demand another. Certainly one answer may be appropriate for the tontine or the profit-sharing policy, and quite another for the return-of-premium provision.

With this brief introduction to the public policy considerations applicable in this field, let us proceed to a discussion of the specialties offered and of the problems each raises, dealing with some lightly and with some in detail.

IV. TONTINE POLICIES

Speculative insurance is not a new invention. The tontine, or the semi-tontine, has been a feature of the American life insurance scene for nearly a century. It is an application to life insurance of a speculative device proposed by Lorenzo Tonti toward the end of the seventeenth century as a way to resuscitate the sagging finances of the French state. A fund was collected from lenders, and each year interest was paid on the loan. Subscribers were divided into age classes, each constituting a closed group, and each year the interest on the fund was divided among the surviving members of the class. The principal sum was never repaid, all obligations of the state ceasing upon the death of the last subscriber. The appeal was to the speculative instincts of the subscribers, for the longer-lived among them eventually realized very handsome incomes by receiving an ever-increasing share of the interest on the entire sum originally contributed by all subscribers of the class. On the other hand, the short-lived subscribers lost a great deal. The tontine was in use into the eighteenth century as a means of raising revenue for the military adventures of European states.³⁰

In the United States, tontine life insurance dates from 1868, when the Equitable introduced its "Tontine Dividend Life As-

³⁰ See 2 ENCYC. SOC. SCI. 70 (1930).

insurance Policies.”³¹ Basically the tontine was a standard participating policy, with the payment of dividends on the policy deferred for ten, fifteen, or twenty years. Those who died forfeited any interest in the dividends, though not in the face value of the policy; those who lapsed forfeited both dividends and the reserve. The accumulated dividends and forfeitures for each class of policies were paid to those policyholders whose policies were still in force. There was no guarantee as to the amount of the “jackpot,” but on the basis of estimates that two out of three policyholders would lapse, the predicted profit would be very substantial indeed. This original tontine plan was soon modified into the semi-tontine, in which there was no forfeiture of reserve values upon lapse. The amount of the premium in excess of the amount allocated to expense, losses, and to the legal reserve of the policy was not distributed as an annual dividend, but constituted the source from which the tontine, or accumulated fund was built. As before, only the survivors whose policies were still in force shared in the accumulated dividends. The semi-tontine was known under various names, such as the “deferred dividend,” “dividend endowment,” “reserve dividend,” “life rate endowment,” or the “dividend investment” policy.³²

The success of the tontine or semi-tontine was phenomenal, most of the companies in the business using it. Riding on it, the Equitable advanced rapidly to first place. Those leading companies that declined to embrace the tontine slipped badly in relative rank. For example, measured by insurance in force, the Connecticut Mutual dropped from second in 1875 to fourteenth in 1905, while Mutual Benefit dropped from fourth to eighth.³³

Soon the abuses to which the semi-tontines were susceptible were revealed by the Joint Committee of the Senate and Assembly of the State of New York Appointed To Investigate the Affairs of Life Insurance Companies, better known as the Armstrong Committee. The fact that the policyholders, even if they did survive the tontine period, would not receive an amount even approaching their expectations became clearly evident. This was mainly the result of three factors. First, there was a decline in interest rates,³⁴

³¹ BULEY, *THE EQUITABLE* 27 (1959). The American Tontine Life and Savings Ins. Co. of N.Y. issued the tontine earlier in the same year, but the Equitable action was the significant beginning. *Id.* at 28.

³² See 1 BULEY, *THE AMERICAN LIFE CONVENTION: A STUDY IN THE HISTORY OF LIFE INSURANCE* 93-96 (1953); STALSON, *op. cit. supra* note 5, at 487-88.

³³ STALSON, *op. cit. supra* note 5, table B, at 793-801.

³⁴ *Id.* at 242; REPORT OF THE JOINT COMMITTEE OF THE SENATE AND ASSEMBLY OF THE STATE OF NEW YORK APPOINTED TO INVESTIGATE THE AFFAIRS OF LIFE INSURANCE COMPANIES 427 (1906) [hereinafter cited as the ARMSTRONG REPORT].

for which no blame can be attributed to the companies. Second, although agents made no binding promises as to the amounts that would ultimately be distributed to the policyholder, they made very confident predictions which were not borne out by events.⁸⁵ Third, the accumulated fund was easy prey for costly and sometimes dishonest business practices because "there was a relative lack of legal accountability for the funds thus accumulated, since they were beyond the legal reserve."⁸⁶ Sometimes these large surpluses were neither properly accounted for nor allocated to the policyholders, but were squandered in extravagance and corruption.

Charles Evans Hughes, later Governor of New York, presidential candidate, and Chief Justice of the United States, served as legal counsel to the Armstrong Committee. He spoke to the crux of the problem when he said that "of all the reforms suggested by the Committee, nothing . . . is more imperatively demanded than that the companies should be compelled to exhibit the results of their management by annual accounting," and that "there seems to be general agreement that the abuses which inevitably flow from the control of large accumulations, said to be held for policy holders but not the subject of any definite obligation, make this necessary."⁸⁷ The requirement of an annual distribution of dividends appeared to provide the solution by preventing the long-term accumulation of funds which in the past had, by reason of accessibility and comparative lack of legal controls, constituted a financial resource available for many questionable practices. Furthermore, a required annual distribution would eliminate a prime source of misrepresentation and exaggeration, namely the speculative idea that the policyholder would share an ever-increasing fund with an ever-decreasing number of persons.

After the Armstrong Committee Report the New York Legislature wasted little time in enacting a statute, effective January 1, 1907, requiring an annual apportionment and distribution of dividends to the policyholders.⁸⁸ About one half of the states seem to have followed New York's lead by requiring annual apportionment and distribution of dividends.⁸⁹ A few states by statute require dis-

⁸⁵ Kimball, *The Role of the Court in the Development of Insurance Law*, 1957 Wis. L. REV. 520, 539; see ARMSTRONG REPORT 422-33.

⁸⁶ Kimball, *supra* note 35, at 539; ARMSTRONG REPORT 422-33.

⁸⁷ ARMSTRONG REPORT 429.

⁸⁸ This is now N.Y. INSURANCE CODE § 216.

⁸⁹ *E.g.*, MO. ANN. STAT. § 376.360 (1949); TEXAS INS. CODE, Art. 11.12 (1963); WIS. STAT. ANN. § 206.13(1) (1957).

tribution no less often than every five years;⁴⁰ a few states prohibit the tontine by departmental regulation.⁴¹

After the wave of legislation which followed the Armstrong Committee's report, it was easy to suppose that the tontine policy was of little more than historical interest. It is probably true that it never died completely, but until recently it appears not to have been common after being discredited early in the century. Lately, however, the semi-tontine seems to have been resurgent,⁴² although it would be impossible to obtain quantitative data as to the number of such policies issued. A memorandum submitted in 1954 to the Laws and Legislation Committee of the National Association of Insurance Commissioners by the National Association of Life Underwriters stated that despite the various anti-tontine statutes "certain companies are becoming so adept at circumventing these laws that it has become necessary to enact some specific anti-tontine legislation."⁴³ In the same year one insurance newspaper stated in an editorial that

"there has been a considerable increase in the writing of tontine policies in the south, the southwest and the southeast. . . . [A]n increasing number of companies, especially the newer and smaller ones, are managing to get a good start during their early years by specializing in the sale of tontine contracts."

The editorial declared that "on the evidence it can no longer be doubted that tontine policies are definitely on the increase."⁴⁴ Lending strong support to the conclusions drawn in these sources is the fact that some departmental regulations prohibiting tontine policies have been promulgated in recent years.⁴⁵ Furthermore, in response to an anti-tontine bill sponsored by the National Association of Life Underwriters,⁴⁶ nearly a hundred small insurance companies formed an association which was later to become the

⁴⁰ *E.g.*, MICH. STAT. ANN. § 24.14020 (1957); TENN. CODE ANN. § 56-1603 (1955).

⁴¹ *E.g.*, Ala. Dep't of Ins. Reg., Sept. 23, 1955, as reprinted in WEEKLY UNDERWRITER, [1955] INS. DEPT. SERVICE [for] ALABAMA 3; Fla. Dep't of Ins. Bull. 152A, Aug. 8, 1961; Ga. Dep't of Ins. Order, May 26, 1955, as reprinted in WEEKLY UNDERWRITER, [1955] INS. DEPT. SERVICE [for] GEORGIA 10.

⁴² "This plan [semi-tontine], which most people supposed had passed out of existence, experienced a revival in 1955 in Texas and a few other states. It was also known as the 'survivorship bonus' plan." RIEGAL & MILLER, INSURANCE PRINCIPLES AND PRACTICE 286 (4th ed. 1959). Another term is "Special Persistency Fund." Prospectus of Surety Life Insurance Company, March 15, 1960, p. 28.

⁴³ [1954] 2 PROCEEDINGS OF N.A.I.C. 290.

⁴⁴ The National Underwriter, Life Ed. (editorial comment), Oct. 29, 1954, p. 14, cols. 1, 2, reproduced in [1955] 1 PROCEEDINGS OF N.A.I.C. 117.

⁴⁵ See note 41 *supra*.

National Association of Life Companies, the primary purpose of which was to defend against the further enactment of anti-tontine legislation.⁴⁷ In reporting that Alabama had issued a formal directive prohibiting the sale of tontine and semi-tontine policies, one paper stated that about thirty companies had been issuing such policies.⁴⁸ This evidence gives justification for assuming that tontine type policies have been issued in recent years on a fairly extensive and increasing scale.

Why has there been such a resurgence? The issuance of tontine and semi-tontine policies prior to the Armstrong exposé showed that often the combination gambler and family man that resides in most of us responds favorably to a combination of life insurance with a speculative element. Even buyers who would never gamble

⁴⁶ One version of the bill is found in [1954] 2 PROCEEDINGS OF N.A.I.C. 291:

SUGGESTED BILL OUTLAWING TONTINE, SEMI-TONTINE, OR "JACK-POT" POLICIES

"Notwithstanding any other provisions of the Insurance Code to the contrary, no life insurance policy other than Group Insurance shall hereafter be delivered in this State:

"(1) Which does not constitute the entire contract between the parties and which does not provide in the contract the amount and manner of payment of benefits, and the consideration therefor.

"(2) Which contains a provision for the segregation of policyholders into mathematical groups and providing benefits for a surviving policyholder or policyholders of a group arising out of the death of another policyholder or policyholders of such group, or under any other similar plan.

"(3) Which contains a provision providing benefits or values for surviving or continuing policyholders contingent upon the lapse or termination of other policyholders, whether by death or otherwise.

"(4) Which contains a provision that on the death of anyone not specifically named therein, the owner or beneficiary of the policy shall receive the payment or granting of anything of value."

NALU submitted a revised version to a later meeting of NAIC. [1955] 1 PROCEEDINGS OF N.A.I.C. 116; *Life Association News*, May 1955, p. 86:

SUGGESTED ANTI-TONTINE BILL

"No life insurance company shall hereafter deliver in this state, as a part of or in combination with any insurance, endowment or annuity contract, any agreement or plan, additional to the rights, dividends, and benefits arising out of any such insurance, endowment, or annuity contract, which provides for the accumulation of profits over a period of years and for payment of all or any part of such accumulated profits only to members or policyholders of a designated group or class who continue as members or policyholders until the end of a specified period of years. Nor shall any such company deliver in this state any individual life insurance policy which provides that on the death of anyone [other than a beneficiary,] not specifically named therein, the owner or beneficiary of the policy shall receive the payment or granting of anything of value."

The words in brackets are in the *Life Association News*, but not in the NAIC *Proceedings*. They represent a modification proposed subsequent to submission to NAIC.

⁴⁷ See note 21 *supra*. The provisional head of this new organization, Claude H. Poin-dexter of Coastal States Life Insurance, said that "the primary reason for organizing was as a defense against the efforts of the National Association of Underwriters to obtain legislation outlawing what it has referred to as tontine or semi-tontine policies." See *National Underwriter*, *Life Ed.*, Jan. 14, 1955, p. 1, col. 4.

⁴⁸ *National Underwriter*, Sept. 30, 1955, p. 1, col. 2; Ala. Dep't of Ins. Reg., Sept. 23, 1955, as reprinted in *WEEKLY UNDERWRITER*, [1955] *INS. DEP'T SERVICE* [for] ALABAMA 3.

in more direct ways may find the speculative aspects of the tontine attractive. This lesson either has not been forgotten or has been relearned and has produced the modern development of the semi-tontine policy as well as the other policies containing speculative features discussed in this article.

A. *Disadvantages of the Tontine*

Several objections have been urged to the issuance of the semi-tontine policy. It has been denounced as a gambling contract, as especially susceptible to misrepresentation, and as leading to waste and graft. Each of these suggested objections will be discussed separately.

1. *Speculative Nature of the Tontine*

It has often been said that the tontine or semi-tontine is bad in itself—that it is a gambling contract and therefore should be made illegal, even if it could be kept under adequate control and even if no abuses were chargeable to it.⁴⁹ This contention is based upon the fact that a larger return may be received than is justified by the premiums paid for the individual policy; *i.e.*, the lucky policyholder who survives and does not lapse receives a return that is much larger than would be provided him by ordinary insurance. Conversely, the unlucky policyholder who dies early or who lapses loses part of the premium which he has paid. This is said to be gambling and properly forbidden by law irrespective of abuse.

“The tontine principle thus clearly adds a gambling element to perfectly legitimate basic life insurance. The ‘estimated’

⁴⁹ The semi-tontine policy is sometimes called the “crap-shooter” policy by its opponents. See BARR, *Coupon and Special Contracts*, [1961-1962] 2 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 42, 45. It has been bitterly and intemperately attacked by its opponents. The NALU recently said that “deferred dividends . . . are not essential to and, in fact, are foreign to the basic life insurance operation, being used only to promote sales by tontine devices that promise highly attractive awards to a relatively few survivors at the expense of the many who cooperated in a risk adventure superimposed on their policies without relation either to the financial needs or policy of the company or to the general interest of all policyholders.” National Underwriter, Life Ed., Sept. 9, 1955, pp. 1, 16, col. 4. Prior to the turn of the century Jacob L. Greene, President of Connecticut Mutual Life, the most dedicated opponent of the tontine in its early days, said: “I believe that the Tontine feature is a complete perversion of the element of protection to the family which is the sole merit of life insurance and the only reason of its being” *Papers Relating to Tontine Insurance*, Connecticut Mutual Life Insurance Co., No. 8, p. 3 (1887) as quoted in 1 BULEY, *op. cit. supra* note 32, at 103. See generally the polemics connected with this controversy, to be found in, *e.g.*, the cited collection and in works cited in STALSON, *op. cit. supra* note 5, notes to Ch. XXI. Stalson gives a summary of the arguments on both sides. *Id.* at 487-95.

jackpot becomes the glittering bait dangled before the prospect as an extra added inducement, and in the *deceptive and misleading estimates* of the profits that are to make up the jackpot and of the termination rates that are to "sweeten" the share of each surviving policyholder therein, lie our legitimate objections and the hazard that threatens the good name of life insurance."⁵⁰

Let us look more closely at the nature of the tontine portion of the contract. It has a certain resemblance to a pure endowment. A person who does not need to insure himself against premature death, for whatever reason, but who does need to insure himself against too long life, might wish to procure a pure endowment policy which pays him only if he survives to the crucial date, or an annuity which terminates in any event upon his death. If his endowment is combined with a life insurance feature, or if his annuity is for a number of payments certain, he will pay more than for a pure endowment or life annuity. The differences in these premiums are easily calculable on familiar assumptions as to interest rates and mortality, and are often very striking. It is difficult to see why any person who needs either a pure endowment or a life annuity, alone or in combination with life insurance, should be denied one based upon assumed grounds of public policy and the assertion that these are gambling contracts. It is difficult to see how the tontine is in any different position if one assumes that no abuses accompany its issuance. The purchaser of a tontine has in practical effect obtained, in combination with his life insurance, a pure endowment in a participating mutual association. The exact amount he will receive depends on the experience of his class, but he will get protection of a certain nature which may be useful to him, and at a relatively low rate. If no abuses accompany the tontine policy, it seems not only innocuous, but may even be valuable under certain circumstances. In any case, there is no justification for prohibiting it because of its essential characteristics. A good deal of the polemic against the tontine misses the mark.

The semi-tontine may be less innocuous. From one point of view, it is less speculative than the full tontine. Thus there is a forfeiture only of the policyholder's share of the deferred dividends, and not of the reserve as well. But the theoretical justification of the tontine is that, like a pure endowment, it provides a

⁵⁰ Walker, *Those Tontines Are Back Again!*, Life A. News, Sept. 1954, p. 54. (Emphasis added.)

large potential benefit for a low premium. This is especially true if the ordinary insurance benefit purchased represents only a small part of the total premium. The semi-tontine does that to a lesser extent. It is a hybrid contract, mainly ordinary insurance but partially a pure endowment. Basically it is traditional life insurance to appeal to the sober family man, yet it has a minor speculative element to appeal to the gambling instinct. It has less of the advantage of providing a cheap way to create a fund for old age than does the full tontine. Instead it is a high cost policy with certain added speculative possibilities to make it appealing. Of course, it, too, may well enough meet the needs of a small part of the insuring population, but that was not the intention of its developers. It was intended both in the nineteenth century and more recently to appeal to a wide range of insurance buyers. No effort is made to limit its sale to those people who may have some special need for which it is well adapted. Its attraction is not its suitability for a special purpose, but rather its speculative nature. It seems to follow that the semi-tontine is more objectionable than the full tontine, primarily because it serves a useful purpose less frequently than does the full tontine. While the existence of a tontine element is not necessarily bad in a contract, and may even be useful, this combination of the tontine element with life insurance prevents either from performing adequately the task for which each is the suitable instrument. However, little more can be said in condemnation of even the semi-tontine, so far as speculative character is concerned, than that it has relatively little value in the market place. It can hardly be castigated as a "gambling" contract without a gross distortion of the facts. It is not a bad contract, but rather a relatively useless contract.

2. *Susceptibility to Misrepresentation*

The second objection to the tontine is its susceptibility to misrepresentation. Attention was focused on this problem by an editorial comment appearing in the *National Underwriter*.

"At the NALU meeting in Boston the objections made to the tontine contract were principally the way in which it is usually sold. It was contended that the tontine policy is almost invariably misrepresented."⁵¹

The assertion that the tontine is almost invariably misrepresented cannot be accepted without further inquiry. But if it is

⁵¹ See note 44 *supra*.

true, then it follows without argument that steps should be taken to control the misrepresentation, for good faith is even more necessary in insurance than it is in most commercial transactions. If a policyholder learns that he will receive only a small part of his expectations in a tontine policy, "he will believe that he has been overcharged and cheated on every other policy he owns. He very likely will look upon all other life insurance as legalized robbery."⁵² If the public should develop a dislike and distrust for the institution of life insurance, it would perform its important role in our social life less adequately.

When one looks at the tontine policy as actually used in this country, it becomes apparent why it is especially susceptible to misrepresentation. It is a hybrid. It is neither pure insurance nor pure endowment, but a combination of both, designed to couple the life insurance that most people need with the speculative element that makes it attractive. The buyer considers that he is getting insurance, the need for which brought him into the market—the need to protect his family against the consequences of a premature death. The tontine policy is an expensive way to do this because the tontine aspect provides protection against excessive duration of life. Only an unusual agent, perceptive and honest and able successfully to communicate difficult concepts to ordinary people, could sell the tontine policy as it exists in the market and be sure that only those persons who need and want it will acquire it. Even if the semi-tontine as well as the full tontine justifies its existence by providing an answer to certain special needs, it seems clear that there inevitably must be much misrepresentation in the sale of such policies.

The tontine is especially susceptible to misrepresentation for three related reasons, all operating to a degree that makes misrepresentation substantially more likely than in the case of a more conservative type of life insurance policy. The first is that to the usual uncertainties of interest earnings, mortality experience, and actual expense is added still another that is even less predictable, the lapse rate.

A first-year lapse rate of fifteen to seventeen percent, which would be quite normal, may easily be stated in such a way as to suggest an equally large annual lapse rate throughout the life of a group of policies, which would be highly unlikely. One opponent of tontine policies made this point in the following language:

"In many cases, an actual first-year termination rate of, say,

⁵² Walker, *supra* note 50, at 60.

17% may be cited to a prospect as the rate that very likely will be experienced during the entire tontine period specified in the policy being offered to him. However, if we assume that in a class of 1,000 policyholders, 17% of them will terminate each year for 19 years, then we will find that only 23 will share in the tontine distribution. Such a termination assumption has no factual basis in the known experience of any company."⁵³

Since a heavy termination rate means a gain for the survivors, there is much temptation for the agent to exaggerate.⁵⁴ Inasmuch as lapse means forfeiture and persistency results in a sharing in profits from lapses, there is a tendency for tontine policyholders to show a higher persistency rate than ordinary policyholders. At least the argument has been made in favor of tontines at a meeting of the National Association of Insurance Commissioners that they encourage persistency.⁵⁵ Surely it is deceptive to emphasize to a prospect that he will have the advantages of a high rate of termination if the tontine encourages a high rate of persistency. There is a misleading appeal to the perpetual optimism in human nature—to the assumption by each person that he will be one of the fortunate few and to assumed facts about lapses that are likely to be untrue.

The second reason for the susceptibility of the tontine to misrepresentation is that the lack of the same degree of legal control over the deferred dividend funds as that which exists over the legal reserve makes it possible to use overconfident assumptions in predicting future developments. While the reserve must be computed on the basis of conservative assumptions, no such requirements are even relevant for deferred dividends. The salesman is free to estimate the profits on deferred dividends on the basis of the most favorable dividend and market price history, using a period such as 1919-1938, for example.⁵⁶ Moreover, it is easy to set up a profitable investment list on the basis of hindsight. The possibilities for misrepresentation seem clear enough, leading in extreme cases to what one opponent called a "fantastic" profit pro-

⁵³ *Id.* at 60.

⁵⁴ *Id.* at 54.

⁵⁵ Memorandum submitted by Herbert Graves and D. D. Murphy. See [1955] 1 PROCEEDINGS OF N.A.I.C. 119.

⁵⁶ The proposal reproduced in Walker, *supra* note 50, at 55, assumes "a repetition of the dividend and market price history, 1919-1938, of the Special Contingency Fund Portfolio of earning securities in each of the following 30 Basic Industries." (There follows a list of thirty leading corporations.)

jection.⁵⁷ The extremes to which such exaggeration may go are found in a sales presentation that proclaimed, for a Twenty Pay Life Policy with a semi-tontine feature, that

“based on a minimum of \$26.00 per unit of \$5,000 being annually contributed to the reserve fund as provided for in the special resolution by the board of directors, in twenty years your share of this distribution of profit would be a cash settlement of \$5,137.15.”⁵⁸

The above proposal assumes that a \$26 annual allocation to the tontine fund, or \$520 in all, will mushroom to \$5,137 within twenty years. The sales interview even suggested that this was ultraconservative. A staff member of the Kentucky Insurance Department is said to have estimated, however, on the basis of the first five years of experience with this fund, that it would in fact be worth between \$700 and \$900 to those who survived and did not lapse.⁵⁹ It must be pointed out, however, that the first five years would not necessarily be representative, and that the ultimate results might possibly be better.

A former president of the National Association of Life Underwriters, a vigorous opponent of the tontine, provides another illustration.⁶⁰ He focused upon a Twenty Pay Life Policy for \$5,000. At age ten the annual premium was \$165.65. After twenty years, the total of premiums paid would be \$3,313, at which time the guaranteed cash value would be \$1,770. The estimated value of annual cash dividends left with the company was stated at \$331.30, and the estimated value of the tontine fund dividend was \$8,656.16. The total, \$10,757.46, was 324 percent of the total premium paid and more than twice the face of the policy.

He then compared this with a \$5,000 Twenty Pay Life, Endowment at age eighty-five, without a tontine feature. As sold by a “representative nonparticipating company” the latter policy cost \$105.15 annually at age ten, and had a cash value of \$1,775 at the end of the twentieth year.

“It is abundantly clear that the company issuing the semi-tontine policy is putting no more into reserves and guaranteed non-forfeiture values despite the fact that it collects \$1,210.00 more in premiums over 20 years to maturity.”⁶¹

⁵⁷ *Id.* at 60.

⁵⁸ Horan, *Gimmick Policies*, *Best's Life News*, June 1962, p. 65.

⁵⁹ *Id.* at 66.

⁶⁰ Walker, *supra* note 50, at 55, 58.

⁶¹ *Id.* at 58, 60.

For the reasons discussed above, the excessive charge is not theoretically objectionable if it all goes into the tontine fund. However, in no tontine policy or proposal that the NALU president examined did the "issuing company propose to set aside in the tontine fund as much as one-half of the excess of the larger premium charged over the full tontine period."⁶² The confident projections seem to contemplate such a total allocation, however. If in fact substantial sums are diverted from the premiums to some purposes other than those stated to the policyholder, it would not be surprising if "the actual results fell so very far short of the rosy picture of dividend bonuses painted for policyholders that many of them actually felt they had been swindled."⁶³

The third reason that the tontine is often misrepresented is that there is little that can be done by the law to ensure that the entire excess is actually allocated to the fund. These extra dollars are largely in the control of the board of directors, and the policyholders have no precise contractual rights. In the heyday of the tontine, this was the great vice; funds for which there was such limited accountability were subject to extravagant practices and graft. There is no way to reach valid conclusions about the extent to which wasteful practices exist today, but there is at least some evidence that they are not unknown. Indeed, it would be surprising if there were not substantial abuses.

3. *Danger of Venality*

Extravagance and graft are themselves objectionable, quite aside from the fact that they lead to misrepresentation. Indeed, they led to the abolition of the tontine policy in many states in the early twentieth century.

When a life insurance company operating on the legal reserve basis makes a promise to pay a specified sum of money upon the death of the policyholder, it is required by law to maintain reserves which are adequate as computed on a sound actuarial basis, to provide the funds with which to pay the beneficiary when the death occurs. The tontine aspect of the policy is different, however. No specified sum must be paid. There is only the promise that the policyholder will share in the proceeds of a fund the exact amount of which is completely uncertain, made at a time when it is even uncertain how much money will be paid into it year by year. The

⁶² *Id.* at 60.

⁶³ United States Rev., June 12, 1954 (editorial comment), reproduced in [1955] 1 PROCEEDINGS OF N.A.I.C. 117, 118.

deferment of dividends that is involved in the sale of the tontine leads to the acquisition by the insurance company of large sums of money for which there is only limited accountability. The absence of close legal control over the funds encourages misuse through wasteful expenditures and through outright graft and corruption. Both kinds of misuse occurred in the latter part of the nineteenth century, eventually leading to the Armstrong investigation. For one thing, the large sums of money held in deferred dividend accounts encouraged companies to engage in a commission war in which the rates of commission for agents continually grew as the companies tried to outbid each other for the better salesmen. Commissions tended to become uneconomically high, leading in turn to rebating and its discriminatory consequences. Second, the large sums of money available without strict legal accountability encouraged the payment of unjustifiably high salaries and the use of other company funds to "buy" legislators and to make other improper and corrupt expenditures.⁶⁴ A repetition of the more extreme forms of these abuses of the Gilded Age seems unlikely. But there is no assurance that some such practices would not be resumed. Even today dishonesty in public and business life, while less prevalent, is by no means unknown.

This lack of accountability is not necessarily inherent in the tontine. Joseph B. Maclean, actuary of the Mutual Life Insurance Company of New York, neatly put it:

"The main defect of the system as formerly practiced was not inherent but arose from the fact that *no accounting* was required of the funds which were being accumulated to pay deferred dividends. . . . [Thus] it was the lack of proper accounting which was wrong, rather than any fundamental defect of the system itself."⁶⁵

The graft and corruption which were associated with the tontine prior to the Armstrong investigation resulted from inadequate laws, not from the nature of the tontine. However, there is little likelihood that a satisfactory regulatory system for tontine policies will be developed, since they are now, and probably will remain, a minor aspect of the life insurance market.

⁶⁴ 1 BULEY, *THE AMERICAN LIFE CONVENTION* 193-244 (1953); JAMES, *THE METROPOLITAN LIFE* 139-65 (1947); 1 PUSEY, *CHARLES EVANS HUGHES* 140-68 (1951). See generally *ARMSTRONG COMMITTEE RECORD: TESTIMONY, EXHIBITS, REPORT* (1905). A good contemporary muckraking account was HENDRICK, *THE STORY OF LIFE INSURANCE* (1907).

⁶⁵ MACLEAN, *LIFE INSURANCE* 166 (9th ed. 1962). (Emphasis added.)

B. *Asserted Justifications for the Tontine*

In defense of the semi-tontine policy, it is sometimes urged that the deferred dividend is nothing more than a terminal or surrender dividend of the type that is regularly issued by many large companies.⁶⁶ A surrender dividend represents a contribution to surplus out of premium to ensure the solidity of the operation. It is returned to the policyholder upon termination in order to produce as much equity as possible among the policyholders. The terminal dividend recognizes that surplus arises out of policyholder contributions and should be shared as evenly as possible.⁶⁷ This is in a sense the converse of the deferred dividend idea, where the terminating policies forfeit all their interest in the deferred dividend fund.⁶⁸ Another suggested justification for the semi-tontine is that many large companies got a start by issuing it in the late nineteenth century.⁶⁹ There is much truth here, but it is a *non sequitur* to conclude that the semi-tontine should therefore be legal. Many a large and now respectable family fortune had its origin in acts of corruption and exploitation; many a great and now respectable company was in its origin little more than organized brigandage. But at least in some respects the moral level of our society has improved, and the fact that some reputable companies have a blemished past does not justify new companies in similar reprehensible practices. What was yesterday only morally wrong may today also be illegal; if it is not yet illegal, perhaps it should become so.

It is urged as a related argument that the past use of specialty policies by companies which are now large was a competitive necessity, and that a similar practice by small companies is today also a competitive necessity.⁷⁰ It is some answer to that assertion that many companies, both large and small, seem to get along without this use. Of course, considerable value is properly placed in our society on free access to the market by new entrepreneurs. But short of imperative necessity, access should be upon terms now regarded as the basis for moral and legitimate operation of the enterprise.

Maclean pointed out other advantages to the tontine. He sug-

⁶⁶ See, e.g., National Underwriter, Life Ed., Aug. 5, 1955, p. 3, col. 1, and Sept. 30, 1955, p. 12, col. 1.

⁶⁷ Surrender dividends are explained in MCGILL, LIFE INSURANCE 303-05 (1959). See also MACLEAN, *op. cit. supra* note 65, at 167-68.

⁶⁸ National Underwriter, Life Ed., Aug. 5, 1955, p. 3, col. 1.

⁶⁹ *Id.*, Jan. 14, 1955, p. 1, col. 4.

⁷⁰ Memorandum submitted to the Laws and Legislation Committee of the NAIC by Herbert Graves and D. D. Murphy. [1955] 1 PROCEEDINGS OF N.A.I.C. 119.

gested that a year might be too short a period for a company to ascertain its profits and losses in a business heavily dependent upon the maintenance of reliable and predictable results over long periods.⁷¹ However, in Maclean's own analysis this is not crucial:

"The amount to be distributed as dividends in any year will not necessarily or usually be the actual surplus earnings of the previous year. When current surplus earnings are not sufficient to maintain the scale of dividends, they may be supplemented by drawing on the existing surplus. In the same way, when surplus earnings are more than sufficient to maintain the existing scale, part of the current year's earnings may be added to surplus. When fluctuation in surplus earnings are small, this is a practical system of avoiding frequent small changes in the dividend scale. . . ."⁷²

Maclean also suggests as an advantage of the deferred dividend system, the reduction of the strain on surplus caused by paying dividends in the early policy years before any surplus had been created.⁷³

In summary, the tontine does not seem to be inherently evil as a gambling contract, but it does seem to be especially susceptible to misrepresentation and, absent the development of some new regulatory patterns, there is serious danger of misuse of the funds for which there is only limited accountability. There is substantial justification for control.

C. *Methods of Control of the Tontine*

The disadvantages in the issuance of the tontine policy are serious and require steps to combat them. Restriction of the tontine to its proper sphere is one possibility. This would require, on the one hand, the development of a new set of legal controls to prevent the misuse of the funds held for deferred dividends and, on the other, the effective prevention of misrepresentation. The most obvious step to take to curb misrepresentation is to proscribe it and prosecute violators. But misrepresentation is a difficult offense to detect and to prove, and consumer protection through the processes of the criminal law is at best a weak reed.⁷⁴ More effective devices seem necessary if it is important to stop the misrepresentation.

⁷¹ MACLEAN, *op. cit. supra* note 65, at 166.

⁷² *Id.* at 149-50 (8th ed. 1957).

⁷³ *Id.* at 166 (9th ed. 1962).

⁷⁴ On this subject, see Kimball & Jackson, *The Regulation of Insurance Marketing*, 61 COLUM. L. REV. 141 (1961).

Prohibition of the tontine would be the most certain means of overcoming the disadvantages it offers. This has indeed been the normal approach to the tontine whenever there has been an attempt at legal control. However, prohibition raises a serious problem of regulatory policy. Freedom of contract is an important value in our legal system.⁷⁵ It rests upon the assumption that no government agency is wise enough to make all contractual decisions for the population—to pass judgment on the social value of all transactions. This is wise as a general policy, and particularly if the contract in question offers real advantages of which the public would otherwise be deprived.

In this case, however, most of the advantages can be obtained by the buyer without using the objectionable contract, by combining, in any proportion the buyer desires or needs, term or ordinary insurance with annuities or endowment insurance. Only if the buyer wants a "pure endowment" might there be a gap in the market, for such a contract is seldom sold. It is revealing that McGill thinks the reason for the absence of the pure endowment from the market is that "few individuals are willing to take the chance of . . . forfeiting the entire consideration paid for the contract."⁷⁶ Yet a great many find attractions in the tontine policy, which provides part of the same element. It is not possible to say that there would be no loss whatever to the market if the tontine were prohibited, but it seems clear that the loss would not be very great.

Though a clear case must be made for the prohibition of any contract, the opponents of the tontine seem to have made a persuasive case for its abolition, and to have discharged the burden of proof. The tontine has serious defects, and it makes relatively little contribution to the market. To prohibit it seems justified if the dangers it presents cannot be eliminated with facility in any other way.

Controls for the tontine other than outright prohibition would be difficult to devise. Although it is not now likely, it is possible for the deferred dividend fund to be subjected to legal control as stringent as that applicable to reserve funds. However, the main danger of the tontine is not that it facilitates misuse of funds, but that it often is the subject of serious misrepresentation. There are already sweeping laws on the books directed against misrepresenta-

⁷⁵ See Kimball, *supra* note 25.

⁷⁶ MCGILL, *op. cit.* *supra* note 67, at 70.

tion by agents. Perhaps a statute which would compel all statements made respecting anticipated dividends to be in writing would go some distance toward the solution of the misrepresentation problem, if it were rigorously enforced. The prohibition of certain representations might help. An Illinois regulation, for example, prohibits any statement that a company makes a profit as a result of policy lapses or surrenders.⁷⁷ However, in the end these techniques of control probably would founder on the same difficulties that generally afflict regulation of misrepresentation. Inadequacy of staff, the difficulty of obtaining testimony, and the lack of official awareness of violation except in a very small percentage of the cases, all combine to make the problem almost insoluble. It seems to follow that the tontine can be controlled effectively only by prohibition. If it is bad enough it should be prohibited. If it is not bad enough to prohibit, then of course it should be controlled so far as is possible, but there should be recognition from the outset that success is likely to be meager.

Freedom of competition or of access to the market is also a value in a democratic society. But this is not a value that justifies access to the market at the expense of accepted moral standards of the community relating to business practice. It is not an argument that should lead us to refrain from prohibition.

It follows from the arguments presented here that the tontine in all its variants should be prohibited. Statutes that require an annual apportionment and distribution of dividends seem to meet this need. Apportionment alone may be enough if there is no forfeiture on lapse or death thereafter.

A tontine-like element sometimes shows up in other contracts such as the charter policy, which is considered next. However, a minor and fortuitous "tontine" element in a contract is not alone enough to condemn it, for the dangers of the tontine lie not in its nature but in its abuse. Consequently there should be prohibition only where the danger of abuse is substantial. Only when the tontine element is significant and tends to encourage misrepresentation or misuse of funds should it be abolished by legal fiat.

V. PROFIT-SHARING AND CHARTER POLICIES

All mutual insurance companies, and many stock companies, issue participating policies which promise to the policyholders a share in the surplus (sometimes miscalled profits) generated by the

⁷⁷ Ill. Dep't of Ins. Rule 9.09, § 5(22), Oct. 31, 1962.

participating business. The company apportions to each policyholder as a dividend, usually annually, that part of the divisible surplus that arises from the participating business, to the extent that it was contributed by him. In short, the dividend is essentially a return, calculated as equitably as possible, of the amount the company charged the policyholder in excess of the real cost of his insurance. A profit-sharing policy goes a step farther than a participating policy in providing for participation in "profits" beyond the excess sum contributed by the profit-sharing policyholder himself. For example, it may contain a clause providing that the policy "will share in the profits of the Company to the extent apportioned to it by the Company."⁷⁸ This vague language does not limit the distribution to the surplus produced by the profit-sharing business. The company may contemplate inclusion of at least a portion of the surplus from the nonparticipating business as well. In the example given here, the promise is not explicit and the policyholder may have no clearly defined enforceable legal rights. This is one of the objections which can be made to some profit-sharing policies although it is not necessarily inherent in this type of policy.⁷⁹

A. *Objections to Profit-Sharing Policies*

There are two main objections, other than indefiniteness, to the profit-sharing feature. First, its opponents argue that it is particularly susceptible to misrepresentation. Second, they urge that it violates universal explicit statutory prohibitions of discrimination between policyholders of the same age and characteristics.

1. *Susceptibility to Misrepresentation*

Any insurance policy is subject to possible misrepresentation, but many persons have urged that the profit-sharing feature is especially susceptible, and even that the use of the term is itself misleading. For example, the Florida Insurance Department has said that "the words *profit sharing* on a policy are misleading

⁷⁸ This is an exact quotation from a policy in our files. Later policies issued by the same company used the word "surplus" in place of the word "profits."

⁷⁹ For example, another company's profit-sharing policy was much more specific in setting out policyholders' rights. It provided that "the company guarantees that, during any year in which Planned Expansion Policies are in force with premiums payable in the amount of \$100,000.00 or more, no dividends will be paid to stockholders of the Company unless dividends are paid on Planned Expansion Profit Sharing policies in a total amount equal to 10% of one year's premium paid on such dividends during such year, or 10% of dividends paid to stockholders in such year, whichever amount is greater." Prospectus of National Western Life Ins. Co., Jan. 9, 1963, p. 12.

to the public, and lend themselves to misrepresentation."⁸⁰ The first part of the Florida statement is not necessarily true. The policy may actually *be* a profit-sharing contract, in which case there is nothing misleading about the appellation. Of course, if profit-sharing is promised but not provided there is deception, but that results not from the use of the words for an appropriate situation but from their misuse in an inappropriate situation. Any words can be misused in this way. In the discussion that follows, it is assumed that the policy is in fact a profit-sharing policy, and it is asked whether the profit-sharing aspect of the policy lends itself especially to distortion of the information which an agent normally provides a policyholder.

Companies selling specialty policies frequently prepare "canned" sales presentations, expecting that they will be memorized by their agents and used verbatim. One such presentation instructs the agent to ask the prospect:

"If you were to invest \$400.00 or any amount, with complete safety, and with no time or effort on your part, what would you consider a fair rate of return on your money?"

The agent then is instructed to await an answer. It is anticipated that the reply will range from four to six percent. Upon receiving an answer, the agent is instructed to say:

"Four to six percent would be excellent and of course would also be taxable The growth (of our company) . . . has been phenomenal This was so far beyond the expectation of our board of directors that they declared . . . a surplus sharing bonus which amounted to 12.4 percent return and that was *tax free*."⁸¹

The purpose of these statements is to characterize the policy as an extraordinary investment because of the profit-sharing feature, while the attractiveness is further enhanced by the assertion of freedom from taxation.

If the surplus sharing bonus is in fact a sharing of profits derived from other classes of policyholders, then it is a good return on the policyholder's investment. The first possibility for deception is, however, that most of the return to the policyholder may be in the nature of an ordinary participating dividend rather than a share of profit.

⁸⁰ Fla. Dep't of Ins. Bull. No. 22, Aug. 8, 1961, as reprinted in WEEKLY UNDERWRITER, [1961] INS. DEP'T SERVICE [for] FLORIDA 15.

⁸¹ These quotations are copied exactly from a sales presentation in our files. The premium in this instance was \$410.40, and the dividend was \$50.90, or 12.4%.

In one such case, the return is alleged to have consisted in large part of (1) a refund of an excess mortality charge of about sixty-five percent of the expected mortality cost, (2) a refund of about twenty percent of the loading, and (3) an interest credit of approximately one percent of the policy reserve at the beginning of the year.⁸² Thus, all of the surplus bonus was simply a refund of overcharge, *i.e.*, it was an ordinary participating dividend and did not represent profits at all.⁸³ It is possible that there may be companies issuing profit-sharing policies and allocating profits to the profit-sharing policyholders in an amount as substantial as twelve to fifteen percent. This would depend upon considerable success of the company in selling nonparticipating policies or policies that participate only after a certain sum has been allocated to the benefit of profit-sharing policyholders. We do not assert that no company ever plays fair with its profit-sharing policyholders, but rather that deception is so easy and profitable that it need not even be intended. The above statement that 12.4 percent of the policyholder's investment, *i.e.*, of the initial premium, was returned to him during the preceding year could be (1) a statement that the profits allocated to the profit-sharing policyholders amounted to a 12.4 percent return on their premiums, which would make it a profitable investment, or (2) an assertion that 12.4 percent of the premium was returned as a participating dividend, or (3) any intermediate combination of the two. Since these policies are participating policies, it is almost certain that in all cases some portion—perhaps a very substantial portion—of the return to the policyholders represents a participating dividend rather than profits in the true sense.⁸⁴ It would be a rare agent who would not describe the facts in the way most advantageous to his company and to himself. The probability of misrepresentation and misunderstanding in the case of the profit-sharing policy is extremely high. Returns to the policyholder that

⁸² Reply Brief for Wis. Ass'n of Life Underwriters and Wis. Life Convention, pp. 25-26, for *Hearing Before the Wis. Dept't of Ins. on Proposed Rule Ins. 2.08* (Jan. 1962). This assertion does not appear to have been denied by the company in the documents filed with the Wisconsin Department of Insurance.

⁸³ Reply Brief for G. L. Ins. Co., at 13, in the hearing mentioned in note 82 *supra*.

⁸⁴ One company recently issued a "President's expansion plan" which was a Twenty Payment Life Plan containing coupons and "special participation" features. This is a charter policy within our definition. When the company announced a dividend of about 10% to its policyholders, the chairman of the board said: "This is indicative of the success of this life insurance policy with its special investment feature . . ." But for the year the dividend was declared the company had an operating loss of over \$100,000. The 10% dividend can hardly have been a profit at all; instead it must have been a return of premiums. See BEST'S LIFE INSURANCE REPORTS 2023-24 (1962 ed.); Insurance Advocate, Nov. 3, 1962, p. 70.

are in reality returns of premium paid are made to appear to be returns on the premium, *i.e.*, profits.⁸⁵ The emphasis on investment and a high rate of return tends to mislead the purchaser into believing that he is acquiring primarily an investment rather than a life insurance policy. The market success of some life insurance stocks prepares the way for even more striking deceptions, and some sales presentations are so successful that they convince the purchaser that he is acquiring stock in the company.⁸⁶

Although it is by no means impossible that a transaction will satisfy the expectations of the profit-sharing policyholder, as one would expect from the distortion in the typical sales presentation, "experience . . . [has] indicated that purchasers of such contracts were more often than not disappointed."⁸⁷

Two characteristics of the business lead to the almost inevitable disappointment of the profit-sharing policyholders. The first results from the competitive position of nonparticipating policies. Agents selling participating policies are able to emphasize in their sales talks that gross premiums less dividends will produce a lower net cost than in nonparticipating policies despite an initially higher premium.⁸⁸ In order to remain competitive, nonparticipating premiums must be kept as low as possible. Thus, price competition limits drastically the nonparticipating surplus available for distribution to profit-sharing policyholders.

The second characteristic of the business that lessens the possibility of the profit-sharing policyholder reaping "tremendous profits" is that ultimate control of the conduct of the business lies, not with the profit-sharing policyholders, but with the stockholders and with a management representing them. A stock insurance com-

⁸⁵ The Wisconsin Insurance Department issued Rule Ins. 2.08 of the Wisconsin Administrative Code on May 4, 1962, which said, in describing the profit-sharing policy, that "such policy forms are so drafted that it appears to a prospective policyholder that he is purchasing a preferential share of the future profit and earnings of the insurance corporation rather than purchasing a life insurance policy which may be subject to refund of excess premium payments."

⁸⁶ "[F]or every dollar this company ever earns, you as a . . . [profit-sharing policyholder] will get a piece of that dollar." (From a sales presentation in our files.) The Indiana Insurance Commissioner stated, in a circular dated June 3, 1959, that "other data [used in sales presentations] indicates how insurance stocks have grown in market value, leaving the inference that if the prospect buys one of these 'profit sharing' contracts, he too is in for making a fortune—the 'chance of a lifetime' they are told. The prospect is again being misled."

⁸⁷ Statement of California Insurance Commissioner, J. of Commerce, March 7, 1960, p. 9, col. 1.

⁸⁸ Three-fourths of all ordinary life insurance in force in the United States is participating insurance, attesting the success of this approach. Belth, *Participating Life Insurance—The Stock Company Version*, 29 J. INS. 229, 231 (1962).

pany is not an eleemosynary institution, but rather it exists to earn money for the stockholders. If discretion is left to each company to decide how much to allocate to profit-sharing policyholders, there is no reason to assume that the board of directors will be any more generous than appears to be necessary. Even if the profit-sharing policyholders have more precisely defined rights than in our original example,⁸⁹ the extent to which there are profits to be divided may be subject to some control by the way in which the business is operated. The amount may be reduced by selling one kind of policy rather than another, and there is every reason to expect management to take such considerations into account in its management practices.

Indeed, when contractual rights permit, it is not unknown for the stockholders, through the management, to make an effort to claim even a portion of the profits generated by the participating business. This is suggested by the existence in five states of statutes or regulations placing ceilings on the amount of profits that stockholders may take from the participating business. Illinois requires that at least ninety percent of the profits on participating business be allocated to the benefit of the participating policyholders.⁹⁰ Wisconsin and New York permit the company to distribute to its stockholders the larger of two amounts, (a) ten percent of the profits on participating policies, and (b) fifty cents per year per thousand dollars of participating life insurance.⁹¹ New Jersey uses the fifty cents per year per thousand limitation.⁹² Nebraska is the most restrictive of all the states; it requires that all surplus generated by the participating business accrue to the benefit of the participating policyholders.⁹³

⁸⁹ See note 79 *supra* and accompanying text.

⁹⁰ ". . . no life company authorized to do business in this State shall issue both participating and non-participating policies unless at least ninety per centum of the profits on its participating policies shall inure to the benefit of the participating policyholders." ILL. INS. CODE § 233 (1961).

⁹¹ ". . . no profits on participating policies and contracts in excess of the larger of (a) 10 per cent of such profits, or (b) fifty cents per year per thousand dollars of participating life insurance . . . in force at the end of the year, shall inure to the benefit of the stockholders . . ." N.Y. INS. CODE § 216(6)(b). WIS. ADM. CODE section Ins. 2.02(4)(a) (1962) sets out similar limitations.

⁹² N.J. STAT. ANN. § 17:34-12 (1962).

⁹³ "All domestic stock life insurance companies, which shall hereafter issue both participating and nonparticipating policies, shall hold all the surplus and earnings arising from the participating insurance for the benefit of and for distribution to the participating policyholders . . ." NEB. REV. STAT. § 44-708 (1960). In Canada, a sliding scale applies. The stockholders' participation is limited to 10% of profits when the profit fund does not exceed \$250 million, to 7½% between \$250 and \$500 million, to 5% from \$500 million to \$1 billion, and 2½% above \$1 billion. The Canadian and British Insurance Companies Act, CAN. REV. STAT., c. 31, § 84 (1952).

2. *Violation of Statutory Prohibitions Against Discrimination*

The second principal objection to the profit-sharing policy is that it violates explicit statutory prohibitions, most of them being concerned with discrimination. Section 3(f) of the Uniform Unfair Trade Practices Act⁹⁴ makes it an unfair trade practice to

“issue . . . stock . . . or securities or any special or advisory board or other contracts of any kind promising returns and profits as an inducement to insurance”

Section 3(g) makes it an unfair practice to

“make or permit any distinction or discrimination in favor of individuals between those of the same class and equal expectation of life in the rates charged for contracts of insurance or of life annuity or in the dividends or other benefits payable thereon, or in any other of the terms and conditions of the contracts it makes . . . [or to] discriminate unfairly between other risks involving essentially the same hazards and expense elements or between risks in the application of like rates and credits.”

Section 3(h)(1) prohibits rebates or

“any special favor or advantage in the dividends or other benefits thereon, or any valuable consideration or inducement not specified in the policy contract of insurance.”

However, section 3(h)(2) states that

“Nothing in this or the preceding subsection [the anti-discrimination and rebate provisions] shall be so construed as to prohibit any company issuing non-participating life insurance from paying bonuses to policyholders or otherwise abating their premiums in whole or in part out of surplus accumulated from non-participating insurance”

⁹⁴ Following the Supreme Court's decision in *United States v. South-Eastern Underwriters Ass'n*, insurance was deemed to be commerce. Consequently it would be within the scope of federal control under the Sherman Act, 26 Stat. 209 (1890), as amended, 15 U.S.C. §§ 1-7 (1958) and the Federal Trade Commission Act, 38 Stat. 717 (1914), as amended, 15 U.S.C. §§ 41-58 (1958). Congress then enacted Public Law 15 (Ferguson-McCarran Act), 59 Stat. 34 (1945), 15 U.S.C. §§ 1011-15 (1958), which preserved the rights of the states to regulate insurance with the proviso that “after June 30, 1948 the Sherman Act, . . . the Clayton Act . . . [and] the Federal Trade Commission Act shall be applicable to the business of insurance to the extent that such business is not regulated by state law.” Prompted by the last phrase, in order to preserve state control, the National Association of Insurance Commissioners undertook studies which culminated in the Model Unfair Trade Practices Act. For reports, proposals, and other information, see PROCEEDINGS OF N.A.I.C. passim (1947). For proposed bills, see *id.* at 392-410; 1 RICHARDS, INSURANCE 199-254 (5th ed. 1952). See also Kimball & Jackson, *supra* note 74, at 143-44 (1961). All the states have in substance enacted this model act. [1960] 1 PROCEEDINGS OF N.A.I.C. 150.

As enacted in some states, for example in New Jersey, the last quoted subsection has contained an important added qualification:

“[P]rovided, that any such bonuses or abatement of premiums shall be fair and equitable to policyholders and for the best interests of the company and its policyholders”⁹⁵

The limiting provision in section 3(h)(2) does not apply to section 3(f); its range of application is explicitly limited to sections 3(g) and 3(h)(1).

Our basic problem is whether profit-sharing policies are legal or whether they are forbidden by the statutes quoted above. There are two separate questions. The first is whether section 3(h)(2) precludes the application of section 3(g), which in the absence of section 3(h)(2) would surely prohibit profit-sharing policies as discriminatory. The second is whether section 3(f), which is unqualified by section 3(h)(2), forbids these policies. We shall consider these two questions separately.

First, does section 3(h)(2) preclude the application of section 3(g)? Read literally, it seems to authorize the payment of bonuses out of the surplus from nonparticipating business without any special limitation of the way in which the bonus must be allocated; *i.e.*, it seems on its face to insulate such bonus payments from any requirement of equitable and fair allocation. The nature of nonparticipating business tends to strengthen this position. By contract, holders of such policies are excluded altogether from participation in surplus. In the normal case, any surplus produced by their policies accrues to the benefit of stockholders. If these stockholders should decide, through management, to make a gift of some portion of surplus to a special class of policyholders, for any reason or for no reason, why should nonparticipating policyholders, who have no claim to share in the surplus anyway, have any ground for complaint? If anyone should have reason to object, should it not be the stockholders whose money is being given away? This is a plausible argument, especially using a literal interpretation of the statute.

However, other interpretations are more persuasive, especially after a consideration of the policy grounds for the enactment of section 3(h)(2). The Uniform Act, section 3(h)(2), contains two other situations to which section 3(g) does not apply.⁹⁶ One is the return to industrial policyholders who pay direct to the home office

⁹⁵ N.J. STAT. ANN. § 17:29B-4(8)(b)(i) (1963).

⁹⁶ 1 RICHARDS, *op. cit. supra* note 94, at 202 n.13.

that portion of the premium which represents the cost of the door-to-door collection which was formerly usual in industrial policies; the other is a readjustment of group life premiums based on either loss or expense experience thereunder. The thrust of all three exceptions to section 3(g) is that in those cases in which policyholders have been overcharged, it is legitimate to return noncontractual dividends, thereby offsetting the overcharge. Light may be thrown on the purpose of the first exception by a look at an incident in the history of the Prudential Insurance Company. The Prudential was organized as a stock company, issuing solely nonparticipating industrial policies; later it added participating ordinary insurance to its portfolio. At first there were no accurate life tables for use with industrial policies, and the experimental premiums charged by the company proved to be excessive. Beginning as early as 1880, at intervals of five to ten years, the company made the industrial policies in effect participating, by granting voluntary dividends or concessions on an *ad hoc* basis. Management felt that the long range interests of company and stockholders would be best served by this action, but dissident stockholders eventually brought a bill in equity asking for a mandatory injunction to compel the directors to distribute the profits as dividends to the stockholders. In 1912, the New Jersey Court of Errors and Appeals upheld the exercise of discretion by the directors and approved the voluntary concessions to nonparticipating policyholders.⁹⁷

Not only is it possible to argue that the Prudential "concession" was the kind of bonus contemplated in the drafting of the section, but the overwhelming importance of equity as a factor in life insurance⁹⁸ makes it hard to believe that a legislature would consciously approve anything else. We have found no indication that legislatures contemplated the return of excess nonparticipating surplus to a group of policyholders who made no contribution to the surplus; the purpose of the whole of section 3(h)(2) is obviously to make it possible for a company to deal reasonably with policyholders by returning overcharges, hence, we cannot interpret it as permitting inequity among classes of policyholders.

The distinction between what the Prudential did and what profit-sharing policies do seems clear. Prudential, out of caution made excessive premium charges and ultimately returned the excess. On the other hand, profit-sharing companies know in advance

⁹⁷ *Blanchard v. Prudential Life Ins. Co.*, 80 N.J. Eq. 209, 83 Atl. 220 (1912).

⁹⁸ See note 25 *supra*, and notes 99, 100 *infra*.

that their premium charges are redundant, for they are deliberately made so; the companies propose to give the excess, not to the people who paid it, but to another favored group. The profit-sharing is held out as a special inducement to the purchase of insurance by the latter group at the expense of the former.

The proviso added to section 3(h)(2) in New Jersey and elsewhere strengthens this position by stating that the bonus is permissible "*provided*, that any such bonuses or abatement of premiums shall be fair and equitable to policyholders . . ." This only makes explicit what is already implicit in the section, and makes this statute consistent with the substantial emphasis upon equity throughout the whole of insurance law:

"Equity clearly requires a system of distribution which does not favor any class of policies at the expense of any other class. . . . It is usually considered that, from a theoretical point of view at least, equity requires a return of surplus to individual policyholders in the proportions in which they have contributed to it. . . . [F]rom a practical point of view *equity* requires a reasonable recognition of profits and the sources from which they have arisen."⁹⁹

The contribution method of allocation is the expression of equity in dividend distribution. It takes into account all variables insofar as they can practicably be ascertained, and contemplates that "each participant should be benefited in proportion to the excess of his payments over and above the actual cost of insurance."¹⁰⁰ The basic principle of the contribution plan provides a standard against which all rules of distribution should be tested for equity.

The Wisconsin statute contains the "fair and equitable" provision.¹⁰¹ Arguing from it, the Wisconsin Insurance Department outlawed profit-sharing policies as an unfair and inequitable allocation of the surplus available for distribution.¹⁰² This interpretation is sound, but it is not essential that the "fair and equitable" provision be found in the statute in order to produce the same result, for equity is a fundamental part of insurance law without the provision.

⁹⁹ MACLEAN & MARSHALL, DISTRIBUTION OF SURPLUS 13-14 (1937).

¹⁰⁰ 11 JOURNAL OF THE INSTITUTE OF ACTUARIES 122 (1863), as quoted in KRUEGER & WAGGONER, THE LIFE INSURANCE POLICY CONTRACT 254 (1953). The contribution method has received court approval. See *Rhine v. New York Life Ins. Co.*, 273 N.Y. 1, 6 N.E.2d 74 (1936).

¹⁰¹ WIS. STAT. ANN. § 207.04(1)(i) (1957).

¹⁰² See the note attached to Wis. Adm. Code section Ins. 2.08 (1962).

Of course it can be argued that if legislatures had wanted to limit the permissible distribution under section 3(h)(2) to non-participating policyholders, they could easily have explicitly so provided. The simple answer to that contention is that the drafting of statutes in the United States is not an exact science, and the determination of legislative intent is an inquiry of considerable complexity. Moreover, the expression "abating their premiums" is at the heart of section 3(h)(2), and it seems quite reasonable to conclude that the distribution of surplus to nonparticipating policyholders, even though that was not provided in the contract, was contemplated as the way to abate premiums. It is not clear what else that expression could mean. We conclude, therefore, that section 3(h)(2) is merely intended to authorize the kind of conduct engaged in by the Prudential, putting beyond doubt the power of the insurance company to deal equitably with its policyholders when it discovers that its premiums are excessive. Any other result, although arguably consistent with the literal language, would be inconsistent with the general tenor of American insurance law.

This result is strongly supported by a 1942 Minnesota case. A group of charter policyholders were entitled to an especially advantageous participation in the profits of the company. The Supreme Court of Minnesota held that the arrangement violated the anti-discrimination statutes; the court placed a lien on the charter policies for the benefit of the noncharter policyholders, to remain until such time as the excessive payments received by the charter policyholders were redistributed more equitably to all policyholders.¹⁰³

It can be concluded that profit-sharing policies are in violation of section 3(g), the anti-discrimination provision of the Unfair Trade Practices Act, and that section 3(h)(2) does not preclude the application of section 3(g) to them. If this result is accepted, it is unnecessary to ask the second question, whether section 3(f) prohibits profit-sharing policies. It is less clear that it does. Primarily, section 3(f) is directed toward a particular kind of discriminatory conduct—the use of special inducements to the purchase of the insurance policy. The items discussed in section 3(f) are mainly separable contracts or documents such as shares of stock, etc., which are offered as an inducement. It is tempting to simplify the interpretation of the section by limiting its application to separate inducements, but this may not be completely sound. There is some

¹⁰³ See *Lommen v. Modern Life Ins. Co.*, 212 Minn. 577, 4 N.W.2d 639 (1942).

basis for the argument, which is discussed later, that the charter policy is a new guise in which the separate advisory board contract is likely to reappear, and that the subterfuge of combining this special benefit with the policy should not succeed, hence section 3(f) should also be applicable to prevent at least the charter policy form of profit sharing.

B. *The Nature of Charter Policies*

Charter policies are issued at the beginning of a company's operation, and give the charter policyholder a special advantage over later policyholders. Although the special advantage can be almost anything, usually it is profit sharing. Such policies constitute a special class of profit-sharing policies, characterized by issuance on a limited basis, and for this reason it is natural to deal with them here.

The charter policy is issued with an assurance that it will be sold only to a limited and predetermined number of persons, or up to a limited and predetermined total dollar amount. Thus, a restricted group of people is promised participation in the long-range earnings of the company, usually arising both from the surplus on the business of the charter group and from all other business written by the company, whether participating or non-participating.

The charter policy is subject to essentially the same criticisms as the profit-sharing policy. Susceptibility to misrepresentation is the first major objection to both, but here a special likelihood of misrepresentation is said to result from the presence of a tontine element. The second major objection, as with profit-sharing policies generally, is alleged violation of nondiscrimination statutes; there are some special considerations which must take us somewhat beyond the earlier discussion.

1. *The Tontine Element—Misrepresentation*

By limiting in advance the number of policies which will be sold, usually to the early purchasers of insurance in the company, the charter policy creates a closed group. As the policies in the group terminate, either by death or by surrender, the size of the group decreases. Since the charter policyholders have been promised a share in the profits generated by policyholders other than those in the group, if the total amount to be distributed is not subject to the discretion of the board of directors, but depends solely on the company's success, then the share of the policyholder might

well increase in the same way that an increase occurs in the tontine policy. This effect is what we call the "tontine element." We have already seen that statutes or insurance department rulings in most states seek to eliminate tontine policies, primarily by requiring an annual (or sometimes less frequent) distribution of surplus arising from the participating business.¹⁰⁴ This tontine element is not dependent upon the accumulation of dividends, but rather upon an annual division of profits of an increasing amount among a decreasing number of people. Hence the prohibition of accumulation has no effect on the charter policy. This tontine aspect of the charter policy seems relatively innocuous, and it is difficult to regard it as serious enough in itself to warrant intervention by the state. The word "tontine" has a pejorative connotation, by reason of historical associations, which is worse than the term deserves. Not every tontine element is so evil that it should be forbidden.

In defense of the charter policy, it is sometimes argued that it does not really contain a tontine feature because the amount of dividends paid out of nonparticipating surplus lies within the discretion of the board of directors. The board determines whether or not it is in the best interests of the policyholders as a group, and of the company as a whole to distribute the surplus, and how much to distribute. No fixed sum or guaranteed percentage of surplus is promised to the policyholders. If the board should choose to distribute such dividends to charter policyholders, it is not compelled to distribute to the surviving charter policyholders an amount as large as it might have distributed if the whole group were alive. In other words, the board of directors may reduce the total benefits to the group in proportion to the decrease in the group size. Thus the tontine element is negated.

An answer to this contention, however, is not difficult. While some contracts may give such discretion to the board, others may not. If they do not and the amount to be shared is fixed by some formula, then the policy does contain the tontine element. If, however, discretion does exist in the board of directors, the discretion may eliminate the tontine element of the policy but it also destroys the policyholder's guaranteed legal rights to share in surplus. His participation right is at the mercy of the board of directors. Hence, either the policy has a tontine element or it has an even greater deficiency. Further, while discretion in the board reduces the similarity of the charter policy to the tontine, this does not

¹⁰⁴ See statutes cited in notes 39, 40 *supra* and regulations cited in note 41 *supra*.

prevent the agent from impressing upon the prospect the notion that he is buying into a tontine contract, *i.e.*, creating an appealing "tontine illusion." Sales material frequently creates this notion. For example, the brochure used by one company contained a diagram showing the gains from the lapses and surrenders of both participating and nonparticipating policies flowing to the charter policyholders. This not only creates an impression that the profits will be large, but also that the charter group decreases in size, and thus, presumably, that an ever decreasing group of persons will have larger individual shares in a constant or increasing fund. Even if discretion exists in the board and there is misrepresentation, the misrepresentation is obnoxious. If there is a special likelihood of misrepresentation, the arrangement is especially objectionable because of that likelihood. The probability of misrepresentation does seem great enough to give concern about the charter policy, despite the relatively innocuous character of the tontine element itself. This likelihood of misrepresentation is in addition to that which is characteristic of profit-sharing policies generally.

2. *Violation of the Anti-Discrimination Statutes*

The charter policy is a modern version of an old promotional technique—the use of the "advisory board" contract. In the latter, a company

"offers to prospective policyholders a percentage of the premiums paid on policies issued by the company in that state [or other specified area] over a fixed period of years. This percentage is to be divided among the policyholders, within this class, in proportion to the amount of insurance taken out by each. The class of policyholders entitled to this benefit is limited In return therefor the insured, in addition to paying his annual premium, agrees to become a member of a special 'advisory board' or 'board of reference,' or to become a 'special agent' or a 'local inspector,' and to render certain services to the company, such as advising the company as to the fitness and desirability of applicants for insurance In some instances the insured agrees to furnish annually the names of ten persons in his community who would . . . make desirable risks" ¹⁰⁵

Professor Patterson has pointed out the purpose of the advisory board contract:

¹⁰⁵ PATTERSON, THE INSURANCE COMMISSIONER IN THE UNITED STATES 315 (1927).

"It is designed to offer to the earlier insureds . . . a reduction in rates which will enable it to compete with the attractions of the older companies [Generally] the courts have held that this marketing device is illegal, either on the ground that it is a 'discrimination' if the special benefits are stipulated in the policy or on the ground that it constitutes 'rebating' if the benefits are stipulated for in a collateral arrangement outside the policy."¹⁰⁶

It is true, of course, that an advisory board contract may be a legitimate manner in which to acquire needed services. There is no public policy which prevents the compensation of persons for the performance of valuable services even if they be only the provision of good contacts. In fact, however, most advisory board contracts existed merely to enable the salesman to sell policies, hopefully without violating the laws against rebating or discrimination. Since the issuance of an advisory board contract was frequently a subterfuge, it could easily be argued that it was a rebate or an illegal discrimination; moreover, most states passed specific legislation prohibiting advisory board contracts on these grounds. At the present time section 3(f) of the Unfair Trade Practices Act makes it an unfair or deceptive practice to "issue . . . any special or advisory board or other contracts of any kind promising returns and profits as an inducement to insurance"¹⁰⁷

Today, essentially the same purpose is served by the issuance of a charter policy which, like the advisory board contract, promises the policyholder that, as a member of a limited group, he will participate with special advantage, not available to the holders of other types of policies issued by the same company, in any future distribution of corporate profits including the "profits" or surplus generated by policies other than the charter policies. The charter policy is used in an attempt to achieve what can no longer be achieved by advisory board contracts because of the statutory prohibitions; the same sales argument is still used. The formal advisory service feature was a mere façade and could easily be sacrificed.

Some companies say they are giving charter policyholders something extra in lieu of advertising expense. Other sales presentations speak of "long range advisory assistance"; still other arrangements require name referrals to lend plausibility to the payment of a

¹⁰⁶ *Id.* at 316.

¹⁰⁷ 1 RICHARDS, *op. cit. supra* note 94, at 202 n.13. An Advisory Board is now sometimes used to promote the sale of stock rather than policies. See, *e.g.*, Prospectus of National Western Life Insurance Company, Jan. 9, 1963, p. 20.

special benefit. Thus, it is clear that the charter policy is functionally a close relative of the old advisory board technique. It is at least arguable that such policies are forbidden by section 3(f). If not, then the general anti-discrimination or anti-rebating provisions may apply as in the old advisory board cases. The close similarity of the functional characteristics of the advisory board contract and charter policies make the cases dealing with the former, in the early 1900's, relevant to the latter.

The advisory board contract began to appear in the opinions of the appellate courts in 1901, often involving suits by the company against the policyholder on a premium note. The policyholder's defense was that the policy, and therefore the premium note, was void because it was connected with a contract under which the policyholder was appointed to an advisory board or was made one of a number of "vice-counselors." Usually the policy did not mention the advisory board contract. The Indiana Appellate Court thought that even if the appointment of the policyholder as a vice-counselor were void, the policy was still effective since the two were separate transactions.¹⁰⁸ The North Carolina Supreme Court also enforced premium notes.¹⁰⁹ On the other hand, the Michigan Supreme Court thought that the illegality of the advisory board contract infected the contract of insurance and therefore the company could not recover on the premium note.¹¹⁰ In these cases, the Indiana and North Carolina courts did not decide that the contracts were illegal, but the language of the opinions suggests that they would have so decided if the question had been fairly raised. The Michigan court did hold the contract illegal. The principal difference was in the courts' views on the technical doctrine of severance; by separating the two contracts, Indiana and North Carolina were able to uphold the insurance policy without reaching the question of legality.

In a second Indiana case, a receiver for a company sued on an unpaid portion of the premium which had not been paid because it was the sum due the policyholder under a special "combination" contract. The company was a mutual, which argued for equality among its members. Moreover, its articles and by-laws made every member an advisory agent "entitled to all its rights and privileges as fully as any other member." The court enforced the receiver's claim, saying that

¹⁰⁸ *Muller v. State Life Ins. Co.*, 27 Ind. App. 45, 60 N.E. 958 (1901).

¹⁰⁹ *Security Life & Annuity Co. v. Costner*, 149 N.C. 293, 63 S.E. 304 (1908).

¹¹⁰ *State Life Ins. Co. v. Strong*, 127 Mich. 346, 86 N.W. 825 (1901).

"[P]ersons not parties to this arrangement . . . must pay in addition to the cost of their own insurance an additional . . . [amount] for the benefit of others. . . . The plan is marked not by mutuality but by inequality and unfairness."¹¹¹

Another form of action was suit by the policyholder on the advisory contract itself. The North Carolina Supreme Court denied recovery, applying the general rule that a court will leave the parties to an illegal contract where it finds them.¹¹² The anti-discrimination statute, the court emphasized, was intended for the protection of the whole body of policyholders and not those seeking to profit by the inequity of the contract. The Wisconsin Supreme Court also refused recovery by the policyholder on the advisory contract.¹¹³ If the services had been substantial and really performed, the court would have regarded the arrangement as valid, but it was convinced this was merely a device to camouflage discriminatory practices.

In Wisconsin the problem arose in still a different context. A policyholder sued in one case to recover the first annual premium, although the policy was accompanied by a contract irrevocably appointing the policyholder a member of the company's state board of special agents for twenty years. The court allowed recovery because of the promptness of the rescission.¹¹⁴ However, the court refused another policyholder's claim to recover four annual payments already made, pointing to the bad effect upon other policyholders if favored ones were permitted, after having the benefit of the contract, to make claims on the company's surplus, or to rescind the contract and recover the premiums.¹¹⁵

In a curious case, an agent sought an injunction against breach of the agency agreement by a refusal by the company to accept applications for special policies connected with contracts appointing "local inspectors." The Georgia Supreme Court denied the relief,

¹¹¹ *Robison v. Wolf*, 27 Ind. App. 683, 691, 62 N.E. 74, 77 (1901). See also *State Life Ins. Co. v. Strong*, *supra* note 110, at 350-51, 86 N.W. at 826.

¹¹² *Smathers v. Bankers Life Ins. Co.*, 151 N.C. 98, 65 S.E. 746 (1909).

¹¹³ *Richmond v. Conservative Life Ins. Co.*, 166 Wis. 334, 165 N.W. 286 (1917). The Des Moines Life Insurance Company had issued many special agent's contracts of the kind invalidated in the prior cases by the supreme court; it sought to keep faith with such policyholders by replacing these contracts with fifteen-payment life policies back-dated to the date of the original contract, but the Attorney General ruled that this action would be a rebate on the ground that the initial contracts were entirely void. 1908 WIS. ATT'Y GEN. BIENNIAL REP. AND OPINIONS 463.

¹¹⁴ *Urwan v. Northwestern Nat'l Life Ins. Co.*, 125 Wis. 349, 103 N.W. 1102 (1905).

¹¹⁵ *Laun v. Pacific Mut. Life Ins. Co.*, 131 Wis. 555, 111 N.W. 660 (1907).

basing its action on the illegality of the contract under the statute prohibiting advisory board and similar contracts.¹¹⁶

The advisory contract appeared in a variety of regulatory problems also. In Wisconsin, the Attorney General first advised the Insurance Commissioner, upon request, that an advisory contract was a violation of the anti-rebate statute, and then said in a subsequent opinion that a contract for the appointment of "special inspectors" or of "special agents" without real duties was within his prior ruling.¹¹⁷ The Wisconsin legislature removed all doubts about the particular form when in 1907 it made the advisory board contract illegal.¹¹⁸

In Mississippi, the court was asked to order the Insurance Commissioner to revoke a company license for issuing contracts illegal under the anti-discrimination statute. Although the court agreed that there had been a violation, it regarded mandamus as an inappropriate remedy, since the Commissioner's action was discretionary, not ministerial.¹¹⁹ In Michigan, the supreme court denied mandamus to compel the Commissioner to license the complainant company, because the company's operation violated the anti-rebate law.¹²⁰

Despite the variety of ways in which the problem arose, and despite the fact that the companies won a number of the decisions, the overwhelming weight of authority supports the proposition that advisory board and similar contracts, under whatever name, are illegal. Only one court has thus far thought otherwise. The Supreme Court of Alabama granted an injunction to prevent the Insurance Commissioner from revoking a company's license to do business in Alabama, holding that the questioned contract, which was in all essential respects like the contracts involved in prior cases discussed above, was not objectionable under Alabama law.¹²¹ The court thought there was "discrimination" only if different members of a class of policyholders were treated differently, and in this case all members were treated alike. The court remarked that if the term "class" applied to all persons of like individual charac-

¹¹⁶ Leonard v. American Life & Annuity Co., 139 Ga. 274, 77 S.E. 41 (1913).

¹¹⁷ 1904 WIS. ATT'Y GEN. BIENNIAL REP. AND OPINIONS 368; 1906 *id.* 618. But compare the earlier opinion in 1904, *id.* at 295, holding that there was nothing illegal on the face of an advisory board contract.

¹¹⁸ Wis. Laws 1907, ch. 504 § 1955(3), now WIS. STAT. ANN. § 207.04(1)(f) (1957). Note that the problem of validity of earlier contracts continued to arise in the cases for many years thereafter. See note 113 *supra*.

¹¹⁹ Cole v. State, 91 Miss. 628, 45 So. 11 (1907).

¹²⁰ Citizens' Life Ins. Co. v. Commission, 128 Mich. 85, 87 N.W. 126 (1901).

¹²¹ Julian v. Guarantee Life Ins. Co., 159 Ala. 533, 49 So. 234 (1909).

teristics, an insurance company could not change any of the terms of the contracts that it issued. This would impair freedom of contract. The position of the court is plausible, but it is doubtful that it is sound. Professor Patterson thought that the "reasoning [was] question-begging, since it would permit the insurer to discriminate with impunity simply by multiplying the number of 'classes' of policyholders."¹²² Under the decision, companies could evade and nullify the intent of the anti-discrimination statute.

Professor Patterson himself has cast some doubt on the soundness of the advisory board cases:

"[I]t can scarcely be denied that the first thousand policyholders in a newly formed life company receive less protection value per \$1000 of insurance than do the second thousand; for while the protection is the same by a purely legalistic standard (that is, the amount of money which the insurer obligates itself to pay), the early insurants take the grave risk that the new company may not survive the dangerous first years. Hence, it is quite arguable that to allow the early policyholders a reduction in premium is no 'discrimination' . . . [T]he 'discrimination' in favor of earlier insurants is no discrimination at all but is merely adjusting the premium charge to fit the actual protection which the insurant receives."¹²³

There is some merit to his point. It is doubtful, of course, that the salesman of the specialty policy would be willing to admit to his prospect this justification for a rate differential. But if the terms of the policy are to be justified as against the anti-discrimination statute on the basis of the greater risk inherent in the purchase of a policy during the early years of a company's life, it would seem appropriate that the policyholder be apprised of the reasons for his advantage. Instead, the appeal is to his cupidity. Despite his theoretical justification for the issuance of advisory board contracts, Professor Patterson recognized that the system "is deceptive because, like most other 'cheap insurance' schemes, it leads the average policyholder to believe that he is getting something for nothing. He is led to think that he is among the 'favored few,' and cupidity outruns caution."¹²⁴ Moreover, if the advisory board contract were justified as non-discriminatory, in view of the greater risk that the early policyholders run, there perhaps should be some consideration of whether the risk and the preferential treatment are

¹²² PATTERSON, *op. cit. supra* note 105, at 317.

¹²³ *Id.* at 317-18.

¹²⁴ *Id.* at 318.

reasonably related to one another, or whether the preferential treatment of the advisory board policyholder is excessive in relation to the extra risk that is incurred. It may be the other way around; the extra risk may be substantial, while the preferential treatment is meager—grossly exaggerated in sales presentation but in actuality hedged by language in the contract itself.

So far as appears from appellate opinions and other readily accessible sources, the advisory board contract did not survive the first decade or so after its introduction. If it were reintroduced in the same form, it would certainly be held illegal everywhere, in view of the overwhelming weight of authority. The case is even stronger now in view of the widespread enactment of the Unfair Trade Practices Act, section 3(g) of which forbids a company to “make or permit any distinction or discrimination in favor of individuals between those of the same class and equal expectation of life . . . in the dividends or other benefits payable thereon . . . ,” and section 3(f) of which explicitly forbids the advisory board contract.

The question that remains is whether the advisory board contract cases are applicable to its modern counterpart, the charter policy. Section 3(f) seems to contemplate a separate inducement and may not be applicable. Two distinctions throw doubt on the applicability of the anti-discrimination provision of section 3(g). One is that the charter policy imposes no duties upon the favored policyholders, although the duties in the advisory board contracts were merely apparent. However, the charter policy is not less, but rather more objectionable because no attempt is made to give even the appearance of consideration for the extra benefits to be received. Another distinction is that the advisory board contract was collateral to, but dependent upon a separate insurance policy, while the charter policy combines the entire transaction in one contract. Hence, the charter policy seems even more clearly to be in violation of the anti-discrimination statute.

On the whole, therefore, it seems to be sound for charter policies which contain a profit-sharing feature to be held illegal under the anti-discrimination statutes on the authority of the advisory board contract cases decided early in the century; for practical purposes the two are the same. The Wisconsin Insurance Department thought the statute applicable; it prohibited the issuance of charter policies, holding that the charter policy violated not only section 3(f) of the Unfair Trade Practices Act, but also the more

general anti-discrimination provision in section 3(g).^{124a} The charter policyholder, like the old advisory board policyholder, either has an unfair advantage over other policyholders or he is misled in the sales presentation by an appeal to his greed. The charter policy, like the profit-sharing policy, is inherently misleading to the policyholder or is discriminatory against other policyholders. There seems no middle position into which it can fall; in either event the charter policy, like its predecessor, is objectionable.

Because of its recent development (or its recent notoriety), there is little direct authority on the charter policy. One interesting case did appear in Minnesota, however. A charter policyholder, as representative of his class, sought an accounting, contending that while the directors had given special treatment to the charter policyholders, they had not fairly allocated to them all that they were entitled to receive. In effect, the special dividend provision secured to the charter policyholder, after five years, a return of one hundred percent of the surplus generated by his class of policies. On the other hand, the dividend provision in the noncharter policies provided that the policyholder would share in the surplus (necessarily surplus other than that generated by the charter policies) as ascertained and apportioned by the company. The effort backfired, however. On its own motion, the court asked whether it was not a violation of the Minnesota statutes to set up the charter members as a favored class, and sent the case back for consideration of the question, suggesting that the trial court see that the noncharter policyholders were represented by counsel of their own.¹²⁵ On the second round, the court held that the participating provisions of the charter policies were in violation of the anti-discrimination statute and decreed an accounting, subjecting the future earnings of the charter policies to a lien in favor of the noncharter policies.¹²⁶ If the old advisory board cases are sound, it is hard to question this decision.

C. *Methods of Control of Profit-Sharing and Charter Policies*

The foregoing analysis has shown that both a special susceptibility to misrepresentation and a discriminatory character are inherent in these classes of policies. If the first defect were all we had to combat, it would be important to answer the question whether the dangers of misrepresentation were so substantial that

^{124a} See note 102 *supra*.

¹²⁵ *Lommen v. Modern Life Ins. Co.*, 206 Minn. 608, 289 N.W. 582 (1940).

¹²⁶ *Lommen v. Modern Life Ins. Co.*, 212 Minn. 577, 4 N.W.2d 639 (1942).

they could not effectively be countered by enforcement of existing laws against misrepresentation, or by the development of new laws forbidding specific kinds of misrepresentation. An earlier article has shown the difficulties in control of that kind,¹²⁷ but despite those difficulties one should be reluctant to use the stringent weapon of prohibition unless failure to do so would present serious consequences. A number of states have tried the intermediate method; some have prohibited the use of such terms as "profit-sharing" or "charter" either in the policy or in advertising material.¹²⁸ Others have prohibited a long list of statements and practices, not only for these policies but also for others.¹²⁹ But charter and profit-sharing policies are not only peculiarly susceptible to misrepresentation, but are objectionable on other grounds as well. There is little justification for continuing their use. Even if the principle of freedom of contract might overcome our inclination to prohibit in order to prevent misrepresentation, it can hardly be argued that freedom of contract should also overcome the strong policy of the law in favor of doing equity among groups of policyholders so far as is possible. Profit-sharing and charter policies should be prohibited on the ground that they seriously compromise important values sought by the legal system.¹³⁰

D. *The Applicability of Securities Legislation*

On November 30, 1960, Mr. Harold G. Lohren of the Securities and Exchange Commission addressed the National Association of Insurance Commissioners and, after describing the profit-sharing policy, said:

"Now, when we get into the area of inducing the sale of insurance through a feature in a policy such as I have been de-

¹²⁷ See Kimball & Jackson, *The Regulation of Insurance Marketing*, 61 COLUM. L. REV. 141 (1961).

¹²⁸ *E.g.*, Fla. Dep't of Ins. Bull. No. 33, Aug. 8, 1961; Ga. Dep't of Ins. Reg. June 24, 1958; Nev. Dep't of Ins. Bull. 58-4, July 1, 1958; N.D. Dep't of Ins. Reg., April 10, 1961; S.C. Dep't of Ins. Bull. No. 1-60, 1960; Ind. Dep't of Ins. circular letter Dec. 16, 1959. Many of the regulations in this and the following two footnotes will be found in the WEEKLY UNDERWRITER, INSURANCE DEPARTMENT SERVICE.

¹²⁹ *E.g.*, Colo. Dep't of Ins. Bull. No. 37, Nov. 1, 1962; Ill. Dep't of Ins. Rule 9.09, Oct. 31, 1962; Kan. Ins. Dep't Reg. 48-11-10, June 13, 1963; Ky. Dep't of Ins. Reg., Feb. 9, 1959; Mo. Div. of Ins. Order No. III-9, Jan. 19, 1962; Neb. Dep't of Ins. Proposed Rule 26, Dec. 20, 1962; N.M. Dep't of Ins. Proposed Reg., Aug. 6, 1962; Wyo. Ins. Dep't Bull. 116, July 3, 1962.

¹³⁰ Several states have enunciated outright prohibitions of profit-sharing policies, *e.g.*, statement made by the California Insurance Commissioner, J. of Commerce, March 7, 1960, p. 9, col. 1; La. Dep't of Ins. Reg. Nov. 13, 1962; Utah Dep't of Ins. Bull. 60-5, May 16, 1960; W. Va. Ins. Dep't Ruling No. 3311, May 13, 1963; Wis. Adm. Code section Ins. 2.08 (1962).

scribing, which represents nothing more nor less than a participation in a profit-sharing arrangement—and I use those words advisedly because then I put my finger on one of the fundamental definitions of a security as defined in the Securities Act of 1933, a profit-sharing arrangement, an investment contract. And at this juncture, the Commission gets concerned, so that we have a dual concern with the Insurance Commissioners and the insurance industry as well as the securities side. . . .

“I don’t know what the solution to the problem is. In the Commission, in such instances as we have run across these policies—and I could say that I have hit about 25 different ones in the last two to three years—we have taken the position that a security is involved. We have advised the company that it should register that security if it proposes to sell it, and we have also taken the position that an investment company is involved.”¹⁸¹

If Mr. Lohren is correct, and the profit-sharing policy is subject to the jurisdiction of the Securities and Exchange Commission, regulation by that federal agency provides a method of control that might be fairly effective. Submission to the registration and disclosure provisions of the securities legislation would be inconvenient to insurance companies, which already must comply with a complex regime of state insurance regulation. Of course, insurance companies are now subject to securities regulation when they issue stock, and this applies also to offbeat issues, such as guaranty fund certificates.¹⁸² Here, however, we are talking about what are basically insurance policies. A threat of intervention by the Commission would tend, in most cases, to induce the company not to sell the questioned policy. Moreover, if the policy is a security subject to registration and is not registered, the policyholder will be able to rescind and get his full premium back. This would be a stringent sanction which would probably be quite effective.¹⁸³

For these reasons it becomes of some importance for us to consider the question of whether the Securities and Exchange Commission has jurisdiction, and if so, whether it should exercise its

¹⁸¹ LIFE COMM. REPORT, N.A.I.C., 19-31, Nov. 30, 1960.

¹⁸² *Donovan v. Dixon*, 261 Minn. 455, 113 N.W.2d 432 (1962).

¹⁸³ Securities Act of 1933, § 12, 48 Stat. 84, as amended, 15 U.S.C. § 771(1) (1958). Misrepresentations through the mails or other means of interstate communication also produce this result. 48 Stat. 84, as amended, 15 U.S.C. § 771(2) (1958). See also Securities Act of 1933, § 16, 48 Stat. 84, 15 U.S.C. § 77p (1958); Securities Act of 1933, § 24g, 48 Stat. 87, 15 U.S.C. § 77x (1958).

power. The starting point is the McCarran Act, which provides in section 2(b):

“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 . . . unless such Act specifically relates to the business of insurance”¹⁸⁴

If the Securities Act “specifically relates to the business of insurance,” it has effect despite state regulation. If it does not “specifically relate,” it can have effect only if it does not invalidate, impair, or supersede, the state laws respecting insurance. Although the matter is not free from doubt, it is possible that, as Mr. Lohren suggested, an insurance policy of the profit-sharing type is a security within the basic definition of section 2 of the Securities Act, which says that “the term ‘security’ means any . . . certificate of interest or participation in any profit-sharing agreement”¹⁸⁵ The doubt is suggested by the language of the House of Representatives Report on the Securities Bill. The Committee said that the exemption of insurance

“makes clear what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible.”¹⁸⁶

A profit-sharing agreement of the type with which we are presently concerned is a part of an ordinary insurance policy, arising within the framework of the insurance institution, and the profit-sharing feature is only peripheral to it. It is possible, of course, that there may be similar contracts in which the insurance aspect is the merest pretense; in such case this argument is not valid. But we are concerned here with contracts which are largely insurance, whatever may be the representations of the soliciting agents. In the absence of a strong showing that the Securities Act was intended to pick up every contract containing *any* security element, an institutionally or functionally oriented analysis would lead to a

¹⁸⁴ McCarran-Ferguson Act, 59 Stat. 34 (1945), 15 U.S.C. § 1012 (1958).

¹⁸⁵ Securities Act of 1933, § 2, 48 Stat. 74, as amended, 15 U.S.C. § 77(b)(1) (1958).

¹⁸⁶ H.R. REP. No. 85, 73d Cong., 1st Sess. 15 (1933).

conclusion that we are not dealing with securities, but rather with insurance.

On the assumption, however, that the profit-sharing policy is a "security," section 3 of the act then goes on to exempt certain classes of securities from the provisions of the act, except as expressly provided. One of the exempt securities is "any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia"¹³⁷ Finally, section 17, which proscribes certain fraudulent acts, states that the exemptions of section 3 do not apply to the provisions of section 17.¹³⁸

It would be difficult to argue that a profit-sharing policy of the type with which we have been dealing is not an insurance policy. Moreover, all states regulate the life insurance business. That being the case, application of the exemption of section 3 seems clear; the registration and disclosure provisions of the Securities Act seem not to apply to the profit-sharing policy even if it is admitted to be a security within the meaning of the act. The case is less clear with respect to section 17, where the exemption does not apply. It is possible to argue that the explicit exemption in section 3 is a kind of specific reference to insurance that, when it is negated by section 17, makes the latter section "specifically relate to the business of insurance" within the meaning of the McCarran Act.¹³⁹ It is possible to argue this, and thus to urge that the fraud section of the Securities Act is applicable to insurance, even if the registration and disclosure provisions are not. It is also *necessary* to argue this, for unless the section does specifically relate to insurance it may not invalidate, impair, or supersede state laws. The argument is not really persuasive, for it makes better sense to interpret the negation of the exemption as leaving the act as if there were no listing of insurance at all. This is all the more likely to be true because the legislative history of the act shows that the purpose of the exemption for insurance was to make clear "what is already implied in the act, namely, that insurance policies are not to be

¹³⁷ Securities Act of 1933, § 3, 48 Stat. 75, as amended, 15 U.S.C. § 77(c)(8) (1958).

¹³⁸ Securities Act of 1933, § 7, 48 Stat. 78, 15 U.S.C. § 77(g) (1958). Securities Exchange Act of 1934, § 10(b), 48 Stat. 891, 15 U.S.C. § 78(j)(b) (1958) is even more extensively used in fraud cases. The exemption does not apply to it.

¹³⁹ This same argument does not seem valid for § 10(b), the fraud section of the Securities Exchange Act of 1934, since there is no exemption section to provide the needed reference.

regarded as securities subject to the provisions of the act."¹⁴⁰ Although certain insurance policies (but not all) fall within the definition of a security to be found within the act, that is not enough to subject them to section 17 without specific reference to insurance. It is not enough, that is, unless it can be said that the Securities Act does not invalidate, impair, or supersede state laws regulating insurance, and there can be little room for doubt that application to profit-sharing policies of registration and disclosure provisions of the act would seriously impair and partially supersede the complex regime of state regulation of life insurance. It is only a little less certain that the same would be true of the application of the fraud provisions, in view of the existence in every state of some version of the Uniform Unfair Trade Practices Act.¹⁴¹ There would be no impairment and no supersession only if the provisions of the two acts were completely consistent and complementary, not concurrent. This is hardly conceivable.

An additional possibility for justifying the application of the fraud provision of the Securities Act to the profit-sharing policy would be the interpretation of the state securities laws to take the profit-sharing policy out from under insurance regulation, and subject it to state securities regulation. In that case, the McCarran Act would no longer be applicable, nor would the exemption of section 3 of the Securities Act, and the whole range of other provisions of the Securities Act would apply in a proper case. But the tendency in state legislation is in the other direction. More often than not, the exemption in the state securities act for insurance is broader than in the federal securities legislation. For example, the Iowa Securities Act exempts from application of the act "any security . . . issued by . . . any life insurance company under the insurance department of this state."¹⁴²

A final possibility is the determination that for purposes of federal law, the profit-sharing policy is not an insurance contract at all, but rather is a security or investment, by analogy to the treatment of the variable annuity given in *SEC v. Variable Annuity Life Ins. Co.*¹⁴³ But in the view of Mr. Justice Douglas, speaking for the Court in the case, the variable annuity was not insurance be-

¹⁴⁰ See note 136 *supra*; 1 LOSS, SECURITIES REGULATION 497, n.116 (2d ed. 1961).

¹⁴¹ See note 94 *supra* for discussion of this act.

¹⁴² IOWA CODE § 502.4(6) (1962). See also, *e.g.*, ILL. ANN. STAT. ch. 121 1/2, § 137.3(M) (Smith-Hurd 1953); NEB. REV. STAT. § 81-312(5) (1958). Compare *Donovan v. Dixon*, 261 Minn. 455, 113 N.W.2d 432 (1962) with *Bates v. Equitable Life Assur. Soc'y*, 206 Minn. 482, 288 N.W. 834 (1939).

¹⁴³ 359 U.S. 65 (1959).

cause it placed all of the investment risk on the annuitant, *i.e.*, there was no guarantee of fixed income. The concept of insurance, he felt, involved some investment risk-taking on the part of the company. As to the basic portion of the profit-sharing policy, there is investment risk-taking by the company, as well as an assumption of the mortality risk. It is only in the supplementary features of the policy that there is anything Mr. Justice Douglas would not regard as insurance. It would be a remarkable extension of the *VALIC* case to say a profit-sharing policy is not insurance, and thus subject it to the regulatory power of the Securities and Exchange Commission.

The concurring opinion of Mr. Justice Brennan¹⁴⁴ is another matter, and the subject cannot be left without recognition of his position. He was concerned with the question of whether insurance regulation or investment regulation was the more appropriate for the variable annuity. He concluded that the latter was, and he might conceivably reach the same result with respect to profit-sharing policies. The pronouncement of Mr. Lohren suggests that the Commission's thinking runs in the same direction, as does the recent opinion of the Commission in the *Prudential* case.¹⁴⁵

If it is assumed, contrary to the conclusions of this argument, that the Securities Act is applicable to the profit-sharing policy, there remains some question of whether the Commission should choose this as an appropriate place to exert its influence. Undoubtedly it has more tasks than it has personnel and funds to handle, and it is doubtful that this is a place where the Commission should try to make its influence felt, inasmuch as there is now full control over the life insurance industry at the state level, and it is currently the public policy of the United States to leave basic decisions about insurance to be made at that level. Moreover, of the types of specialty policies which this article considers, only profit-sharing and possibly, under certain interpretations, the tontine are even arguably within the jurisdiction of the Commission. There is merit in having a single agency which can see the entire problem provide comprehensive regulation for this whole group of coverages, rather than attempt a piecemeal regulation. Only the state insurance departments, not the Securities and Exchange Commission, could provide this comprehensive oversight. The problem is most appropriate for solution by the insurance regulatory authorities; only if

¹⁴⁴ *Id.* at 73-93.

¹⁴⁵ Decision of Securities and Exchange Commission (File No. 812-1386), Jan. 22, 1963.

there is no action in that quarter should the Securities and Exchange Commission consider intervening. Even then, the serious doubt that exists about its power should lead the Commission to leave the matter alone, despite the fact that some persons in the life insurance business would welcome the intervention.

VI. COUPON POLICIES

Neither the coupon policy nor vigorous criticism of it is new; as early as 1905, some companies issued coupon policies. For example, one policy¹⁴⁶ contained nineteen coupons which could be used to reduce premiums, to purchase additional paid-up life insurance, or could be left to accumulate interest for the remainder of the coupon period of twenty years. In another early policy, we find the coupons payable annually beginning one year after the insurance date "as a dividend guaranteed."¹⁴⁷ The coupon policy probably developed from the competition between participating and nonparticipating policies,¹⁴⁸ and at first was commonly referred to as the "guaranteed dividend" policy. By 1913 approximately sixty companies seem to have been issuing coupon or guaranteed dividend policies.¹⁴⁹

Criticism of the coupon or guaranteed dividend policy began at once. In a statement to the National Association of Insurance Commissioners in 1909, the Oklahoma Commissioner said that the issuance of such policies was "hurting the country," and that "no man . . . [would] defend it."¹⁵⁰ The Association classed the coupons with "frills that are foreign to legitimate life insurance" and resolved disapproval, urging its members "to discountenance such methods as highly deceptive and misleading."¹⁵¹ The actuary for the Wisconsin department said the purpose of such a policy was "simply to mislead the public into thinking they will get a big profit on their money."¹⁵² The conservative companies also criticized the

¹⁴⁶ This policy, issued by Security Mutual Life Insurance Co., was discussed in a letter dated March 24, 1905, which appeared in 10 LIFE INSURANCE COURANT 265 (1904-1905).

¹⁴⁷ Such a policy was involved in *Empire Life Ins. Co. v. Wier*, 135 Ga. 130, 68 S.E. 1035 (1910).

¹⁴⁸ See Cathles, *Coupon Policies—Their Advantages and Disadvantages and a Description of an Original Office Method of Caring for Exceptional Policies*, 2 AMERICAN INSTITUTE OF ACTUARIES, THE RECORD, pt. 2, at 1 (Nov. 1913). Mr. Cathles was with the Southwestern Life Ins. Co. of Dallas, Texas. "The inability of the participating company to guarantee its dividends formed a tempting opening for the nonparticipating company . . ." *Id.* at 2. Policies were issued at participating rates but with guaranteed premium reductions after the first year.

¹⁴⁹ *Id.* at 8.

¹⁵⁰ PROCEEDINGS, NATIONAL CONVENTION OF INSURANCE COMMISSIONERS, FORTIETH SESSION 39 (1909).

¹⁵¹ *Id.* at 146-50.

¹⁵² *Id.* at 148.

policies as misleading; they urged that the word "dividend" and the word "coupon" suggested a return to the stockholder or policyholder in the nature of profit or interest *on* principal, whereas in fact in the coupon policies there is a return *of* principal.¹⁵³ Nor did the criticism remain merely at this level. The Minnesota legislature in 1913 flatly prohibited the issuance of coupon policies.¹⁵⁴

Criticism, however, did not stop the use of coupon policies, which have been issued more or less continuously ever since. In 1937, for example, one policy contained coupons that could be surrendered for cash, applied to reduce the premium, or used to purchase a pure endowment addition which would increase the paid-up values of the policy and, if repeated each year, would mature it as an endowment for the face value after twenty years.¹⁵⁵ Another had similar options except that the purchase of a fully paid-up policy at an earlier date required surrender of *all* the coupons; an additional option was to let the coupons accumulate at $3\frac{1}{2}$ percent compound interest.¹⁵⁶

Today a typical coupon policy provides that the coupons may be used in any of four ways. A coupon may be surrendered to reduce the premium, for a cash amount equal to its face value, for nonparticipating paid-up additions to coverage, or it may be held to accumulate with interest for a specified number of years. Additional options occasionally exist. One, for example, would permit the policyholder to direct the company to pay the money to anyone he designated; the intention of the company was to encourage the use of the coupons to buy stock from a designated broker. Another would use the coupons to buy shares in an affiliated mutual fund,¹⁵⁷ and still another to buy shares in the insurance company itself.¹⁵⁸

It is uncertain how widespread the present use of coupon policies is. However, recent action of several states to prohibit or control coupons is an indication of extensive use. Two states now have prohibitory statutes.¹⁵⁹ Within the past few years seven state in-

¹⁵³ See Cathles, *supra* note 148, pt. 2, p. 3.

¹⁵⁴ Minn. Laws 1913, ch. 443, § 1, now MINN. STAT. ANN. § 61.41 (1945).

¹⁵⁵ Such a policy was involved in *Adroin v. Great So. Life Ins. Co.*, 186 La. 583, 173 So. 112 (1937).

¹⁵⁶ Such a policy was involved in *General Am. Life Ins. Co. v. Stephens*, 130 F.2d 511 (9th Cir. 1942).

¹⁵⁷ An arrangement such as this was involved in the Matter of MidAmerica Mutual Fund, Inc., SEC Investment Company Act Release No. 3612, Jan. 11, 1963.

¹⁵⁸ See Prospectus of National Western Life Ins. Co., Jan. 9, 1963, p. 3. Cf. Prospectus of National Sec. Life Ins. Co., March 1, 1962, p. 7.

¹⁵⁹ See MINN. STAT. ANN. § 61.41 (1945); NEB. REV. STAT. § 44-503 (1960). Also, in

insurance departments have prohibited them,¹⁶⁰ and fifteen departments have issued regulations using other methods of control.¹⁶¹ But until quite recently coupon policies were legal in nearly all the states and were issued by dozens of companies.¹⁶² It is not possible to be much more precise without an unprofitably extensive inquiry.

A coupon added to a life insurance policy is not fundamentally complicated. In lay language, the level premium life insurance contract can be regarded as a combination insurance policy and savings account. The savings account grows throughout the life of the policy, while the insured sum decreases. The total of the two is equal to the amount payable under the policy. When coupons are appended to the contract, it merely means that an additional and separate savings element is added, and the coupon options do no more than state what the policyholder is permitted to do with the extra savings account that he has established with the insurance

1963 the Kansas legislature repealed § 40-430, which had affirmatively permitted the issuance of coupon policies. Kan. Laws 1963, ch. 262, § 1.

¹⁶⁰ See Mich. Dep't of Ins. Reg., Oct. 19, 1962; N.D. Dep't of Ins. Reg., April 10, 1961; W. Va. Ins. Dep't Rule No. 3311, May 13, 1963; Wis. Adm. Code section Ins. 2.08 (1962); N.J. Dep't of Banking and Ins., Reg. No. I-1963A-1, July 15, 1963. A companion to the last regulation, No. I-1963A-2, prohibits the use of passbooks and language referring either to "passbooks" or "premium deposits" or similar language suggesting savings. Most of these regulations may be found in the WEEKLY UNDERWRITER, INS. DEP'T SERVICE. See also letter from Charles C. Dubuar, Chief Actuary of N.Y. Ins. Dep't, to Pak H. Louis, July 29, 1952; letter from Carl Stumer, Deputy Commissioner of Dep't of Ins. of S.D., to Charles Manson, Commissioner of Wis. Dep't of Ins., Nov. 30, 1961.

¹⁶¹ These regulations are of two types. The first embodies a disclosure approach; it requires that the amount of the gross premium allocated to the coupon be stated on the face of the policy. See Fla. Dep't of Ins., Bull. No. 33, Aug. 8, 1961; Kan. Ins. Dep't Rule 48-11-10, ¶ 1, July 1, 1963; La. Dep't of Ins., ¶ 5, Nov. 13, 1962; N.C. Ins. Dep't Reg., July 15, 1960; S.C. Ins. Comm'n, Reg., July 31, 1962; Va. Corp. Comm'n Reg., Sept. 22, 1958; letter from Earl Nicholson, Deputy and Actuary of the Nev. Ins. Dep't, Aug. 24, 1962. Ga. Dep't of Ins. Regulation, June 24, 1958, employs a modified disclosure approach by allowing the company the option of stating separately the amount of the premium for the coupon or of stating on the face of the policy that "the premium above includes an extra premium for coupon benefits." The second type is a limited prohibition. Five insurance departments attempt to regulate coupon policies by prohibiting language which states or implies that coupons represent interest earnings, return on investment, etc. See Ill. Dep't of Ins. Reg. 9.09, § 5(9), Oct. 31, 1962; announcement made by the Ind. Dep't of Ins., Dec. 16, 1959; Mo. Div. of Ins. Order No. III-9, Jan. 19, 1962; Va. State Corp. Comm. Reg., Sept. 22, 1958; Wyo. Ins. Dep't Reg. ¶ 2(c), July 3, 1962. There are two proposed regulations: N.M. Dep't of Ins. Proposed Reg., ¶ 2(c), Aug. 6, 1962; Neb. Dep't of Ins. Proposed Rule No. 26, Dec. 20, 1962. The Nebraska proposed regulation talks in terms of a "series of one-year pure endowments or a series of guaranteed periodic benefit," which would include coupons. But in light of NEB. REV. STAT. § 44-503 (1960), which already prohibits coupons, this regulation appears to go farther and prevent efforts to avoid the statute by a change in form. Most of these regulations may be found in the WEEKLY UNDERWRITER, INS. DEP'T SERVICE.

¹⁶² See note 9 *supra* and accompanying text.

company. Technically, coupons "should be treated as a series of pure endowments in the calculation of minimum cash values under the Standard Nonforfeiture Law."¹⁶³ An endowment is essentially a savings element in an insurance policy.

A. *Objections to Coupons*

There is nothing sinister or even objectionable about a savings account. Indeed, it is widely thought to be a good thing for private persons to save money in a capitalistic society, for some of the money is likely to be channeled into investment in new enterprise, as a result of which the economy expands. If there is nothing objectionable about a savings account, there is nothing inherently wrong with a high-savings insurance policy, or with a pure endowment. Likewise there is nothing wrong with a coupon in itself.

1. *Inherent Vice in the Coupon Policy*

But is it objectionable in the way it is used? This question has two aspects. It may be asked first whether the combination of an insurance policy and a series of pure endowments is bad when neither is bad in itself, simply because the combination has no legitimate economic function, because it tends to increase the cost of insurance, because it makes pure insurance unavailable to those who need it, or for any other reason? Second, is the coupon policy evil because it is peculiarly susceptible to misrepresentation and deception?

It would be hard to argue that it is always bad in itself to combine insurance coverage and savings. To so argue would lead inevitably to the further proposition that all forms of life insurance other than term insurance are bad. Ordinary life insurance, limited payment life insurance, and endowment policies are all combinations of pure life insurance with a savings element. Both insurance and savings are benign institutions, and in combination as well as apart they are valuable adjuncts of the economy. Nor it is easy to argue that it is bad per se to have such a large savings component as exists in the coupon policy. The savings component of the usual coupon policy is not as large as that in many endowment policies issued by the most conservative companies. It cannot be argued that the high-savings insurance policy is evil if it is sold to people who want it or need it. It would be equally difficult to say that the

¹⁶³ See *Report of the Hooker Committee of the National Association of Insurance Commissioners*, PROCEEDINGS, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 119 (1951).

coupon policy is inherently bad if it is sold to the right people. Nor would the existence of coupon policies necessarily exclude term insurance or lower-price ordinary life insurance from the market, making them unavailable to people who need them. One must conclude, unless there are arguments which are not apparent, that there is nothing in the nature of the coupon policy that makes it unsuitable as a commodity readily available in the market, provided only that it is not put into the hands of people who are in need of something else.

2. *Susceptibility to Misrepresentation*

Before there should be a prohibition of the issuance of coupon policies in order to prevent misrepresentation and misleading of policyholders, there should be a showing that the problem is serious and that it cannot be solved or sufficiently ameliorated in any other way. It is necessary, therefore, that we attempt to determine how serious the problem is and whether it can be solved by steps short of prohibiting the use of coupons.

The choice of the word "dividend" in connection with these policies has sometimes been attacked as misleading in itself, and prohibition of its use has been proposed. It is true that the word "dividend" suggests profits, by virtue of its long association with the distribution of corporate profits to stockholders. Indeed, for many years there have been actuaries who have objected to its use in connection with any life insurance policies, since "dividends" under a participating policy, and "guaranteed dividends" under a nonparticipating coupon policy, are both repayments of overcharges rather than profits in the usual sense. But this proves too much, for if use of the term "dividend" were to be forbidden, it would require a change of terminology for all participating insurance, and there is no serious contention that the term is sufficiently misleading when used by the conservative participating companies to justify prohibiting its use.

The word "coupon" has also been asserted to be misleading, because of its long association with the payment of interest on bonds. Thus, it is thought to mislead policyholders into supposing that the coupons represent interest or profits on the principal, rather than the return of overcharges. There may be an element of truth in this assertion, but it is doubtful that there is enough for this alone to justify restrictive legislation. *Webster* has several definitions for "coupon." One is "a certificate of interest due . . .," but other definitions are "a section, as of a ticket or certificate, show-

ing the holder to be entitled to some service or right," "a certificate given with a purchase of goods and redeemable in merchandise or cash," and "a part of a printed advertisement designed to be cut off for use as an order blank." The idea that is common to all these definitions is the existence of a physically separable portion of a contract that is to be separated and exchanged for something. Thus the ordinary usage of the term is wide enough to include use with an insurance policy, and it is hard to mount an attack on coupon policies merely because of the use of the term "coupon." Of course, it is possible to use the term in a context in which it contributes to deception, but this is probably no more true than with most other words.

Since there seems to be no legitimate objection to coupons based on terminology alone, let us consider the way in which they are used. Although there is little criticism of high-savings insurance policies when considered as commodities available for people who want them, there is much criticism of the widespread sale of high-savings policies. It comes in part from competitors, such as the sellers of mutual fund shares, and in part from less interested observers. Such criticism depends in essence upon the propositions that (1) for most insurance buyers the quantity of insurance protection they actually need can be afforded only if they minimize immediate drain on income through the use of term insurance or a combination of term and ordinary life insurance, while (2) for buyers who have income left for saving after buying adequate life insurance protection the rate of return on savings in life insurance policies is relatively low, and a better return can be obtained with reasonable safety by investing in mutual funds or in other ways, and (3) that these facts, or alleged facts, are not generally known to prospective buyers of insurance and it is to the interest of the sellers of high-savings policies to keep them from being known. In essence, then, the objection to the high-savings insurance policy is that it is sold to people who would be better off with something else, but do not realize it. The arguments thus made apply not only to coupon policies but also, though in lesser measure, to many policies of conservative insurance companies, whether participating or non-participating. The argument is often persuasively made and probably has considerable merit. It hardly seems doubtful that many insurance buyers would be better off with more insurance protection and a smaller commitment to savings in the form of life insurance. But it is a long step from this conclusion to an argument for control or prohibition of high-savings insurance. In a free so-

ciety in which the state does not assume the duty and the prerogative of telling citizens what they should buy, it is hard to advocate with justification the control or prohibition of a commodity that is not harmful in itself and that has a beneficial use. Indeed, it should not be done because of a mere possibility of sale to persons who should not buy, but should be done only if there is misrepresentation and misunderstanding in enough cases to create a serious problem requiring control by public agencies. Substantial possibility of misrepresentation and misunderstanding is necessary to justify concern about the use of coupon policies. Two aspects of the typical coupon policy seem to make it peculiarly susceptible to misrepresentation. One is in the form of the policy—the coupon itself, and the other is the usual failure to separate the cost of the coupons from the cost of the basic policy, which leads to the obscuring of information about cost.

The form of the coupon policy facilitates misrepresentation because of its similarity to the coupon that represents interest or profits. One sales presentation included the following statement: "Here is a page of coupons. . . . They are colored green to look like money because they actually represent money [T]here are several things you can do with your coupons. You can clip these out upon maturity, *just like in a bond* and exchange them for cash."¹⁶⁴ Salesmen frequently tell prospects that coupon policies are bonds, securities, investments and so forth.¹⁶⁵ Possible misconception is furthered by the pains taken to make the coupons a prominent and attractive part of the policy.

"The coupons are devised to give the appearance of the interest coupons that are frequently attached to investment bonds. Although the face amount of the coupon benefit is essentially a refund of premium previously paid by a policyholder, it is frequently represented that it is the earnings or return on the investment of the policyholder in life insurance."¹⁶⁶

Either express or implied reference is thus made to returns from stocks, bonds or savings accounts. The fact that the words "profit" or "investment" are absent from the coupons and the clauses of the contract dealing with the coupons does not preclude them from misleading applicants on many occasions:

¹⁶⁴ From our files. Compare the introductory sales presentation, note 1 *supra*.

¹⁶⁵ See, *e.g.*, letter from Carl Stumer, Deputy Commissioner of Insurance of South Dakota, to Charles Manson, Wisconsin Commissioner of Insurance, Nov. 30, 1961.

¹⁶⁶ Wis. Adm. Code section Ins. 2.08 (1962).

“To print the coupon in the color and format of interest coupons commonly attached to investment bonds disguises the true nature of the product being purchased by the public. A series of one year endowments affords a special type of benefit which the average life insurance buyer would seldom purchase if he were in possession of the full information concerning the premiums paid for the pure endowment benefits provided.”¹⁶⁷

The use of a passbook instead of coupons may make the form somewhat less objectionable, but probably not decisively so, for passbooks, too, suggest earnings rather than a refund of an overcharge.

In another respect the form of the coupon policy may facilitate deception, or may itself deceive. It is normal for a coupon policy to contain only nineteen coupons, the first coupon being payable at the time the second annual premium is paid, and one being payable at the corresponding time each year thereafter, up to the twentieth premium payment. There is none associated with the first premium. The shortage of one coupon is of course quite obvious to any one who takes the trouble to examine the policy carefully, but it is not pointed out and may be the basis for misunderstanding in the case of the unsophisticated applicant. The absence of a coupon corresponding to the first premium is related to cost of acquisition, *i.e.*, the sum goes to help pay the heavy first year acquisition costs and especially the agent's commission. One actuary expressed his dislike for the nineteen coupon arrangement as follows:

“If the agent in his presentation said that . . . they were only going to give you nineteen coupons and that the first coupon they were going to keep to build the agency force on, you might go along with that. Then you would know exactly what you are getting. Of course, that is never divulged to the applicant.”¹⁶⁸

Of course a perceptive insurance buyer would realize the facts, but many are not perceptive.

The probable rejoinder of the coupon-issuing company is not without relevance. It would point out that the policyholder who buys ordinary insurance from a conservative company is not told that he gets no cash value during his first year or even during his

¹⁶⁷ See note appended to Wis. Adm. Code section Ins. 2.08 (1962).

¹⁶⁸ This was a statement made in discussion by David C. Silletto, Assistant Secretary, Lincoln National Life Ins. Co., Fort Wayne, Ind., 1960-1961 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 58.

second year, because the first year's premium goes in large part to pay an agent's commission and other acquisition expenses. This is true, but the fact that the deceptive possibility is to some extent common to all insurance policies and all companies should not lead us to obscure it when we discuss the problems associated with coupon policies. We deal here with coupon policies, not because they pose the only problems that exist in the marketing of life insurance, but because the problems which they create are more serious and difficult than those of more traditional forms of coverage.

In some policies, the coupon matures at the end rather than at the beginning of the policy year, with the first coupon maturing only after the policy has been in effect for two years. Since the policyholder pays his premium at the beginning of the year, if he dies or lapses during the year, he forfeits the coupon benefit for which he has already paid. The same thing would be true in any year of the first twenty. This is a minor problem of the kind which led, many decades ago, to the enactment of nonforfeiture laws.

More important than the misleading aspects of the form, however, is the usual failure to disclose cost information about the coupon. Ordinarily the cost of the coupon is not stated separately; only the total premium is announced to the applicant. Nor is it possible to ascertain the cost of the coupon by examining the contract, even with great care. In a recent Wisconsin Insurance Department hearing, on cross-examination the following exchange took place between the witness, a distinguished professor testifying on behalf of an insurance company issuing coupon policies, and the attorney for the Wisconsin Association of Life Underwriters:

Q. "Is it possible to scan a contract and determine the cost of the coupon?"

A. "No."

Q. "So that the buyer of the insurance couldn't by reading his contract know how much he is paying for the election of that contract other than coupons, and how much he is paying for the coupons?"

A. "I think that is correct, yes."¹⁶⁹

¹⁶⁹ See *Hearing Before the Wis. Dept. of Ins. on Proposed Rule Ins. 2.08*, p. 65 (Jan. 1962). Some efforts at ascertaining cost information may be found in Reply Memorandum, Wis. Ass'n of Life Underwriters and Wis. Life Convention to the Wisconsin Insurance Department, In the matter of Consideration of Adoption of Proposed Rule Ins. 2.08 of the Wisconsin Adm. Code, pp. 18-23. One cannot use the results with confidence, but the figures are suggestive. See also Reply Brief of General Life Ins. Corp., pp. 7-9.

At the same hearing, a spokesman for the department stated that "it is doubtful that many policyholders [of coupon policies] understand the premium which they pay at the beginning of the year contains a charge to provide the funds from which the coupon can be paid by the company at the end of the year."¹⁷⁰ Inability to learn the price of the coupon prevents the applicant from comparing the cost of the benefit with its value. Indeed, the agent may allow the policyholder to infer, may suggest, or may even affirmatively represent to the prospect, that the whole face value of the coupon represents a return *on* investment, instead of a return *of* investment. Even if the agent does not so misrepresent, there is a substantial likelihood of this misunderstanding. If, for example, the gross annual premium is \$100.00 the face value of the coupon is \$10.00 and the cost of the coupon \$9.70, then the actual return on the amount invested in the coupon is about three percent, but since the face value of the coupon is ten percent of the gross premium, the policyholder may think he is getting a ten percent return. This misconception is made possible by the failure to state separately on the face of the policy the amount of the premium allocated to the coupon.

The possibility that a policyholder will misunderstand the nature of a coupon policy is increased by the varied benefits that are contained in many coupon policies. Though the four basic options generally available are familiar in connection with ordinary dividends on orthodox policies, coupon policies seem to have greater variability. Additional options are also possible. One policy contains a sweeping fifth option that permits the policyholder to use, transfer, or assign the coupon to anyone for any purpose he may designate. In fact, that company expected to encourage the policyholder to transfer the coupon to a specified stockbroker on a regular basis for the purchase of common stocks. These options may make the coupon policy difficult enough to compare with more orthodox policies, and the addition of other specialty features, without any specification of the separate premiums attributable to each one, makes the task of comparing prices even more tricky.

In the nature of things, the coupon benefit is merely a refund of principal paid in by the policyholder, augmented by interest and reduced by any expenses that are charged to the coupons. In the first years, the actual cumulative return is markedly less than the

¹⁷⁰ *Hearing Before the Wis. Dep't of Ins. on Proposed Rule Ins. 2.08*, p. 18 (Jan. 1962).

cumulative total of premiums because of acquisition costs. The fact that no coupon is associated with the first-year premium is eloquent testimony to this proposition. Until after a number of years, the exact number depending on company and policy, there is a net loss for the policyholder, even without taking interest into account. If interest earnings are to be considered, the coupon policy method proves to be an inefficient way to save money. The coupon company may justifiably reply that the same thing is true of the cash values and dividends of the orthodox insurer, but, as before, we should not ignore disadvantages and problems inherent in the coupon policy merely because the same problems and disadvantages exist in lesser measure in the orthodox policy. The greater problem should be dealt with before the lesser, for there is less justification for legal intervention in connection with the latter.

Some conservative life insurance men have put the case against coupons very strongly. Thus one actuary, a spokesman for a large life insurance company, said:

"I think the problems with the so-called coupon policies have resulted purely from the merchandising of them. I was once talking to a man who was a very successful merchandiser of special policies He told me, further, that there were two reasons for their success. The first was that the coverage was easy to misrepresent by the agent. I think that is true. Second, he said that many of the provisions of the policy had been deliberately designed to give the prospect . . . the impression that he is taking advantage of the life insurance company" ¹⁷¹

There is no practicable way to ascertain the extent to which coupons are the basis of misrepresentation, just as there is no practicable way to measure the extent of deception in the marketing of the more traditional policies of insurance. It is hard to doubt, however, that there is more deception in connection with coupon policies, and possibly a great deal more. Coupons are not added because they are needed to make the insurance policy meet a need, but rather they are added because they help to sell despite a higher price. For the most part, the companies issuing coupon policies are rather new companies which need sales gimmicks, and there is a tendency for them to become more conservative as they become better established.¹⁷² Under the circumstances it would be surpris-

¹⁷¹ 1960-1961 PROCEEDINGS: CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 58.

¹⁷² See note 20 *supra* and accompanying text.

ing if there were not more misrepresentation than with traditional policies.

It seems reasonable to conclude, on the basis of the available evidence, that the misrepresentation problem is serious enough in the coupon policy that it should be subjected to control, if control without excessive adverse collateral consequences is possible.

B. *The Regulation of Coupon Policies*

1. *Prohibition*

The simplest way to control coupon policies is to forbid them. That solution has appealed to a number of legislatures and insurance departments when they have been led to take action. As early as 1913 the Minnesota legislature prohibited coupon policies.¹⁷³ In more recent years, other legislatures and state insurance departments have adopted a similar policy.¹⁷⁴

One of the consequences of outright prohibition is loss of whatever advantages are offered by the coupon policy. It seems useful to examine the advantages claimed for such contracts, to see whether there would be a serious loss to the public if they were kept off the market. The chief advantage urged by the proponents of coupon policies is flexibility in working out an insurance program. That flexibility comes from the options available in connection with the coupon, which are basically the same as the standard dividend options available from most participating companies.¹⁷⁵ The flexibility provided by the coupon policies can thus be attained through ordinary participating insurance without the disadvantages of the coupons. The coupons offer only a guaranteed savings component. Even the supporters of the coupon policy say little more than that. One coupon company stated that the coupon "is merely a convenience to the insured in his use of the pure endowment feature provided by the policy."¹⁷⁶ If it is merely a convenience, it should not be purchased at too high a price measured in potential misrepresentation and misunderstanding. Moreover, there is also an element of inflexibility introduced by the coupon. The coupons increase the premiums, so that they are large in relation to insurance protection and thus more difficult for the policyholder to maintain except at the cost of using each coupon to

¹⁷³ Minn. Laws 1913, ch. 443, § 1, now MINN. STAT. ANN. § 61.41 (1945).

¹⁷⁴ See notes 159, 160 *supra*.

¹⁷⁵ See NATIONAL UNDERWRITER, WHO WRITES WHAT 222-33 (1962).

¹⁷⁶ Brief for F.L. Ins. Co., In the Matter of Consideration of Adoption of Proposed Ins. Rule 2.08 of the Wis. Adm. Code, p. 5 (1962).

reduce premiums. But if they are thus used, they add net cost to the policy without any corresponding benefit, since the first year commission on a coupon policy is higher than on a similar policy without coupons because of the higher gross premiums.¹⁷⁷

Despite the fact that the coupon policy offers no significant advantage over other available policies, and despite the fact that it is more susceptible to misrepresentation than traditional policies, one should be cautious about prohibiting it. Prohibition requires a judgment that the potential harm from coupon policies is substantial. Not only may such policies offer some advantages to an occasional buyer under certain circumstances, but we should start with a substantial bias against interfering with freedom of contract, which is one of the prime values of our legal system. Indeed, it can be said quite categorically that a heavy burden rests on anyone who proposes to interfere with the making of contracts as negotiating parties wish to make them. Freedom to make one's own judgments about his contracts is an important value, even if the freedom will sometimes be used foolishly. The fact that the advantages of coupon policies are slight and that they involve a serious danger of misunderstanding justifies outright prohibition only if it is not possible to make them inoffensive in some less drastic manner.

2. *Disclosure*

The most objectionable aspect of the coupon policy is not its form, but the failure to disclose cost. The companies issuing coupon policies surely work out the premium charges by making separate computations for coupons and for insurance. If so, they can easily disclose the charges separately. The only obvious reason for nondisclosure would be to mislead the policyholder, or at least to permit him to mislead himself. An assertion that the public interest requires a full and fair disclosure of coupon costs to the policyholder is hard to answer. Of course, disclosure may make it more difficult for the company to make an attractive sales presentation, for awareness of the actual cost of the coupon would at once dispel all illusions of a high rate of return on the initial investment. The nature of the coupon as an endowment, or savings account, would at once become apparent, with a drastic reduction in its marketing appeal.

¹⁷⁷ See Memorandum to the Subcommittee on Reserves and Nonforfeiture Values and Related Matters of Coupon and Similar Policies, June 16, 1963, by Earl Nicholson, Actuary and Deputy Ins. Comm'r of Nevada. But see Reply Brief for G. L. Ins. Corp., In the Matter of Consideration of Adoption of Proposed Rule Ins. 2.08 of the Wis. Adm. Code, p. 7 (1962).

As the Wisconsin Department said, "A series of one-year endowments affords a special type of benefit which the average life insurance buyer would seldom purchase if he were in possession of the full information concerning the premiums paid for the pure endowment benefits provided."¹⁷⁸ But it is hardly an appealing argument against a disclosure requirement that the prospect is less likely to buy if he knows the truth.

The coupon company may retort that it is unfair to compel disclosure of the cost of the coupon if you do not also compel participating companies to disclose the extent to which their premiums exceed those of nonparticipating companies, *i.e.*, the cost of their dividends. There is some merit in the argument, but some weaknesses also. First, the coupon is a guaranteed dividend, and thus clearly separable from the rest of the policy, whereas ordinary dividends come from the residue of the premium which is left after paying losses and expenses, and cannot be estimated with complete accuracy. Second, the nature of the ordinary dividend is fairly well known, and apart from misleading statements occasionally made about the size of future dividends by unscrupulous salesmen, policyholders generally do not suppose that the dividends of participating companies constitute profits. It is not necessary to disabuse them of their illusions, since they have none. This is not to say that there may not be room for more disclosure in connection with other insurance as well, but only that the problem is less serious than with coupon policies, and that one should deal with the more serious problems first.

Even disclosure has been traditionally beyond the scope of normal state intervention in contracts. However, there has been a growing feeling that it is legitimate for the state to compel full disclosure in connection with any contract where people are apt to be deceived. There is less need to prohibit contracts or control their terms if only the truth is made known. The general disclosure policy of the securities and investment legislation of Congress illustrates the tendency.¹⁷⁹ Moreover, and more important, the philosophy underlying the insurance codes would seem to dictate the disclosure of the amount charged for the coupon benefit. The whole insurance business is operated in full public view. Insurance stat-

¹⁷⁸ See authority cited note 167 *supra*.

¹⁷⁹ President Kennedy's special message to Congress of March 15, 1962, also expressed a disclosure philosophy: "Under our system, consumers have a right to expect that packages will carry reliable and readily usable information about their contents." *N.Y. Times*, March 16, 1962, p. 16, col. 8.

utes have created machinery to make a public record of the costs of the various components of insurance policies in nearly all fields. Several states require companies to keep separate accounts for, and to set forth in annual statements the gains and losses arising from, participating and nonparticipating business. Some insurance departments are now trying, through the Blanks Committee of the National Association of Insurance Commissioners, to secure an amendment to the nationally used annual statement blank to require submission of a separate gain and loss exhibit for participating and nonparticipating business.¹⁸⁰ But more explicitly, such statutory provisions as the following require disclosure of the kind with which this section is concerned:

“No figures used in any statement or illustration of future dividends or of future net cost shall be issued or used by any company or agent, unless the same shall be a mathematical calculation based upon assumptions of the policy and dividend scale in actual use, nor unless each edition thereof . . . has been filed with the commissioner.”¹⁸¹

Furthermore, the law requires each policy to meet the standard non-forfeiture and valuation requirements.¹⁸² This requires that a great deal of detailed information be supplied to the regulatory authority. Insurance departments examine forms, rates charged, non-forfeiture benefits provided, and valuation standards employed to determine whether the appropriate requirements have been met.¹⁸³ There is no reason that this comparative cost data should not be as fully available to the purchaser as to the insurance departments. It would be contrary to the disclosure philosophy that runs through the insurance statutes to permit the merging of the premium charge of components (coupons, life insurance, return of premium, etc.) to mask the information the policyholder needs to make his judgments informed ones.

¹⁸⁰ The reform is vigorously opposed by some companies and some departments. In an April 1963 meeting of the Blanks Committee of the N.A.I.C., a motion to amend the annual statement blank to require a separate gain and loss exhibit for participating and nonparticipating business lost by an 8-7 vote. See Joint Gen. Bull. No. 1044, June 4, 1963, American Life Convention-Life Ins. Ass'n of America.

¹⁸¹ Wis. STAT. ANN. § 206.51(2) (1957).

¹⁸² See standard non-forfeiture requirements, *e.g.*, Wis. STAT. ANN. § 206.181 (Supp. 1962); standard valuation requirements, Wis. STAT. ANN. § 206.201 (Supp. 1962).

¹⁸³ See, *e.g.*, Wis. STAT. ANN. § 206.17(1) (1957), which provides: “No policy of life . . . insurance . . . shall be issued . . . until the commissioner has approved the same or until there has been filed with him at least 30 days the form of such policy and a copy of any table of rates or statement of benefits furnished to agents or to the public”

But the coupon company may respond that its benefits are so variable and so complicated that it is not possible to separate the coupon cost from the cost of the regular insurance. If the benefits are really so complicated that disclosure of cost is impossible, that alone would be a devastating indictment of the policy, and would be a strong argument for prohibition. Moreover, there is reason to doubt that it would really be so difficult to separate the charges if there were a will to do so.

The case for full disclosure of the cost of coupons is a strong one. It might be quite different if the variable benefits represented commodities of such special value to the consumer as to justify keeping him uninformed, but to state the proposition is to answer it. If the components of coupon policies were required to be simplified enough to be priced separately, if terminology were made more nearly standard to facilitate understanding, and if full disclosure could effectively be compelled, the objectionable aspects of the present coupon policies would be largely eliminated without any loss to the policyholders, who could still buy any combination of savings and insurance they really desired.

In 1961 the Florida Insurance Department issued a regulation that uses the disclosure solution directly, stating that "no coupon policy will be approved after this date unless it bears the words on the face: 'The premium above includes an extra premium of \$. . . for coupon benefits.'" The regulation goes on to specify, later, that the "statement should be placed in a prominent place on the face of the policy, preferably near the premium schedule and should be of large type (18 pt. or better)."¹⁸⁴

There are similar regulations in a number of other states.¹⁸⁵ The Wisconsin Insurance Department has interpreted a section of the Wisconsin statute as requiring such disclosure with coupon policies, though it does not deal explicitly with coupon policies. The relevant provisions are as follows:

"No policy . . . shall be issued . . . unless it contains . . . the following provisions: . . . Provision 2, specifying separately the premium charged for any benefit promised in the policy other than life or endowment insurance."¹⁸⁶

Thus when a life or endowment policy carries with it fringe benefits such as waiver of premium, accidental death benefit, etc., a separate

¹⁸⁴ Fla. Dep't of Ins. Bull. No. 33, Aug. 8, 1961.

¹⁸⁵ See regulations cited note 161 *supra*.

¹⁸⁶ WIS. STAT. ANN. § 206.18 (1957).

statement of the premium for each additional benefit must be made. It has been argued that the words "other than life or endowment insurance" require disclosure of no more than the gross premium of the coupon policy as a whole, which is a combination life and endowment policy. In answer, it has been urged that the true meaning of this provision is apparent only when it is restated:

"No policy . . . shall be issued . . . unless it contains . . . the following provisions: . . . Provision 2, specifying separately the premium charged for any benefit promised in the policy other than life . . . insurance . . . [if it is a life insurance policy]"

[and]

"Provision 2, specifying separately the premium charged for any benefit promised in the policy other than . . . endowment insurance . . . [if it is an endowment policy]."¹⁸⁷

According to this view, if an endowment policy is issued, the premiums for benefits in addition to the endowment insurance must be separately stated, and if a basic life insurance policy is issued, the premiums for benefits in addition to the life insurance must be separately stated. It would seem to follow that where a policy combines both life and endowment insurance, the separate premium for each kind of benefit must be separately stated.

This proposed interpretation appears to have been accepted by the Wisconsin Department of Insurance in its promulgation of Rule 2.08.¹⁸⁸ The rule explicitly forbade the use of coupons. To prevent evasion of the regulation by stopping the use of coupons and describing the benefits merely as endowments, the departmental statement included this: "Any policy containing a series of one-year pure endowments or a series of guaranteed periodic benefits maturing during the premium paying period of the policy . . . [must state what] the premium charged for such benefits shall be . . . without deception or misrepresentation."

The disclosure approach seems to provide a direct and simple method of regulation, and therefore seems at first to be a plausible solution to the problem. It has the great advantage that it preserves a large measure of freedom to contract, subject only to the requirement of truth in the sales presentation. However, it also presents some problems.

¹⁸⁷ This construction of the statute was suggested in the Reply Brief for Wis. Life Convention, pp. 14-15, filed for *Hearing Before the Wis. Dep't of Ins. on Proposed Rule Ins. 2.08* (Jan. 1962).

¹⁸⁸ See Wis. Adm. Code section Ins. 2.08 (1962).

The most important defect in the disclosure approach, if disclosure is required merely in the policy, is that most agents never use the policy form in making the sales presentation. Even those who do now use it could discontinue doing so in order to avoid the embarrassment of making the disclosure. Information on the face of the policy thus would be of little aid to the applicant before he makes his decision to purchase. When he reads the policy it is too late. Moreover, few buyers of life insurance ever examine an insurance policy and, of those who do, not many are sufficiently sophisticated to appreciate the implications of what they see. The insurance business and the insurance policy are too complex.

A possible remedy for the foregoing weakness of the disclosure approach is to require the agent to make an affirmative disclosure of separate cost data in the sales presentation, whether he uses the policy or not. But to see that this is done would pose a difficult problem of regulation. To see that it is fully done, and fairly done, would be beyond the financial resources of the most affluent insurance department.

Even if the policy were required to be used, or in fact were used, in the sales presentation, and even if it did contain a full disclosure of relevant cost information, there is still no assurance that the total impact of the presentation, in context, would not be seriously misleading. There still is no assurance that the prospect will have the ability to assimilate and use all of the data that is presented to him, usually presented very rapidly in an interview filled with many subtle pressures. These considerations lead to doubt whether the disclosure approach provides sufficient protection to the public to make it adequate. There is no doubt, however, that a requirement of disclosure both in the policy and in the sales presentation is a minimum requirement for decent protection of the public against easily perpetrated and highly probable misrepresentations in connection with coupon policies.

3. *Control of Representations*

A method of control that has some elements both of disclosure and of prohibition is the effort to prohibit in a discriminating way certain kinds of statements in connection with the marketing of coupon policies. There might be an effort, for example, to prohibit reference to "profits" or to "income in investment" in connection with coupons. This is the thrust of a 1959 ruling by the Indiana In-

insurance Department.¹⁸⁹ Illinois Department of Insurance Rule 9.09, section 5(g), forbids and makes unlawful the "stating or implying that the principal amounts payable under coupons represent interest, earnings, return on investment, or anything other than benefits the cost of which is included in the total premium."¹⁹⁰ This is an effort to take all the objectionable features out of the coupon policy and its marketing, without prohibiting it altogether. The greatest difficulty which is apparent in such proposals is the difficulty of policing such prohibitions, because of the large number of synonymous expressions that need to be anticipated and proscribed. If the prohibition were couched in general language, it would have the disadvantage of all penal legislation which does not accurately apprise the citizen of the forbidden conduct. If it is made specific, it must be encyclopedic to catch everything, and then is unlikely to be sufficiently discriminating for the reason that the use of particular words or phrases is less important than the whole context of the sales presentation. Moreover, if there is any legitimate use for the coupon policies, it is in the public interest to permit an effective sales presentation, so long as it is consistent with the truth. Unless a more discriminating and skillfully drafted proposal is presented than any yet made public, such an approach is probably foredoomed to failure. Moreover, even adequate and well articulated standards do not solve the problem of enforcement; this is the kind of enforcement which is difficult or even impossible.

Prohibition of coupon policies has some obvious advantages over the other methods of control. It would be almost completely effective. The insurance department must approve all policies before they can be issued. Issuance of a coupon policy that does not have approval from the department would lead to license revocation; enforcement would be as simple as that. But the more subtle methods of control present difficult enforcement problems. Complaints must be investigated, hearings held, and difficult statutory or regulatory standards applied. This takes more time, men, and

¹⁸⁹ See Ind. Dep't of Ins. Reg., Dec. 16, 1959, which says, "Coupons are not to be referred to in any manner as 'profits' or 'income' in investment."

¹⁹⁰ Ill. Dep't of Ins. Rule 9.09, § 5(9), Oct. 31, 1962. In its proposed form this section prohibited "stating or implying that the principal amounts payable under coupons or as endowments represent interest, earnings, return on investment, or anything other than benefits the cost of which is included in the total premium." Proposed Rule 9.09, § 17. (Emphasis added.) The rule as adopted eliminates the italicized words, giving rise to the possibility of achieving the same thing in another form (*i.e.*, guaranteed annual dividend payments).

money than are available to most departments. Under such a system, even departments with sufficient resources can provide protection only to policyholders who complain. Ferreting out violations without a complaint as a starting point would be an impossible task. Thus only persons who complain will receive redress; those who are not sufficiently discerning to appreciate that there is a basis for complaint will have no protection. All this argues strongly for prohibition as the only really effective remedy. Against this must be balanced the advantages of coupon policies, which are slight, and the value of freedom of contract, which is substantial. But the value of freedom of contract is not one that can never be overridden; there seems ample justification here for subjecting it to the pursuit of fairness in the insurance transaction.

As suggested earlier, the passbook form is little less objectionable than the coupon form. The New Jersey Department of Banking and Insurance, with what seems sufficient justification, has objected to the use of a passbook in connection with coupon or guaranteed endowment policies since the book

“in itself is likely to create the impression . . . that the transaction is one where the premium deposits will be returned in full, with interest, in a manner similar to that where money is put in a savings deposit in a bank. Actually, however, the transaction is primarily in the nature of insurance and the amount returned to the insured in the event of surrender or lapse may be very much less than the premiums paid in alone without any interest.”¹⁹¹

Consequently the New Jersey Department prohibits the use of passbooks.¹⁹²

Whether or not it is concluded that coupon policies should be prohibited, or permitted only with full disclosure of the cost information that would make comparison possible, there is enough danger of misrepresentation and misunderstanding to justify additional effort in policing the marketing process. Special attention should be given by complaint bureaus within insurance depart-

¹⁹¹ N.J. Dep't of Banking and Ins. Reg. I-1963A-2, July 15, 1963.

¹⁹² *Ibid.* Other states have also shown awareness of misuse of the savings account idea, e.g., the Ill. Dep't of Ins. Rule 9.09, § 4(10), Oct. 31, 1962, prohibits “describing premium payments in language which states the payment is a ‘deposit’” Some states follow the Mo. Div. of Ins. Order No. III-9, ¶ 1(d), Jan. 19, 1962, which prohibits “references to premiums as ‘deposits’ in such a manner as to lead the prospective policyholder to believe that they create a fund which is withdrawable without reference to the cash surrender or loan provisions of the policy”

ments to ferreting out and punishing misrepresentation by agents for coupon companies. A previous article has shown how difficult this task is, and there should be no expectation of great success from it.¹⁹³ It would require no new legislation, for every state seems already to have a statute broad enough to meet the need,¹⁹⁴ but what is needed instead is larger, more competent, and better-financed complaint bureaus.

VII. ADDITIONAL SPECIALTY FEATURES AND COMBINATIONS

A. *Miscellaneous Specialty Provisions*

Three additional specialty features are common enough to be discussed in this paper.¹⁹⁵ One is the "return of premium" provision, which promises to pay to the beneficiary, in addition to the face amount of the policy, all premiums paid to the time of the insured's death. It applies only in case the insured dies within a specified period from the execution of the policy; permanent coverage of this kind would be actuarially impossible. This is merely increasing term insurance. The "return of cash value" provision is similar to the "return of premium" provision, the only difference being that the measure of the benefit is the cash value of the policy at the time of death rather than the premiums paid. It, too, is increasing term insurance. The "sight draft" or "immediate cash draft" provision is a feature promising to pay the beneficiary a percentage of the face value of the policy if the insured dies before

¹⁹³ Kimball & Jackson, *The Régulation of Insurance Marketing*, 61 COLUM. L. REV. 141 (1961).

¹⁹⁴ Section 3(a) of the Model Unfair Trade Practices Act provides that "no person engaged in the business of insurance in this state shall make, issue, or circulate, or cause to be made, issued or circulated, any estimate, illustration, circular, or statement of any sort misrepresenting the terms of any policy issued or to be issued or the benefits or advantages promised thereby, or the dividends or share of the surplus to be received thereon, or shall use any name or title of any policy or class of policies misrepresenting the true nature thereof," and section 3(b) provides that "no person engaged in the business of insurance in this state shall make, publish, disseminate, circulate, or place before the public, or cause, directly or indirectly, to be made, published, disseminated, circulated or placed before the public, in a newspaper or other publication, or in the form of a notice, circular, pamphlet, letter or poster, or over any radio station, or in any other way, an advertisement, announcement or statement of any sort containing any assertion, representation or statement with respect to the business of insurance or with respect to any person in the conduct of his insurance business, which is untrue, deceptive, or misleading." For a discussion of the Model Act, see note 94 *supra*.

¹⁹⁵ "These plans are usually on some basic life plan or contain a unique investment fund, supplemented by level, increasing, or maybe decreasing term, sometimes with frills of coupons and return premium benefits added which preclude any cost comparison." 1957-1958 PROCEEDINGS, CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 56.

the lapse of a specified period, typically twenty years. Actuarially this is merely level term insurance, but it has some obvious advantages; it is usually paid without formality and very quickly and thus is useful to pay the expenses of last illness and death. In fact, a part of its attractiveness is that it is often attached to the policy in the form of a sight draft, as its name suggests. The draft may be taken to a financial institution and presumably will be paid with a minimum of formalities.

There is nothing inherent in the nature of any of these three coverages that is objectionable. The first two are merely increasing term insurance; the third is level term insurance. It is hard to see why most people would need or want increasing term, since decreasing term corresponds more often to real financial needs. But it is not objectionable, even if it may not be adapted to most people's requirements. Clearly, however, none of these coverages add anything to the insurance market that is not otherwise obtainable. Their elimination would detract not at all from the usefulness of the insurance institution. The only question for us is whether the way in which these coverages are used is so misleading that they should be prohibited or otherwise controlled, not because they are inherently evil but because the abuses cannot otherwise be prevented.

The return of premium provision and the cash value provision are attached to policies in that form mainly because they facilitate a certain kind of sales argument. The introduction to this essay presented an illustration of the way in which these arguments are phrased. These forms of coverage are objectionable because they can very easily be used to facilitate misrepresentation and fraud in the sale of the policy by making misleading comparisons with traditional forms.

The sight draft provision is less objectionable. It is difficult to see how it can be the subject of misrepresentation, except perhaps as it leads to inaccurate imputations of delay in payment by other insurance companies. However, this kind of misrepresentation is easily possible with ordinary insurance policies and it is doubtful if the sight draft provision is any more likely to be thus misrepresented than other coverages. Thus there seems to be no sound objection to any of these three coverages as such, but there is a serious objection in the ordinary use of the first two, for they encourage unfair and misleading comparisons with other, more traditional policies. They contribute nothing of value to the in-

insurance market and they facilitate misrepresentation. Actually it is hard to object to the issuance of increasing term insurance, *eo nomine*. It is the use of the terms "return of premium" and "cash value" that facilitate deception. Perhaps the best the law can do here without unduly interfering with freedom of contract is to forbid the use of these and similar terms which lend themselves to sharp selling practices. There seems to be no justification for prohibition of the sight draft provision at all.

Perhaps one additional provision can properly be dealt with as a "specialty" provision. That is a provision for the future increase of benefits. A New Jersey department release speaks of policies "where the sum insured after ten or twenty years is trebled."¹⁹⁶ This specialty does not seem seriously objectionable on the ground that it facilitates misrepresentation, or other unfair practices, but it does enable the issuing company to evade statutory limitations on first-year expenses. It should probably be forbidden on that ground alone.

B. *Combinations of Provisions*

Thus far this section and earlier sections have dealt with the merits and demerits of the various features separately. However, almost invariably two or more features are presented at once. This is especially true with respect to the coverages now under discussion. They rarely exist alone. If any specialty feature is subject to condemnation when it is considered separately, a fortiori it should be condemned when it is combined with any other that is also of doubtful value. Moreover, a feature that is not itself objectionable may become so because of the cumulative impact of a number of features. A specialty company may issue a policy combining the coupon, charter, profit sharing, return of premium, and sight draft features. Such a combination has two functions from the point of view of the company. First, the cumulation of specialty features adds to the marketing appeal. The more advantages about which the prospect can be told, the more likely he is to buy. In the sales presentation with which this essay began, the impact of the cumulation of various features may be seen. Though not every policy contains all of the features, some contain almost all of them. In any event cumulation is important in most specialty policies.

The second function of the cumulation of specialty features, from the point of view of the company issuing the policy, is

¹⁹⁶ N.J. Proposed Reg. No. I-1963A-1, pp. 1-2.

the obstruction of meaningful cost comparisons. The premium is lumped together into a single gross premium with no indication of the separate cost of each feature. Certainly the actuaries for the company can separate the charges. Indeed, it would be irresponsible for an actuary to set a premium for such a package without arriving at it on the basis of careful computations for each individual component. The cost of conventional life insurance undoubtedly constitutes the greatest portion of the premium in most specialty policies. A charge for the coupon benefit is then added; the latter may be constant or may vary from year to year according to some formula. Finally, on top of the premium for these two features will be a charge for the level or increasing term insurance in the form of the specialties dealt with here. These may be combined in a variety of ways, so that it becomes impossible to make a fair comparison of the price of a complicated specialty policy with that of conventional insurance issued by one of the more conservative companies.

It is usually possible to make a meaningful comparison between policies issued by different companies when the form of the insurance is roughly comparable. Of course, it is difficult for the average insured to make such a comparison himself but he can have it made for him by an insurance counselor. In any event, he can depend upon agents to explain, so far as possible, the advantages and disadvantages of the policies issued by competing companies. However, when a complicated specialty policy is to be compared with conventional insurance, the comparison becomes extremely difficult and therefore meaningless to the ordinary policyholder.

The combination of the premiums into a single premium is done deliberately in order to preclude cost comparisons. The life insurance market is fiercely competitive on the price level, and new, small companies tend to seek protection from the full force of the competition.

Earlier in this article an effort was made to decide just how objectionable each specialty feature is and to make recommendations for its prohibition, its control, or for the neutrality of the law with respect to it. At this point some conclusions must be added on the combination of specialty features, for although the article has generally suggested stringent control measures or even prohibition, its suggestions will not necessarily prevail. On the whole, perhaps the best solution to the problem presented by combinations of specialty features is to treat each feature separately when consider-

ing whether to prohibit it or merely to regulate it. The significantly distinctive factor here is the combination of charges in a lump sum. It seems to be very important to prevent the concealment of the separate cost of each feature, and thereby to enable the policyholder to make cost comparisons. This is no less true because most policyholders are incapable of making such comparisons or will not take the trouble to do so. At least comparison should be made possible. For combinations, therefore, even if a decision is made not to control or prohibit the component parts, the law should at least require a separate statement of the cost of each feature. This should create no real difficulties for specialty companies other than to make sales presentations somewhat less effective. But the diminution in effectiveness will result from the decreased ease of misrepresentation or misleading statements; hence this diminished impact can be no proper objection to this control device. Although it is possible to argue that some combinations ought to be prohibited even when the component parts need not be, it would generally be so difficult to devise rules to handle such problems appropriately and without unnecessary prohibitions that the solution to combinations should be couched in terms of the separation of charges only.

VIII. CONCLUSION

The subject of this article is a fast-moving and timely field in which noteworthy developments will undoubtedly appear in the interval between the completion of the writing and its publication. Indeed, between the time the body of the article was finished and the writing of this concluding section, an important event has served to underscore this point. This occurrence was the action taken by the Ohio Insurance Department to stop the use of a chain letter system for the merchandising of life insurance policies.¹⁹⁷ If *A*, having first purchased a particular policy, induces *B* to buy one also, then *A* receives a bonus of 150 dollars. If *B* then induces *C* to purchase one, *A* gets fifty dollars. Finally, if *C* induces *D* to purchase, *A* gets twenty-five dollars. Meanwhile, *B* and *C* receive their turns at the larger sums. Obviously the first year premium has to include an additional amount of approximately 250

¹⁹⁷ See J. of Commerce, June 12, 1963, p. 8, cols. 6-7. Even more recently, a "new plan to lease life insurance" has been announced. J. of Commerce, Sept. 16, 1963, p. 8; Ins. Advocate, Sept. 14, 1963, p. 38.

dollars to pay these bonuses. The Ohio Department castigated the plan as a system of rebates, but perhaps it is more nearly akin to the profit-sharing or charter policies heretofore discussed. In any case, there seems little doubt that the practice is objectionable and that the Ohio Department was justified in its suppression.

The changeable character of the field emphasizes the difficulty of dealing with it adequately. For example, if coupon policies are forbidden *eo nomine*, they merely become pass book policies, or guaranteed dividend policies; with abandonment of the form of coupons the prohibition becomes ineffective. While abolition of the coupons does in fact eliminate some of the difficulty, it does not eliminate all of it. Any statutes or regulations developed to treat these problems must contemplate the probability of constantly evolving forms, or at least terminology, even if the reality behind the form remains much the same.

The number of distinct specialty policies that could be formed from the various possible permutations and combinations of specialty features is staggering. For this reason, it would be impracticable to deal in an article such as this with each specialty policy as a whole, though in some measure it is unfair to judge it on any other basis. However, the requirements of practicality lead to the separate treatment of each specialty feature as if it stood alone, despite the fact that it seldom does. By its nature, therefore, this article can be only a starting point for discussion, not a blueprint for action.

Fairness, reasonableness, and equity in the insurance market—what one might call “purity of the market”—states the approximate content of a fundamental goal of insurance law that urges us in the direction of close regulation or even of prohibition of the specialty policies described above. To be weighed against it are the values of freedom of contract and freedom of access to the insurance market for new companies. The latter are values of considerable importance in a free economic system, moving us to caution before deciding in favor of intervention in the insurance market. But they are not absolute values; it is quite generally agreed at this date that they only compel the advocate of intervention to make a case for the necessity of proposed action.

Both of these latter values have their justification largely in the economic advantage thought to flow from them. Part of the case for intervention in connection with specialty policies lies in the fact that the American life insurance market is not in desperate need of new company formations. The large number of companies now

operating in the United States, and the rapid rate at which the number has grown in recent decades, suggests that some restriction upon access to the market would do no harm and might possibly be desirable.¹⁹⁸ Restriction can come about through the raising of minimum requirements for entry, especially capital and surplus requirements, or it can come about by making the conditions of operation in the market less attractive to new companies, such as by restricting or prohibiting the kinds of contracts that may be offered for sale. If the situation were to change, and the higher standards of morality imposed by the law led to a decline in the number of companies operating in the market, then a sound public policy might call for a relaxation in the terms of access or some other form of encouragement to new enterprise. However, it seems unlikely that even complete abolition of all specialty policies would prevent the formation of enough new companies to satisfy our needs.

Freedom of contract is also to be justified in economic terms, in large part. This is expressed by the specialty companies themselves when they speak of the desirability of having the "boundaries of 'public interest' established by policyholder demands and not by departmental regulation made without consideration of individual or group needs and desires for protection."¹⁹⁹ Of course they also put their case in more selfish terms when they talk of the right of the small companies "to compete freely insofar as [their] conduct is not injurious to the public."²⁰⁰ The economic advantage that is thought to come from freedom of contract is the development of new and better products at lower cost. But so far as cost is concerned, there is now complete freedom to price life insurance at as low a level as the individual company can justify, subject only to the need to meet the reserve standards set up by law. In fact, the use of specialty policies is not aimed at reduction of cost but more frequently at masking an increase in cost so that it will not play its accustomed role in a free market. Partly the increase is sought in order to provide a larger margin for acquisition costs—mainly the

¹⁹⁸ See Kimball, *The Purposes of Insurance Regulation: A Preliminary Inquiry into the Theory of Insurance Law*, 45 MINN. L. REV. 471, 514 (1961), for a discussion of the "need test" as applied in some European countries. New companies, whether domestic or foreign, are simply not admitted to the market in some countries unless there is a need for them and the insurance commissioner thinks the market will benefit by their presence. While there would be objection to this restriction in the American context, it is not unthinkable to close the market to new company formations. It is done in some other fields by requiring a "certificate of convenience and necessity" before permitting an entrepreneur to begin business activity.

¹⁹⁹ National Underwriter, Life Ed., Aug. 11, 1962, pp. 15, 21, col. 1.

²⁰⁰ *Ibid.*

commission of the agent. For instance, one "specialty" that has received only casual mention here is the provision of an increased face value or other benefit, beginning at some time in the future. The New Jersey Insurance Department speaks of policies in which the "sum insured after ten or twenty years is trebled."²⁰¹ Both this increase in benefit and the coupon provision enlarge substantially the first-year expense allowed under the Standard Nonforfeiture Law.

If the freedom to issue specialty policies produced new and better products, that fact would go far to justify their use. On the contrary, however, the asserted imagination and aggressiveness of the vigorous new companies has not succeeded in producing anything really new. The reason is that there is little new to produce; all life insurance policies are combinations in varying proportions of protection and saving. A term insurance policy and a savings account can do virtually anything any life insurance policy can do. No specialty policy discussed here provides anything new enough and valuable enough to demonstrate the importance of preserving freedom of contract in this market. The situation is quite unlike that in fire and casualty insurance, where there have been new developments of considerable value within recent years. But one must not be too dogmatic about this point. The most that can be said with assurance is that the particular forms discussed in this article have no great value. The way should always be kept open for any really new ideas in life insurance. Regulation or prohibition should, therefore, be restricted to carefully defined and demonstrably objectionable contracts.

It is the necessity of such restriction that makes the task of control such a difficult one. This article has not discussed the administrative law problems relating to the competence of the insurance department, partly because of their complexity, but also because it seems probable that carefully drafted statutes can constitutionally give the departments all the power they really need. Because of the ingenuity of entrepreneurs, prohibitions or restrictions defined in detail in statutes seem unduly cumbersome. Almost inevitably the departments must be entrusted with the power to act within broad limits. Practically, most departments can do so already. The power to require policy forms to be submitted for approval before they can be used is not an unlimited power, but for all practical purposes it

²⁰¹ N.J. Proposed Reg. No. I-1963A-1, pp. 1-2.

enables departments to deny approval on any ground reasonably related to the public welfare. Under existing statutes, they can also act to forbid a wide variety of marketing practices.

The commonly used specialty policies all seem objectionable. Although the tontine feature does not seem nearly so bad in itself as it is often pictured, it makes little contribution to the market and could be eliminated without damage to the public. Moreover, it is subject to serious abuse, both because of the danger of the dissipation of the inadequately controlled deferred dividends and because of the severe danger of misrepresentation. Profit-sharing and charter policies also encourage serious misrepresentation. Moreover, they violate the fundamental public policy in favor of equity in insurance pricing, which is also embodied in statutory prescription in most states. The coupon policy, too, lends itself to misrepresentation, especially because of the failure to disclose cost information. It would be possible to require that separate cost information be provided; theoretically that would be sufficient to prevent the harm that arises from the misrepresentation, but as a practical matter it would be difficult effectively to police the requirement to see that the policyholder had the information at a time sufficiently early to make any difference in his decision. The conclusion has thus been reached that each of the three major classes of specialty features should be abolished. The minor ones—the “return of premium” provision—the “return of cash value” provision, and the “sight draft” provision, do not seem very dangerous. However, they contribute little that is not already available in the market, if they contribute anything at all. Therefore, abolition is a small price to pay for the greater purity of the market that would result. The ultimate conclusion reached by this study is, therefore, that the entire range of specialty policies available in the life insurance market, as described herein, are growths of little value that can be pruned away without loss to the public. Hopefully this can be done without putting the industry in a “strait jacket,” as the National Association of Life Companies fears. If, after careful definition, the specialty policies are forbidden by name, there should be no question of a “strait jacket.” If the insurance department remains watchful and ready to extend its prohibited list as new forms appear, there is no need for the sweeping prohibition that would prevent the development of something new and valuable. The only question then is whether a particular form should be on the list or not. As it appears in a submitted policy form the question

can be decided. Of course this assumes competence in the policy-examining section, which is not always there.

Where to draw lines between prohibited and permitted forms is a difficult question. It seems clear, for example, that coupons should be prohibited, but it is not obvious that guaranteed dividends should be, or that a series of annual endowments should be. But it is not necessary that there be merely a twofold division of the field of life insurance between absolutely prohibited and unrestrictedly permitted coverages. There can also be, and should be, an intermediate area in which coverages are permitted under restrictions. For example, guaranteed dividends might be permitted when accompanied by a sufficiently clear separate statement of costs.

If the question were completely new, a forceful argument might easily be made that life insurance companies should never have become involved in the "banking" business to the extent that they have—over 100,000,000,000 dollars. But that decision was made long ago and can hardly be considered open at this date. Since all legal reserve companies are deeply involved in "banking" already, it would be discriminatory to go too far in preventing the slightly different forms of "banking" engaged in by coupon companies. It is the special danger of misrepresentation, and not objection to high savings policies per se, that justifies the prohibition of coupons. However, there seems to be no sound argument whatever against a requirement that costs be disclosed as fully as is practicable under the circumstances. To the insistence of coupon companies that it is unfair for them to be required to disclose separate costs if participating companies are not also required to separate the cost of the policy from the excess in the premium from which dividends are paid, it can be answered that such a disclosure would undoubtedly be desirable and quite possibly should be compelled if a formula can be devised under which it can practically be accomplished. But that is the subject of another article, not of this one; more important problems should be solved before spending time and effort on less important ones.

The danger most apparent in the specialty provisions is that of misrepresentation. A number of states have sought to control the misrepresentation while continuing to permit the coverage. This is a plausible approach, but with one serious weakness. It is confronted directly by a consideration which one might call a value of the legal system, and in a sense it is a "value." But more realistically, it is only a practical necessity. This is economy of means in

the regulatory process. Solutions must be devised that do not make demands for extensive use of manpower, although it is unfortunate to be governed by this necessity. Although economy in government is a value no one should decry, the amount spent in the regulation of insurance is pitifully small in relation to the importance of the business. But as a practical matter, all insurance departments are terribly overburdened and, until that day when the sheep and the lion lie down together, will continue to be overburdened. Legislatures simply do not and will not supply enough funds for the departments to do the jobs well which are assigned to them. Consequently, all proposed solutions to problems must face the economy test. Relative to the means probably available to the department, will this remedy be reasonably effective? Tested by that standard, it is clear that the regulation of marketing practices will achieve far less to purify the market at much higher cost than the outright prohibition of certain provisions. Prohibition is administered relatively surely and inexpensively in connection with the approval of policy forms. On the other hand, regulation of marketing practices would require an expensive enforcement program. Disclosure lies between them, with respect to ease of enforcement. Its value depends, however, on the understanding of the policyholder, and that would be substantially enhanced by disclosure only if terminology were made more nearly uniform in the insurance business. But that is quite another question that cannot be here pursued further.

Life insurance performs a great service to the community. It is an essential prerequisite to the working of an industrial society; if it is not adequately provided by private enterprise, then undoubtedly government agencies will fill the gaps. Life insurance is especially important to the lower and middle classes of the population. In view of the complexity of the life insurance contract, these groups of people cannot understand it and need special protection; hence it is important to our society that reasonable efforts be made to ensure reasonable "purity of the market" in life insurance. The regulator's task is not to prevent new developments that may prove to be of value to the public, but to prevent the use of mere gimmicks that do no more than complicate the policy and make it harder to understand, or make it more expensive. The balance among conflicting values is one difficult to maintain, but the effort must be made. Responsible and intelligent supervision of the insurance market is an important activity of government. It de-

serves the best efforts of regulators and the best thinking of all those interested in it.²⁰²

²⁰² Several items have come to our attention too late to be incorporated into the text or regular body of footnotes. Related to the textual discussion of the cost of small, new companies are two cost studies: Business Men's Assurance Company of America, *Young Company Expense Study*, Reinsurance Bulletin, August 1962; and Life Insurance Company Cost Study, August 1963, compiled by the Life Insurance Company of Kentucky. The latter study concentrated on specialty policy companies.

In an address by Harold Franklin at the Annual Seminar of Association for Advanced Life Underwriting, as reported in the *National Underwriter*, Life Ed., Dec. 29, 1962, p. 2, col. 2, he pointed out several factors tending to narrow the competitive advantage of a large over a small company. Small companies benefit from institutional advertising. Most persons purchase life insurance from the agent rather than from the company, thereby negating the advantage of an established name. Because of the improvement in mortality experience, a new company's experience should be better than that of the industry as a whole. A new company has an advantage in interest earnings since its investment portfolio does not include fixed dollar investments reflecting the low interest yields of the postwar period.

Two recent coupon regulations have been promulgated. N.J. Dep't of Banking and Ins., Reg. No. I-1963A-1, July 15, 1963, among other things, prohibits the use of coupons, prohibits guaranteed annual endowments being contingent on payment of a premium due when the endowment would otherwise be payable, requires separate disclosure of the premium charged for the guaranteed annual endowment, etc. Reg. I-1963A-2 prohibits use of books resembling savings deposit books in banks in connection with policies containing guaranteed annual endowments. Mass. Dep't of Banking and Ins., Div. of Ins., Reg. Sept. 17, 1963, among other things, prohibits payment of guaranteed annual pure endowments contingent on payment of premium due when such benefit would otherwise be payable, and prohibits coupon policies.

At a recent N.A.I.C. Zone IV meeting, Sept. 29-Oct. 1, 1963, Mr. James Douds announced that the NALU was conducting an independent study of specialty policies. We have not yet seen the results of that study.