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## STATUTORY REGULATION OF LIFE INSURANCE INVESTMENT

As long as provident men were content to utilize their savings by putting them to work in enterprises of their own or of a neighbor, the tissue of the common law—with the aid of some statutory and judicial mending—could cope with the problems of investor protection. And there was little cause to question the relation of savings and investment to the general economic welfare. But when savings grew and were entrusted to specialized financial institutions, the traditional processes were put to the test.<sup>1</sup> Although a large body of financial law evidences the endeavor, existing regulation of life insurance investment suggests that efforts have not kept pace with needs. Today, the \$51,500,000,000 of life insurance funds<sup>2</sup> present an increasing number of unsolved economic and legal problems.

From modern economic theory comes an impressive statement of the importance of insurance investment regulation. As economists came to recognize that full employment and prosperity were fundamentally dependent upon the stimulus of private investment, vital significance was attributed to life insurance funds, the nation's largest private capital pool,<sup>3</sup> and the existing regulations governing investment of these funds were seen as a major determinant of the level and stability of the national economy.<sup>4</sup> But judges and legislators

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1. See Headley, *A Trustee in a World of Changing Values*, 5 LAW & CONTEMP. PROB. 355 (1938); HORTON, *SOME LEGAL ASPECTS OF LIFE INSURANCE TRUSTS* (1927); ZARTMAN, *THE INVESTMENTS OF LIFE INSURANCE COMPANIES* c. 6 (1906).

2. LIFE INSURANCE ASSOCIATION OF AMERICA, *PROCEEDINGS* 39 (41st Annual Meeting, 1947) (hereinafter cited as LIAA, *PROCEEDINGS*). See note 62 *infra*. This estimate relates only to "legal reserve life insurance companies." These companies agree to pay policyholders a sum or benefit which cannot be scaled down, and for which is charged a premium that ordinarily cannot be increased. Such a company is required to establish, in respect to each policy issued and in force, a reserve as defined by law, constituting a fund which on the basis of actuarial computation is deemed exactly sufficient to guarantee that the company will be able to meet its obligations under policy contracts as they fall due. GESELL AND HOWE, *STUDY OF LEGAL RESERVE LIFE INSURANCE COMPANIES* 5, n. 1 (TNEC Monograph 28, 1940) (hereafter cited as TNEC Monograph 28). For possible alternative theories of life insurance see note 78 *infra*. Other types of life insurance companies, such as fraternal orders and assessment associations, are not included in this definition, but account for only about 5 percent of the life insurance in force in the United States. *Ibid.* Throughout this entire discussion the term "life insurance companies" refers only to legal reserve companies as defined above.

3. Life insurance company assets exceed the combined savings deposits of the nation's mutual savings banks and savings and loan associations by 20 billion dollars, and are almost 25 percent greater than the total of time deposits in the nation's commercial banks. FORTUNE, April, 1948, p. 109.

4. For general economic analysis of the role of capital and savings in a free enterprise society see HANSEN, *ECONOMIC STABILIZATION IN AN UNBALANCED WORLD* (1932); FISCAL POLICY AND BUSINESS CYCLES (1941); KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* (1936); ANGELL, *INVESTMENT AND BUSINESS CYCLES* (1941).

have been refractory students of economics. The patchwork of regulation they have constructed serves mainly to limit insurance investment to relatively unproductive debt-financing—a practice which appears both to retard prosperity by inhibiting the economic stimulus of insurance capital,<sup>5</sup> and to threaten the ability of insurance companies to invest their funds safely.

To the perplexing economic problems of regulating life insurance investments must be added a number of unsolved legal issues. Traditionally, the most persistent of these has been protection of the individual policyholder, for when large numbers of citizens entrust their savings to private financial institutions, the state has long been called upon for safeguards against unscrupulous or unsound investment practices.<sup>6</sup> And wealth is a coordinate of power. If the savings of thousands of individuals are controlled by the management of large corporations and financial institutions, society encounters the additional problem of protecting the public from the risks inherent in such concentration.<sup>7</sup>

Finally, there is increasing interplay between these economic and legal problems. For economic pressures appear to be forcing insurance investment to abandon safe and relatively impotent debt-financing, and to enter the field of equity or ownership investment, which in turn raises the greatest legal problems of both policyholder and public protection.<sup>8</sup> No easy escape from this dilemma can be offered. But in view of the vital nature of the issues, and the complex corrective action which apparently will be required, it is important to give at least a warning.

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See also Report of the Joint Committee of the Senate and Assembly of the State of New York, Feb. 22, 1906, vols. I to X (special committee of New York legislature, known as the Armstrong committee, appointed to investigate the affairs of life insurance companies); TNEC Monograph 28.

5. This problem becomes increasingly more critical as life insurance company assets grow. In the year 1947, a total of three and one-third billion dollars of new funds were received to be invested. LIAA, PROCEEDINGS 41. This increase was more than two and one-half times the increment in 1937, and almost twice as much as was received by life insurance companies in 1941, only 5 years before. *Id.* at 50. Total life insurance resources tend to double every 10 years. This accelerating yearly growth has been a characteristic feature of the life insurance business since its inception, and all present indications point to a continuation of this trend into the future. See notes 62, 88 *infra*.

6. ZARTMAN, *op. cit. supra* note 1, at 146 ff; HUEBNER, LIFE INSURANCE 549-50 (1935).

7. "It should be easier to achieve the values of democracy in a society where economic power and social status are more widely distributed, and less concentrated, than in the United States today." Rostow, *The New Sherman Act*, 14 U. OF CHI. L. REV. 567 (1947).

"A commitment to free enterprise is deeply imbedded in public policy. A score of statutes proclaim a competitive design to which all industrial conduct is expected to conform. The Sherman Act, "a charter of freedom" for American business . . . is flanked by the Clayton and the Robinson-Patman Acts . . ." HAMILTON, THE PATTERN OF COMPETITION 6 (1940). For the most extensive discourse of governmental interest in concentration see reports of the Temporary National Economic Committee.

8. See pp. 1273-75 *infra*.

## THE PATTERN OF STATUTORY CONTROL

Born of dalliance of conservative legal attitude with the Commerce Clause, the present statutory regulation of life insurance investment betrays its parentage in both form and substance.<sup>9</sup> When the Supreme Court held that insurance was not commerce,<sup>10</sup> the form of insurance investment regulation was destined to be an amorphous mass of 49<sup>11</sup> sovereigns' statutes. Since the proper role of government control over commerce was generally viewed to be one of protecting from abuse, the substance of the insurance investment laws was limited to a body of prohibitions against the dangers of uncertain or unsound investments.<sup>12</sup>

Although decentralized regulation of life insurance investment has led to a large number of regulatory statutes,<sup>13</sup> little variety in scope has resulted. These

9. Descriptive literature on the life insurance investment statutes is somewhat sparse. ZARTMAN, *op. cit. supra* note 1, describes the statutes in force in 1906, giving the historical development of investment statutes and arguments for their abolition as ineffective. HOBBS, *THE INVESTMENT LAWS RELATING TO INSURANCE COMPANIES* (1921) surveys the statutory scene in 1921. No more recent extended analysis has been discovered, but a brief summary is contained in TNEC Monograph 28 at 372.

10. *Paul v. Virginia*, 8 Wall. 168 (U.S. 1869); *Hooper v. California*, 155 U.S. 648 (1895). The now famous case of *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944) declared the insurance business to be interstate commerce whatever its position within individual states. State regulation now exists by virtue of Congressional permission, albeit supplemented by various Federal statutes regulating interstate commerce. 59 STAT. 33 (1945), 15 U.S.C. §§ 1011-4. See American Management Association, *The Implications of Federal Control over Insurance* (1946) (Insurance Series No. 6, 1946). There is little question that the life insurance business is predominantly interstate. The TNEC found that, of the 365 legal reserve life insurance companies in the United States in 1939, two-thirds, holding 99½ per cent of all assets, did business in two or more states. 46 percent of the companies, with 90 percent of assets, operated in five or more states, and 17 companies with over 75 percent of assets, operated in 40 or more states. TNEC Monograph 28, 5, 379-81. Today, the 10 largest companies, controlling over 70 percent of all life insurance investments, extend their business into 40 or more states. MOODY'S MANUAL OF INVESTMENTS, BANKS, INSURANCE COMPANIES, ETC. (1948).

11. The District of Columbia is included as a separate jurisdiction, inasmuch as the District has its own set of investment statutes. D.C. CODE §§ 35-535, 6 (1940).

12. Legal regulation of insurance investments has been almost purely protective. It has sought to serve two objectives: to secure the investment of the assets in "safe" securities and to safeguard against careless, incautious or unscrupulous management. HOBBS, *op. cit. supra* note 9, at 3, and ZARTMAN, *op. cit. supra* note 1, at 178. The only significant departure from this purity of purpose was the early tendency to confine investment capital to activities within the home state. ZARTMAN, 151, 161, but few traces of autarchy remain in the present statutes. See notes 19 and 27 *infra*, and also the so-called Robertson law in Texas, VERNON'S TEXAS STATS. §§ 4765-80 (1936), requiring all companies doing business in Texas to keep 75 percent of the reserves on Texas policies invested in "Texas securities."

13. Inasmuch as almost every state imposes some degree of investment supervision upon foreign insurers, most insurance companies are to some degree subject to the control of several states' statutes. The manner of supervision differs widely: some states impose express statutory requirements that foreign insurers comply with restrictions imposed upon domestic companies; others leave to the discretion of the insurance commis-

laws in general prescribe seven major types or classes of investments which may be made—for example, government bonds, mortgages, corporate bonds, corporate stock—with added provisions defining minimum standards for particular investments within each class.<sup>14</sup> Five of these major classes are secured loans of capital, paying a fixed rate of interest and backed by the faith and credit of a government or the pledge of security. The general result of the complete statutory pattern<sup>15</sup> may be summarized: to the degree that investment approaches equity or risk financing, deriving return from profits instead of interest, it will be increasingly discouraged as an outlet for life insurance funds.<sup>16</sup>

Foremost among investments favored for life insurance companies are government bonds. Obligations<sup>17</sup> issued by the United States,<sup>18</sup> any state, or

sioner the determination of the soundness of a foreign insurer's investments; and perhaps the most prevalent practice is for the commissioner to approve investments authorized by the foreign company's domicile. The variance in these practices, and the discretion vested in the commissioners render it virtually impossible to evaluate the effect of this statutory interplay upon investment of total life insurance assets; the net result, however, is certainly to give primary importance to the regulatory statutes of those few eastern states in which many of the largest companies are domiciled. See Sotterthwaite, *Investments by Life Insurance Companies in Income Real Estate*, *INS. L. J.* 771 (1947) for careful analysis of this statutory interplay in the realm of real estate purchase.

14. Though the general pattern of most of the statutes is of this form, there are of course numerous minor variations and a few exceptions. Rhode Island has no general insurance investment statute. Alabama and Florida have no compulsory investment statute governing funds in excess of \$100,000 and \$200,000 minimum capital, respectively. ALA. CODE Tit. 28, § 70 (1940). FLA. STATS. §§ 518.06-08, 626.04, 626.06 (1941). South Carolina has no restrictive provision of any kind. The Connecticut statutes are generally prohibitory in form, rather than authorizing various classes. CONN. GEN. STAT. § 1269(e) (Supp. 1939). In the following discussion the statutes are divided according to the seven major classes and aberrational states are classified according to the apparent status of a particular investment class under their statutes.

15. Some recent statutory innovations authorize investment of a small percentage of assets without specific limitation. At least 8 states have passed such statutes, 6 specifying five percent, one seven and one-half percent, and one 10 percent. Several states do not apply their statutes to excess reserves or surplus funds. The effect of these statutes cannot be evaluated in the following discussion.

16. The statutes prescribe limits upon the percentage of assets which may be invested in certain classes of investments. The pattern of actual investment within these limits is determined primarily by company officials. ALTMAN, *SAVING, INVESTMENT, AND NATIONAL INCOME* 43, 49 (TNEC Monograph 37, 1941) (hereinafter cited as TNEC Monograph 37).

17. Though literal definitions of the obligations which may be purchased vary, the most general requirements are that they be interest-bearing, direct obligations of the issuing governments, or secured by its faith and credit. Many statutes also provide for interest-paying obligations which are guaranteed by authorized agencies of these governments. These provisions are of importance with respect to the great multitude of governmental agencies, federal, state and local, which are authorized to float securities in order to finance for example, construction, welfare, or assistance programs of various types.

18. United States Government Bonds constituted approximately twenty billion dollars or 39.3 percent of total life insurance reserves at the end of 1947, a decrease of 5.6 percent during that year, the first such drop since 1930. LIAA, PROCEEDINGS. These bonds have

the District of Columbia are legal investments in every state;<sup>19</sup> and the obligations of counties, cities and other political sub-divisions are also generally eligible.<sup>20</sup> Foreign government bonds, however, have never been allowed to form a significant part of insurance company portfolios;<sup>21</sup> and in recent years

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been the most important of all classes of life insurance holdings during the past two decades, because of the decline of private investment outlets relative to government obligations and insurance assets. From 1930 to 1946, holdings of U. S. Governments increased from 300 million dollars, or 1.8 percent of total investments, to 26 billion dollars, or 44.9 percent. *Id.* at 44, 48.

19. At the end of 1947, state, county, and municipal bonds constituted 625 million dollars, or 1.2 percent of total investments. This class of security reached its peak in 1940 at 6.0 percent of total assets, after a steady rise during the depression. After 1940, however, the volume of state and local bond flotations fell considerably, and their position in life company portfolios has steadily declined since that time. LIAA, PROCEEDINGS 41, 44.

Included in these figures are holdings of obligations of the District of Columbia (almost universally authorized) and of territories and possessions of the United States which are authorized in 31 states.

Except for Idaho and Arkansas, which limit purchases to their own securities, all states allow purchase of the securities of any state. However, half the states prohibit purchase of obligations of states which have defaulted on any obligation during a stated prior period, usually from 5 to 10 years. No state limits the percentage of total assets which may be invested in federal, state or territorial bonds.

20. Statutes usually define the kinds of governmental units whose securities may be purchased by a generic provision referring to the obligations of "any civil or political subdivisions", but such minor units as townships, school districts, taxing districts, water or drainage divisions receive frequent specific mention. Only a very few states place any significant limitation upon the amount of assets that may be invested in such obligations and these have set the relatively generous figure of 25 percent. An even smaller number of states confine purchases of local governmental securities to those issued by local units within their own state boundaries. But other significant limitations are frequent: there must have been no default on the security or the same flotation; principal and interest often must be payable from general ad valorem or income taxes; and occasionally, payment is not allowed to rest on special assessments levied only on property benefitted by local improvements. Also the ratio of the issuer's debt to total taxable property value must be below a given minimum, varying from three to 10%; the population must total a minimum figure, and no default on any outstanding obligations may have occurred within a specified prior period.

21. Bonds of foreign governments, other than Canada, formed less than one-tenth of one percent of total insurance investments at the end of 1947; and amounted to \$25,000,000, almost double the volume of such investments at the end of 1946. The 1947 figure represents the first significant reversal in the decreasing trend in this class of investment since 1906, when this class of investment was in the neighborhood of 65 million dollars, or two percent of all assets. LIAA, PROCEEDINGS 45, 48.

Recently, a small number of states have allowed purchase of securities of the International Bank for Reconstruction and Development, an indirect method of foreign investment. These bonds will undoubtedly receive acceptance by many more states, because they rest largely on the credit of the United States Government. Edmunds, *Outlets for Life Insurance Investment*, 25 HARV. BUS. REV. 409, 424 (1947).

General foreign investments, including those in private enterprises, other than Canadian securities, are permitted by about one-half of the states, limited generally to

the only foreign securities purchased have been bonds of the Dominion of Canada which are permitted in approximately three-quarters of the states.<sup>22</sup>

Closely resembling the protected position of government bonds, real estate mortgages<sup>23</sup> are similarly favored as life insurance investments<sup>24</sup> and are permitted by the statutes of every jurisdiction.<sup>25</sup> The only significant restrictions on these investments limit the amount which may be loaned upon a given parcel of real estate, usually to two-thirds<sup>26</sup> of the appraised value, and require that the mortgage be a first lien.<sup>27</sup>

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countries in which an insurance company does business. They often may be made only to the amount required by such country or the amount necessary to cover the company's obligations upon policies covering lives in such countries, and must be of the classes of securities authorized for domestic investment. The remainder of the states have no express provision for foreign investment.

See, for a careful analysis of the future foreign investments as outlets for life insurance funds. *Id.* at 423-424. Except for purchases of bonds of the International Bank, private loan capital in the United States did not furnish a significant amount of funds for foreign reconstruction during 1947. *N.Y. Times*, May 11, 1948, p. 35, col. 4.

22. Bonds of the Dominion and provinces of Canada are given authorization, separate from other foreign securities, in three-quarters of the states, and are generally made eligible on the same basis, and subject to the same restrictions, as obligations of the United States or its states. Occasionally, however, the percent of assets that may be invested in Canadian governments is limited to five or ten percent. Approximately two-thirds of the states also authorize purchase of evidences of debt of local Canadian governments, on the same basis as local United States governments.

Canadian corporate and mortgage investments, when authorized, are included in the statutes dealing with these classes of investments. See notes 27 and 30 *infra*.

Canadian government bond investments, including political subdivisions, have maintained an approximately constant ratio to total assets since the end of 1945 when they had reached an all time high of 2.6 percent as a result of wartime increases. Such investments totalled about \$1,300,000,000 at the end of 1947, an increase of about 39 million during the year. LIAA, PROCEEDINGS 45, 48.

23. Mortgages, perhaps even more than bonds, fit traditional conceptions of the ideal life insurance investment: steady, fixed income, long-term and adequately secured. Moreover, they generally yield a better return than bonds, and in "normal" times, are felt not to be as subject to market fluctuations. HUEBNER, *op. cit. supra* note 6, at 530-4, 544, Edmunds, *supra* note 21, at 415.

24. At the end of 1947, total mortgage loan investments were approximately \$3,575,000,000, representing a 29 per cent expansion since the end of the war, and bringing the mortgage loan ratio to about 16.6% of assets as against 14.8% at the end of 1945. Of this total 7.7 billion were on non-farm properties, and 875 million were on farm properties. Until 1945, there had been a steady downward trend in mortgages beginning in the late 1920's, when mortgages constituted over 40 percent of total assets, and accelerating rapidly during the depression years due to the unprecedented rate of foreclosures. LIAA, PROCEEDINGS 43.

25. About 8 states also allow mortgages on long-term leaseholds. It is generally required that the leasehold have a duration of 50 years or more.

26. This figure is adopted by 30 states, while 10 states limit the amount to 50 percent of the appraised value, and eight states have figures varying between 50 and 85 percent. A number of states also provide for variation in the limit, if certain amortization and duration-of-loan requirements are met.

27. Additional common requirements are that the land be improved or be productive,

Two remaining classes of secured debt holdings complete the less restricted classes of life insurance investment. Loans to policy holders, in an amount equal to the reserve value of the policy at the time of the loan, are authorized in every jurisdiction.<sup>28</sup> In addition, about three-quarters of the states permit life insurance companies to make loans secured by a pledge of collateral. But the collateral is required to consist of securities which would be eligible for direct purchase by the life insurance company, and the amount of the loan is generally limited to eighty or ninety percent of the value of the pledged securities.<sup>29</sup>

Corporate bonds are approved for life insurance company investment in practically all states, and unsecured corporate obligations, such as debentures and notes, are permitted by about two-thirds of the states.<sup>30</sup> But instruments of corporate debt<sup>31</sup> are apparently felt to share the dangers of equity interests,

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but there are few restrictions upon the type of activity which may be conducted upon the property mortgaged. Of more significance but very infrequent, are limitations on the amount which may be invested in one mortgage and the percentage of total assets in all mortgages. The former figure is often two percent of total assets, and the latter may vary from 40 to 80 percent. Most states permit mortgages on Canadian real estate to be taken, while the remainder restrict eligible property to land within the United States. Maine, North Dakota, and Arkansas, however, allow their insurance companies to make mortgage purchases only on land within the state itself or its immediate neighbors.

An extremely important part of the mortgage loan provisions are the statutes of  $\frac{3}{4}$  of the states permitting unlimited investments in mortgages and loans insured under the National Housing Act; and similar laws in one-third of the states regarding the Servicemen's Readjustment Act.

28. Policy loans at the end of 1947 totalled an estimated 1.95 billion dollars, or 3.8 percent of all assets, a slight increase over 1946, the low point in a steady decline from the 1932 peak of about five billion dollars. LIAA, PROCEEDINGS 45, 49.

Inasmuch as the policyholder pledges his policy contract in exchange for a loan upon that contract, policy loans are actually riskless investment. Moreover, the interest rate on these loans, as specified in the policy, is usually extremely favorable to the company. HUEBNER, *op. cit. supra* note 6, at 538.

There are several disadvantages, however, to this type of investment. Being made upon policyholder request, no discretion rests with the company to determine either the magnitude or the timing of this use of funds. A high proportion of borrowing policyholders eventually permit their policies to lapse, instead of repaying the loan. Finally, policy loans are essentially a disaster credit, sought in times of financial difficulty, and thus are not a steady investment outlet. See TNEC MONOGRAPH 28, at 366-8; Edmunds, *supra* note 21, at 418.

29. This type of investment is of largely academic interest, inasmuch as collateral loans have been less than one-tenth of one percent of all assets since 1934, and in the past quarter century have never exceeded two-tenths of one percent. LIAA, PROCEEDINGS 49.

30. The great bulk of these statutes refer to any United States corporation and the remainder speak of railroad, public utility, and any industrial corporation. During the past several years life insurance companies have entered the field of private business term loans which are similar to bank loans, although usually having a longer maturity. Edmunds, *supra* note 21, at 420. As their assets continue to grow, life insurance companies may well be expected to increase steadily their activity in this field.

31. Following conventional life insurance investment vocabularies, the term "cor-



for they are subject to a number of restrictions placed on the latter type of investment. Most important of the restrictions on purchase of these securities are provisions limiting the percentage of total assets which may be so invested.<sup>32</sup> Even within the allowed quota many different types of qualifications are imposed before individual securities are eligible for purchase. Almost all states require that the issuing corporation have maintained substantial minimum yearly earnings for a prescribed number of years prior to the date of purchase of the security.<sup>33</sup> Other frequent restrictions prohibit the purchase of the bonds or debentures of a corporation which, at any time during a specified prior period,<sup>34</sup> defaulted on the interest or principal of any outstanding obligation, and a few states make eligible only securities of corporations whose funded debt is less than a prescribed ratio to its capital stock.<sup>35</sup>

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porate" is used generically to refer to commercial and industrial business activity in general. A detailed breakdown of these statutes reveals that over one-half of all the states permit investment in the bonds of *any* corporation. A second group speaks of the bonds of any *industrial* corporation, in addition to railroads and public utilities, and these two groups together constitute substantially all the states. A very few states authorize the bonds of railroad and public utility corporations only.

The term "bonds" as used here refers to secured obligations, including both mortgage and collateral trust bonds. An additional type of secured obligation mentioned in the statutes of almost every state are railroad equipment trust bonds, secured by mortgage on rolling stock or equipment for use on United States, and often Canadian, railroads. Only about 20 states expressly confine corporate investments to those of United States businesses. The remainder either expressly include Canadian corporations in the statute, or make no reference to any nation.

32. These limitations, found in over half the states, take two forms: A limit upon the proportion of a company's assets which may be invested in the securities of one corporation, which varies from one percent to 10 percent; and a limit upon the total assets which may be invested in all corporate securities, which varies from 25 to 50 percent. Either or both types may be found in the statutes of one jurisdiction.

33. The earnings requirements take many different forms, but most commonly prescribe a ratio of earnings to total fixed charges. The required ratio varies from one and one-fourth to two in the case of railroads and public utilities, and from one and one-fourth to three for other types of corporations. Other expressions of required earnings may take the form of a minimum allowable gross earnings, varying from \$500,000 to five million dollars, or of a net earning volume sufficient to pay a stipulated dividend on all capital stock, ranging from four to six percent.

The measuring period also takes many forms, most common of which is to stipulate a two to seven year period during which earnings must have averaged the required minimum. Other laws require that the minimum have been earned during each year of the period, and still others prescribe a combination of these two types.

34. This period is most commonly five years.

35. Typical is a ratio of one to three. This requirement in effect may prevent insurance companies from encouraging corporations to assume excessive debt. See note 71 *infra*. Other restrictions are that the corporation be "solvent," and that the security not be "speculative." In addition, the obligations of mining and oil companies are occasionally prohibited.

At the end of 1947, life insurance investments in corporate interest-paying obligations totalled an estimated \$14,550,000,000 or 28.2% of total assets. Of these, \$2,680,-

Deemed to be radically different in character from investments in the loan group, the two remaining major classes of investments are corporate stocks and real estate.<sup>36</sup> Both of these place the life insurance companies in the status of "owners," rather than "creditors," and the return from these classes is received as "profits, rather than interest."<sup>37</sup> Less favored than any other

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000,000 were railroad bonds, \$6,640,000,000 were public utility bonds, and \$5,140,000,000 were bonds of other types of corporations.

The class of corporate obligations has increased rapidly since the end of the war period, climbing from an all-time low of approximately 22 percent at the end of 1945. Investment in corporate obligations rose steadily during the twenties, to a peak of 31% of total assets in 1930, and then gradually declined until 1945. The greatest change, however, has been in the distribution of these investments among the three types named above. Though railroad bonds dominated this group until the early 1920's, their importance has steadily declined, replaced first by a spurt of public utility securities through the twenties and thirties, and later, as insurance resources continued to double each decade, by increase in obligations of other types of corporations. The post war increase has been primarily in securities of this third group, with some expansion in public utility obligations, and little change in railroad holdings. LIAA, PROCEEDINGS 41-42, 48-51. See also Edmunds, *supra* note 21, at 411.

36. Life insurance holdings of corporate stock totalled \$1,550,000,000 at the end of 1947, about 3.0% of assets. This was an increase from 2.2% of total assets at the end of 1945. After the Armstrong investigation in 1906, see note 4 *supra*, life insurance stock investments dropped from five percent to about two percent and have never exceeded three percent until the past year. LIAA, PROCEEDINGS 42-3, 51. The distribution of stock holdings among railroad, public utility and other corporations, and the change in that distribution over the past 25 years, is similar to the distribution and change in the corporate bond category. See note 35 *supra*.

Real estate investments should be carefully distinguished from investment in real estate mortgages. Largely as a result of housing project and commercial real estate investments during 1947, total real estate investments increased during that year for the first time since 1936 to a total value of 825 million dollars or 1.6 percent of assets. The depression years, and consequent foreclosures of mortgages, saw real estate ownership rise to an all-time high of 8 percent of total assets in 1936, from which it steadily declined until last year. LIAA, PROCEEDINGS 43-4.

37. For evidence that the interest-profit, debt-equity distinction may be largely artificial, see note 80 *infra*. In addition to the classes of investments discussed in the text, and the various miscellaneous categories described in note 17 *supra*, several other minor classes of investments deserve mention. 1) Cash. Though cash holdings receive little mention in the statutes, life insurance companies are generally permitted to maintain such cash balances as they see fit. The magnitude of funds held as cash during the thirties aroused grave fears on the part of the TNEC investigators. TNEC Monograph 28, 355-9, 371-8. See also TNEC Monograph 37, 44, 49-50 and compare STATEMENT ON LIFE INSURANCE 9 (TNEC Monograph 28-A, 1941.) (hereinafter cited as TNEC Monograph 28-A). Cash holdings at the end of 1947 totalled 800 million dollars, or 1.6 percent of all assets. 2) Acceptances and bills of exchange, eligible for purchase by the Federal Reserve Banks, are authorized in twelve states. 3) Securities acquired pursuant to corporate reorganizations, or to protect prior corporate investments are eligible in eighteen states. 4) In addition to insured mortgage loans under the N.H.A. and S.R.A., see note 27 *supra*, the insured unsecured loans provided for in these statutes may be made by life insurance companies in approximately one-half of the states, under the former statute, and sixteen under the latter.

type of major outlets, investments in stock or real estate are limited to a small percent of total assets and many restrictions are placed on individual investments within each class.<sup>38</sup>

One-half of the states do not permit any investment by life insurance companies in common stocks, and one-third forbid purchase of preferred shares.<sup>39</sup> In those jurisdictions which do permit the purchase of stock, the kinds of restrictions imposed are similar to those which limit investment in corporate bonds and debentures.<sup>40</sup> As applied to shares of stock, however, these requirements are more stringent, and always include earnings and dividend records of excellent stability.<sup>41</sup>

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38. Common stocks: One of the most controversial of all classes of life insurance investment, stocks were found by the Armstrong Committee to be "fundamentally objectionable" as life insurance company investments. Armstrong Report, *op. cit. supra* note 4, at vol. X, 389. The TNEC failed to accept a recommendation by its special investigators that wider investments in stocks be advocated. TNEC Monograph 28, 372-8. Final Report and Recommendations of the Temporary National Economic Committee, SEN. DOC. No. 35, 77th Cong., 1st Sess. 42 (1941) (hereinafter cited as TNEC FINAL REPORT). The nation's life insurance companies strenuously opposed this recommendation. TNEC Monograph 28-A, 4. Numerous economists, life insurance officials, and governmental officers have participated in the controversy. HOBBS, *op. cit. supra* note 9, at 29. Edmunds, *supra* note 21 at 418-9, 426-7. See Rose, *The Policyholders Interest in Equity Investments*, address by Dwight C. Rose, president of the Investment Counsel Association of America, before thirty-fourth annual meeting of American Life Conference (reprinted in TNEC Monograph 28-A, 32). For an early writer's view that investment in stocks should be permitted, see ZARTMAN, *op. cit. supra* note 1, at 184. See also note 20 *infra*.

Real estate—due to the unfortunate experiences of many insurance companies—as well as other investors—with real estate as a result of land price fluctuations, a definite prejudice has also existed against life company investment in real estate. ZARTMAN, *op. cit. supra* note 1, at 157-60, HOBBS, *op. cit. supra* note 9, at 13; Armstrong Report, *op. cit. supra* n. 4, at vol. X, 382-4. The pressure of expanding assets has tempered this policy in recent years. See page 1266 *infra*.

39. The purchase of Canadian corporate stocks is permitted in approximately one-third of the states, either by express inclusion of Canadian corporations in the provisions dealing with stock or by omission from the statute of any mention of any country.

40. See pp. 1262-63 *supra* and notes 32-35.

41. The tests applied to earnings require that net earnings average over a given prior period, generally five years or more, a certain percentage of the value of all outstanding stock, usually between 4 and 12 percent. Frequent tests for preferred stock require the ratio of net earnings to the sum of total fixed charges plus maximum preferred dividends to have equalled one and one-half to two and one-half over a similar period. A third type of requirement judges soundness in the light of past dividend payments during a prior period, requiring the prescribed dividend to have been paid on preferred stock, and dividends varying from 4 to 6 percent on common stock. There are, of course, many variations upon these major types.

Standards often applied to the issuing corporation may require that it be at least 5 years old, have a surplus greater than 50 percent of its capital stock, be solvent, and that its interest-bearing obligations be eligible for insurance company purchase. Less severe standards regarding railroad and public utility securities are found.

Most important are the limitations, varying between 5 and 10 per cent, upon the percentage of total assets which may be invested in stocks. Also common are provisions limiting the percentage of the assets which may be invested in one corporation.

When the subject of life insurance company investment is land, a hierarchy of restrictions is encountered depending on the purpose of ownership.<sup>42</sup> Ownership of real estate necessary for a home office, or for the transaction of a company's business is authorized by all states.<sup>43</sup> And the acquisition of real estate through foreclosure of mortgages or in satisfaction of debts is also generally permitted although realty so acquired must be disposed of within a given period of years.<sup>44</sup>

About one-third of the states<sup>45</sup> approve investment of life insurance funds in real estate for the purpose of constructing housing and redevelopment projects.<sup>46</sup> But the proportion of total insurance assets which may be so invested is usually limited to ten or twenty percent.<sup>47</sup> Apart from a general ban on the construction of hotels few other restrictions are imposed upon the acquisition of real property for this purpose.<sup>48</sup>

Wholly separate from any powers related specifically to housing projects, realty ownership for the purpose of leasing to business concerns or to individuals for residential use,<sup>49</sup> has recently become authorized as an outlet

42. A summary of the statutes of each state dealing with life insurance company ownership of real estate may be found in *Analysis of State Laws Affecting Investments in Real Estate by Life Insurance Companies* (1947) (prepared by the Life Insurance Association of America).

43. Ownership of real estate necessary for business purposes or acquired in the ordinary course of business, has always been authorized for life insurance companies; but the amount that may be so invested is often limited, varying among the states from 5 to 25%. See Hobbs, *op. cit. supra* note 9, at 11-17 for a detailed description of the statutes relating to real estate under this heading.

44. The period is usually 5 years, though the insurance commissioner is generally given power to extend this period if the company would suffer by a forced sale.

45. Including all states within which the 10 largest companies are domiciled: Connecticut, Massachusetts, New Jersey, New York, Pennsylvania and Wisconsin.

46. Though life insurance entrance into this field has been recent, such investments are of great importance to both the companies and the communities benefited. Edmunds, *supra* note 21, at 421-3 presents a careful analysis of the investment aspects of housing projects, from the point of view of life insurance companies, emphasizing the difficulty that smaller companies face in attempting to enter this field.

47. These provisions take various forms. Five states limit the total amount that may be invested in all housing projects, to 5 or 10% of assets. Others limit the total real estate investment only, specifying between 10 and 20%.

48. The statutes generally authorize construction of "housing projects," "tenements," and "apartments." Occasionally, these projects are required to be in or close to cities of a certain minimum population, ranging from 50,000 to 100,000.

In addition to the authorization of direct project construction, two-thirds of the states authorize the purchase of bonds of local public housing authorities issued pursuant to assistance contracts with the Federal Public Housing Authority, under the Federal Public Housing Act. At least three states have also provided for the formation of redevelopment companies under their own laws and have made the securities of these companies eligible for life insurance companies.

49. For an excellent survey of the statutes dealing with so-called "income real estate," particularly as they concern companies who seek to purchase land in foreign states, see Satterthwaite, *Investments by Life Insurance Companies in Income Real Estate*, INS. L. J.

for life insurance company investment in at least 40 states.<sup>50</sup> With the exception of prohibitions against the leasing of land for agricultural use, few restrictions are imposed upon the type of activity which may be conducted upon property owned under these provisions.<sup>51</sup> It is generally required, however, that realty investment for leasing purposes be limited to a small percentage of the company's assets, and that leases extend for at least ten years.<sup>52</sup>

#### ECONOMIC ASPECTS OF REGULATION

But the statutory snare of yesteryear can hardly be expected to catch the problem of today. While the 49 sovereigns have successfully furnished policyholder safety in the past by means of the existing statutes, the nation's economic evolution not only threatens to frustrate them in this purpose in the future, but also to produce new and more serious problems related to the regulation of insurance company investment. Existing regulation seems incompatible with the capital requirements for national economic health—and, as a corollary, for the financial security of the life insurance companies—in that it prevents investment of the nation's largest private capital pool in equity financing of new enterprise.

It is generally recognized that national prosperity and well-being depend upon avoidance of cyclical depressions and the stabilization of the economy at a level providing full employment.<sup>53</sup> These conditions, according to modern

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771 (1947). Definitions of the type of property which may be purchased are "real estate for production of income," "for purposes of leasing," "business or residential property for leasing." See also *Levis v. New York Life Insurance Company*, 358 Pa. 57, 55 A.2d 801 (1947) (upholding constitutionality of Pennsylvania income real estate statute).

50. Primary impetus for this legislation arises from the pressing need for new investment outlets. Though such properties present opportunities for highly satisfactory investments the lessees must be chosen with care to insure full utilization of the property *Edmunds*, *supra* note 21, at 423. See *N.Y. Times*, April 11, 1948, Sec. 8, p. 2, col. 6-7. At present, most investments of this type appear to have been confined to commercial, rather than industrial or residential, properties.

51. Hotels, mining, and recreational properties are prohibited in various provisions. Several states also impose a value write-down requirement, generally at 2% per year.

The extent to which insurers doing an interstate business are subject to the investment laws of states other than their domicile, discussed in note 13 *supra*, is increased with regard to income real estate. Sixteen states which do not otherwise impose their investment statutes upon foreign life insurance companies nonetheless require that real estate within those states be held by foreign insurers only in accordance with the restrictions applied to their domestic companies. *Satterthwaite*, *supra* note 49, at 342.

52. With very few exceptions, investments in income real estate are limited to 5 or 10% of total assets. The limit upon the amount which may be invested in one parcel of income real estate, found in a number of jurisdictions, generally varies between ¼% and 1%.

53. See the Declaration of Policy in Full Employment Act of 1946, § 2, 60 STAT. 23 (1946), 15 U.S.C.A. § 1021 (Supp. 1947); Address by President Roosevelt at Soldier's Field, Chicago, Illinois, Oct. 28, 1944, *N.Y. Times*, Oct. 28, 1944, p. 1, col. 1; COUNCIL OF ECONOMIC ADVISERS, FIRST ANNUAL REPORT TO THE PRESIDENT 2, 8-18 (1946);

economists, depend in turn on the continuous creation of new business activity,<sup>54</sup> which requires that private savings withdrawn from the national income stream be promptly returned to productive uses.<sup>55</sup>

In past decades even within the limited area allowed by regulatory laws, it was possible to keep life insurance funds invested in a way conducive to the necessary business expansion. A young nation busily waging the industrial revolution could satisfactorily place its relatively smaller insurance company funds in railroad and utility bonds—and to a lesser degree in high-grade industrial bonds. But the great increase in insurance funds,<sup>56</sup> together with a decline in the flotation of quality bonds have rendered the traditional outlets of investment increasingly inadequate.<sup>57</sup>

Between 1936 and 1946, for example, life insurance companies accumulated twenty-four billion dollars in new assets,<sup>58</sup> while the total amount of private debt outstanding in the nation remained essentially constant.<sup>59</sup> The only large outlet for these funds was federal obligations which increased throughout the period.<sup>60</sup> While the wide-scale industrial reconversion of the post-war period provided enough debt outlets to absorb new funds received during the past two

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Neifeld, *The Choice before Institutional Investors*, 79 TRUSTS AND ESTATES 159; and treatises cited in note 4 *supra*.

This discussion analyses the economic importance of a life insurance business based upon the existing net-level-premium, legal reserve theory, the fundamental basis of which is investment of policyholder premiums. Alternative theories of life insurance operation, based upon a pay-as-you-go or strictly risk spreading principle, and eliminating the need for investment of savings, might relieve the problems raised herein, but are not considered in this treatment.

54. The economy can be maintained upon an even keel only if pressures toward contraction of the level of economic activity are constantly resisted and overcome by stronger stimuli toward expansion—stimuli which result from the promotion of new activity. For further discussion on the importance to the economy of the rate at which new business activity is stimulated see ECONOMIC REPORTS OF THE PRESIDENT Part I, cc. 1, 4 (1948); KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY* (1936); EZEKIEL, *JOBS FOR ALL THROUGH INDUSTRIAL EXPANSION* (1939). See notes 4, 53 *supra*.

55. TNEC Monograph 37, 5-10, 49-50; KEYNES, *op. cit. supra* note 54. For discussion of the importance of life insurance funds in the total flow of savings, see TNEC Monograph 37, at 35-50; Geren, *The Contribution of Life Insurance to the Savings Stream*, 51 J. POL. ECON. 33 (1943).

56. Edmunds, *supra* note 21, at 410; Huntington, *Response of Life Insurance Funds to the Nation's Demand for Funds*, ASSOCIATION OF LIFE INSURANCE PRESIDENTS, PROCEEDINGS 21 (19th annual meeting, 1947); LIAA, PROCEEDINGS, 49, Table I (1947); Fortune, April, 1948, p. 109.

57. TNEC Monograph 28, 360-3. TNEC Monograph 37, 42-50.

58. LIFE INSURANCE ASSOCIATION PROCEEDINGS, *op. cit. supra* note 57 at 50, Table I. Inasmuch as total assets at the start of this period were \$24,874,316,000, these companies thus doubled in size in the ten year period. See also note 5, *supra*.

59. Edmunds, *supra* note 21, at 412, Exhibit II. The relative decline in long-term private debt was emphasized by TNEC Monograph 37, at 42, and was a chronic feature of the United States capital scene from 1932 through 1945. During this thirteen year period, the total increase in life insurance assets was 28 billion dollars.

60. See note 18 *supra*. TNEC Monograph 28, 364, 374.

years,<sup>61</sup> it is probable that the future annual demand for debt capital by governmental and business units will not again be adequate to absorb the rapidly growing body of life insurance capital.<sup>62</sup>

Several factors inherent in the types of new activity needed in future American economic development prevent them from being financed by the traditional debt methods required by life insurance companies. At the outset, it is clear that the major economic need is for capital promotion of new industrial and commercial enterprises.<sup>63</sup> With a higher national income and standard of living, a greater net share of national production must be diverted to complex consumer goods and services.<sup>64</sup> The rate of capital obsolescence will be greatly increased by the development of the types of new products and resources in which expansion is most likely to occur.<sup>65</sup> The difficulty of ascertaining degrees of risk will be increased as intensive industrialization develops products requiring longer periods of exploration, development, accumulation of materials, manufacture and market building. The capital required will be greater and less secure as production tends to new items probably representing less value in form of natural resources or salvageable components.<sup>66</sup> Finally, as the rate of population increase levels off, initial estimates of demand and consumption become increasingly critical, for a bountiful increase in population can no longer be counted upon to rescue enterprise out of scale with initial demand.<sup>67</sup> While to some extent these inhibitions to debt financing might be avoided if new ventures were undertaken as extensions of existing corporations of secure financial status, such a practice

61. LIAA, PROCEEDINGS 42-7. For the first time since 1930, holdings of United States governments decreased, and holdings of corporate securities and mortgages increased. *Ibid.*

62. See Edmunds, *op. cit. supra* note 21, at 413-14; Fortune, April, 1948, p. 169. A projection of the past rate of increase of life insurance assets reveals that the  $3\frac{1}{2}$  billions which life insurance companies received for investment during 1947 will have swollen to a yearly increase of about  $4\frac{1}{2}$  billion dollars in 5 years, and of about 6 billion dollars in 10 years. It does not appear that the amount of secured obligations available for purchase will increase at such a rate. See also notes 58 *supra*, and 88 *infra*.

63. See note 54 *supra* and TNEC FINAL REPORT, at 15-6, 30-1; ECONOMIC REPORTS OF THE PRESIDENT, pt. I, 59 (1947).

64. ECONOMIC REPORTS OF THE PRESIDENT, pt. I, 56-86; pt. II, 34-47 (1947). Edmunds, *supra* note 21, at 409-10.

65. A more rapid rate of development of new products necessitates an equally rapid abandonment of old capital investments in favor of new capital facilities. Far greater emphasis upon consumers' goods and services increases the subjection of the nation's productive plant to changes in consumer demand, for consumer favor and sales technique become the masters of investment flow. See Caplan, *Premature Abandonment and the Flow of Investment*, 54 Q. J. ECON. 152 (1939).

66. The man-made contribution to capital formation, and the importance of managerial and engineering vision and foresight must be relatively greater than the contribution of physical materials. Edmunds, *supra* note 21, at 410.

67. See Hauser and Toeuber, *The Changing Population of the United States*, 237 ANNALS 12 (1945); REDDAWAY, *THE ECONOMICS OF A DECLINING POPULATION* 117-19 (1939).

would have the undesirable result of increasing centralization of economic power<sup>68</sup> by denying new corporate ventures access to the vast life insurance funds as a source of necessary capital.

But even if new enterprises and existing corporate ventures could make the showing required for life insurance debt investment, basic disadvantages in this capital form would prevent it from furnishing a satisfactory method of utilizing life insurance funds to expand the level of business activity. The assumption of large fixed debt charges frequently prevents the most economic operation of the nation's productive plant.<sup>69</sup> The premature precipitation of bankruptcy or reorganization which may result from an unsound debt ratio not only causes wide-spread disruption of industrial plant,<sup>70</sup> and disintegration of general business morale, but also may force the withdrawal from production of business units which economically speaking should remain active.<sup>71</sup> For as long as the value of the goods produced by a business exceeds the prime costs of production, a net increase in total wealth is effected, and the economy suffers when the producing unit is forced into bankruptcy because of inability to meet interest requirements.<sup>72</sup> Even when current prime production costs exceed value of current production, bankruptcy may be premature if long-run earnings would be satisfactory, despite a few lean years.<sup>73</sup>

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68. See TNEC FINAL REPORT, § I (1941) for an analysis of the problems of economic concentration; also message from President Roosevelt to the Congress, April 29, 1938, 83 CONG. REC. 5992 (1938). Cf. p. 1274 *infra*.

69. For suggestions by various commentators that one of the greatest disadvantages of the preeminence of life insurance companies in capital markets has been that the tremendous "appetite" of these companies for fixed interest investment has tempted borrowing corporations into unsound financial structures, see Edmunds, *supra* note 21, at 414; TNEC Monograph 28, 373; Fortune, April, 1948, p. 109.

70. TWENTIETH CENTURY FUND, DEBTS AND RECOVERY 232, c. 6 (1938); BALLANTINE, CORPORATIONS 495 (1946); 1 DEWING, FINANCIAL POLICY OF CORPORATIONS 261-2 (4th ed. 1941).

71. See R. F. Harrod, *The Expansion of Credit in an Advancing Community*, 1 *ECONOMICA* (n.s.) 287, 289-90 (1934). Actual operation of the enterprise may continue throughout and after the reorganization or bankruptcy. But where the insurance companies inherit the enterprise through their position as senior security holders, management may be seriously disrupted. See note 84 *infra*.

72. ". . . ideally the whole ownership of fixed means of production ought to be of the 'equity' form. For it is economically sound that fixed means should continue to be exploited, so long as the value of the product exceeds the prime costs. The existence of fixed money charges brings the operation of firms to a premature end, if and when the value of the product, while exceeding prime costs, does not exceed them sufficiently to meet the fixed charges." *Id.*, at 289. See also BOULDING, *ECONOMIC ANALYSIS* c. 21 (1941).

73. An additional consideration of practical significance arises with respect to those enterprises, such as service industries, whose success depends largely upon public favor and acceptance. The withdrawal from active competition of such a business may well mean its permanent death, through loss of its position of prominence and favor. Thus, the future of such enterprises may warrant their continuation during periods of development or depression in spite of operating losses.



Moreover, by disregard of the industry's ability to pay, the necessity of meeting fixed interest requirements often gives rise to unsound operating practices. In particular, management policies may be affected with regard to depreciation allowances, ploughed back earnings, maintenance, research and reserves.<sup>74</sup>

The disadvantages of excessive debt financing are particularly great in the case of new enterprises. Because no record of past operations is available upon which estimates of probable future earnings may be based, it is almost impossible to estimate a fixed debt which the company may safely attempt. Moreover, in actual operation of the new venture, lean years and unpredictable difficulties are more likely to arise. Coupled with the new venture's usual inability to raise additional capital in time of stress, assumption of a large fixed debt seriously lessens its ability to withstand business difficulties.<sup>75</sup>

The life insurance companies themselves would benefit from use of their funds as equity capital in the financing of new business expansion. To the degree that such investment improves the economic health of the nation it would increase the actual security of life insurance companies, for the best and probably only effective guarantee of the safety of life insurance investments is a stable economy, whether the contractual terms of the investment give a "creditor's" or "owner's" interest. Although they suffered some losses,<sup>76</sup> the better managed life insurance companies weathered the 1929 crash. But today, the great magnitude and broad placement of life insurance funds within the economy make it extremely questionable that in a more serious depression, destroying the ability of a large portion of the nation's enterprises to produce, a fifty-one billion dollar island of security and stability could remain.<sup>77</sup>

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74. Experience with the nation's railroads provides perhaps the clearest object lesson of the managerial dilemma which results from excessive fixed charges. Moore, *Railroad Fixed Charges in Bankruptcy Proceedings*, 47 J. POL. ECON. 100 (1939); see also BOULDING, *op. cit. supra* note 72, c. 31; and TNEC Monograph 28, 377, n. 190.

75. See Masslich, *Financing a New Corporate Enterprise*, 5 ILL. L. REV. 70 (1910). "Many a corporation defaults on its bond interest during a temporary depression and ends its career in a receivership, when if its capitalization had been represented by fewer bonds and more stock it could have passed the stock dividend and weathered the storm." *Id.* at 72. See also authorities cited in note 70 *supra*.

76. From 1930 through 1934, the total loss suffered by the chief life insurance companies on investments other than mortgages was about 583 million dollars. TWENTIETH CENTURY FUND, DEBTS AND RECOVERY 31-2, 286 (1938); the net loss on bonds and stocks over the 1929-1938 period was \$483,000,000. TNEC Monograph 28, 363. No important company failed in this period. However, of 101 life insurance companies which discontinued operation between 1930 and 1939 as a result of merger, receivership or reinsurance, 39 were failures the retirement of which resulted in a loss to policy holders. 19 of these brought initial policyholder losses of one million dollars or more, or a total initial loss of 138 million dollars, much of which has since been recouped through assumption of liabilities by other companies. See TNEC Monograph 28, 131; TNEC Monograph 28-A, 5.

77. Life insurance companies hold about 30 percent of the nation's total long term debt. FORTUNE, *supra* note 63. The 51 and one-half billion dollars of investments held by these companies, representing about 15 per cent of total estimated national wealth, would

Similarly it is to the best interest of the life insurance companies that the economy be free from the undesirable effects of the present over-emphasis upon debt financing. In addition to their general interest in the national financial soundness, certainly life insurance companies have direct interest in the soundness of the particular enterprises in which they have invested, and in preventing both the undue pressures on management and unnecessary bankruptcy which result from excessive fixed debt.

An even more immediate consequence to life insurance companies of the current restrictive statutes is the present critical lack of insurance investment outlets. The ability to invest is the fundamental basis of all present private life insurance operation.<sup>78</sup> The limited supply of "high quality" investment opportunities has already created grave problems for life insurance companies, one of the most important of which is the recent decline in interest return to a point uncomfortably close to the minimum guaranteed in policy contracts.<sup>79</sup>

But do new enterprises present a sufficiently safe investment for life insurance companies? Such a program would unavoidably involve some increase in risk,<sup>80</sup> but the life insurance companies seem excellently situated for mini-

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appear to bind life insurance welfare inextricably to the national economic welfare, including its stability and security.

78. HUEBNER, *op. cit. supra* note 6, at pt. 2, (1935); see generally, HUEBNER AND McCAHAN, *LIFE INSURANCE AS INVESTMENT* (1933). See mention of possible alternative theories of life insurance operation in note 53 *supra*.

79. LIAA, *PROCEEDINGS* 45-47 (1947); TNEC Monograph 28, at 368-71. Net investment earnings have steadily dropped since 1930, and dropped below 3 percent for the first time during 1946. Total net investment earnings in 1946 were almost one billion dollars less than they would have been at the 1930 earnings rate level.

80. An increase in risk would result primarily from the nature of the investments advocated; expansion into new fields, promotion of untried enterprises; development of as yet unfamiliar products.

However, this risk should not be confused with the risk which some legislators have thought to be inherent in crossing the forbidden barrier from debt to equity capital. See note 37 *supra*. Relinquishment of the equity cushion which protects debt investment theoretically means greater loss, when failure occurs. TNEC Monograph 28-A, 4. However, on the record the aggregate return from equity investments, the total number of failures, and the extent of loss indicate that a policy of equity investment would probably be as favorable to life insurance companies as the present investment pattern, if conducted on a comparable scale.

The legal incidents of "owner" and "creditor" interests are in many instances identical. For example, neither interest on income bonds nor dividend claims should be considered to constitute a "debt," since neither form the basis of an action against the issuer for non-payment. And many stock issues share with bonds a lack of voting voice in company meetings. The real difference is one of *priority* of claims, both on principal and income. In general, secured and unsecured interest claims have a claim prior to that of any other invested capital, and in the event of reorganization or bankruptcy, this priority not only gives "creditors" greater security, but also a large degree of control over the debtor corporation. See address by Dwight C. Rose, *op. cit. supra* note 38; Phelps, *Stocks for Life Insurance Companies*, 146 *COMMERCIAL AND FINANCIAL CHRONICLE* 483 (1946); Neifeld, *The Choice before Institutional Investors*, 79 *TRUSTS AND ESTATES* 159 (1944); Dissent by Commissioner Frank in North American Company, SEC Holding Co. Act Re-

mizing the danger. They have long-term capital; and the vast size of their resources would enable them to retain the finest research, analytical and managerial talent. By the size of the funds involved, the companies would be able to spread their interests widely so that failure in one particular venture could be offset by success elsewhere, and some variety of inter-company insurance might be developed similar to the cross-insurance techniques developed to protect fire and casualty companies from disaster losses at present. Moreover, careful equity investment in new enterprise would probably not increase the injury to life insurance companies from even a nationwide recession, for the long-run record of American business is sufficiently successful to balance depression losses by increased returns in periods of prosperity.<sup>81</sup> The economy has certainly not yet stagnated to the point where it is no longer possible to establish new sound and profitable businesses.

#### OBSTACLES TO EASY SOLUTION

Although the diversion of life insurance investment into equity capital seems necessary for the welfare of the national economy as well as of the insurance companies, any development along these lines appears to raise prohibitive legal problems. The main legal task of arranging such a shift would be replacement of present investment statutes.<sup>82</sup> But once life insurance funds began to flow into equity capital, the problem of protecting the policyholder from risk of financial loss and the public from the dangers of monopolistic control appears to lead to government intervention to a startling degree.

At the outset it appears that life insurance companies could not safely entrust any large amount of their funds to equity capital without exercising managerial control over the businesses in which they invest. Safety to the policyholder under present insurance investment lies theoretically in security pledged behind a debt, a tangible res of high value, requiring no managerial control for its preservation.<sup>83</sup> In contrast, the security behind equity financing

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lease No. 1427, January 30, 1939; TWENTIETH CENTURY FUND, DEBTS AND RECOVERY 256 (1938).

81. Absolute absence of risk cannot be obtained from any type of investment. Nothing like such perfection has been achieved with security loans, see note 76 *supra*, particularly where the amount of investment is so large that its success must vary with the health of the economy as a whole. Yet careful calculation of premiums, conservative interest rate guarantees in policies, even more conservative mortality assumptions, and the maintenance of adequate reserves have enabled the nation's life insurance business to maintain a remarkable record of solvency. The same techniques, however, could be applied to investments in new enterprises. See Edmunds, *supra* note 21 at 416.

82. Since the *South-Eastern Underwriters* case, there is no question of Congressional power to take such action. See note 10 *supra*. Compare TNEC, FINAL REPORT 587-90 with TNEC Monograph 28-A, at 20-1.

83. See Edmunds, *supra* note 21, at 414, 416. Huebner, *op. cit. supra* note 6, at c. 33; ZARTMAN, *op. cit. supra* note 1, at 151, 178. For a suggestion that life insurance company managements lack vital managerial and promotional experience—the very essence of success in a business enterprise—see Edmunds, *supra* note 21, at 425, 427. And life insurance

would be mainly the "going concern" value of the enterprise. Especially in the types of new enterprises most likely to be developed, rarely would the venture have great salvage value or large fixed assets to cover insurance investments should the company fail.<sup>84</sup> Lacking the criteria of past performance which are so useful in evaluating the securities of well-established companies, life insurance companies would have only such factors as the quality of management and soundness of initial organization as their guarantees of probable success of a new venture.<sup>85</sup> Moreover, the large fluctuations in value which characterize equity interests in most corporate enterprises, and the increased risk of great losses from unwise management policy, would make it imperative that insurance companies supervise management in order to protect their invested interest.<sup>86</sup>

Traditional governmental responsibilities of policyholder protection thus probably could not be satisfied by a simple body of law restricting insurance investment from areas which seem dangerous. If the present body of statutory restrictions were abandoned, government protection of policyholders from the risks of insurance company investment in equity capital would probably lead to a degree of supervision approaching the stature of a partnership between the government and the insurance companies in exercising control over industries receiving life insurance funds. The importance of extreme deliberation and care in the planning and initial organization of business enterprises would necessitate great participation by government in original investment decisions. Moreover, since the safety of direct investment in enterprises rests on the wisdom with which the business is operated throughout its existence, adequate policyholder protection would require the government continuously to scrutinize those management policies which the insurance companies had approved.

But there would be an even more compelling cause for government intervention, both in life insurance investment policies and in the enterprises so controlled. For life insurance company control of enterprises would raise a great anti-trust danger; the result could be an unprecedented integration of American industry. So vast are the insurance company investments that the

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officials have sought to avoid participation in management of companies in which they invested. TNEC Monograph 28, at 373, n. 179.

84. BALLANTINE, *op. cit. supra* note 70, at 499. The financial losses attendant upon failure of a corporate enterprise are already well-known to life insurance companies. Between 1929 and 1938, these companies wrote off \$624,153,000 of their investments, as a result of bond defaults. TNEC Monograph 28, at 363. See also *Investigations of Railroads, Holding Companies, and Affiliated Companies pursuant to S. Res. 71*, SEN. REP. NO. 25, 76th Cong., 1st Sess., pt. 2, 81 (1939).

85. The heavy reliance by the investment statutes upon past record of corporate enterprises, as the basis for sound investment, has already been stated. See note 33 *supra*. The extent to which this factor also influences life insurance company investment officials is shown in TNEC 28, at 359-63, 375.

86. Tracy, *The Problem of Granting Voting Rights to Bondholders*, 2 U. OF CHI. L. REV. 208 (1935); BALLANTINE, *op. cit. supra* note 70, at 498.

total of new investments in 1947 would build two railroads the size of the Pennsylvania Railroad, or an automobile industry the size of General Motors and the Ford Motor Company combined.<sup>87</sup> The six billion dollars per year which life insurance companies will probably be receiving in new funds in 1958 would rebuild the entire Bell Telephone system, or three steel companies the size of the United States Steel Corporation.<sup>88</sup> Moreover, in addition to these annual increments to total assets, the companies annually have available funds from maturing past investments that currently may be as much as two billion dollars.<sup>89</sup> And the problem is not only one of the size of insurance funds; it arises also from the high degree of cooperation and joint action characteristic of American insurance.<sup>90</sup> This cooperation is not only desirable, but would appear unavoidable if life insurance companies were to invest in equity or venture capital, for it would allow a splitting of enterprise risks among insurance companies so that the failure of any one enterprise would not seriously weaken any one company.

#### CONCLUSION

Public interest in the vast economic resources of insurance companies is not new. In 1906 the Armstrong investigation in New York State suggested that the happy optimism of insurance company officials over the expansion of insurance funds might be described as unwitting pride in the growth of a monster.<sup>91</sup> In 1938, the TNEC's similar though more extensive investigation produced similar diagnosis.<sup>92</sup> But the economic dynamics of the problem—that the areas into which national economic health and insurance company security would force insurance funds greatly magnify the legal problems of safeguarding public and policyholder interest—have been slighted.

It seems highly desirable that a further government study be made with special emphasis on the economic aspects of insurance investment. While no easy answer appears, it is possible that by taking action before the situation becomes critical an escape from the dilemma may be found. Absent a satisfactory solution, the addition of economic depression or unsettled political conditions to the unsolved problem would seem a sure formula for producing ill-advised and drastic action.

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87. MOODY'S MANUAL OF INVESTMENTS, INDUSTRIALS (1948).

88. *Ibid.*

89. Edmunds, *supra* note 21, at 411.

90. Intercompany cooperation and agreements exist to an unusually high degree in the insurance business. TNEC Monograph 28, c. 10.

91. See note 4 *supra*.

92. See note 2 *supra*.