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Exemption Statutes and the Right to Proceeds of Life Insurance

It is the purpose of this article to trace briefly the development of the law as to the conflicting rights in the proceeds of life insurance policies of beneficiaries as against creditors of the insured, to compare the amount of insurance exempted from claims of creditors by statutes in the various states, to discuss the effect of fraud on creditors by change of beneficiary or payment of premiums after insolvency, and the effect of the Bankruptcy Act on the state exemption statutes.

The idea originated in this country, and has been generally accepted, that the right of a beneficiary of a policy of insurance is vested, where no power is reserved to change the beneficiary. The insured has no title or interest in the contract, and consequently, in the absence of a statute creating special rights in his creditors they can find no interest in such a policy which they can subject to the payment of his debts.¹ Even where a right to change the beneficiary has been reserved, some courts have said that the beneficiary's rights are not divested unless such right has been exercised and a new beneficiary designated.²

The common law rule has been codified in some states, typical of which is the Alabama statute:

"If a policy of insurance . . . is effected by any person on his own life or on another life, in favor of a person other than himself . . . the lawful beneficiary thereof . . . shall be entitled to its proceeds and avails against the creditors and representatives of the insured . . ."

However, this rule as to the vested rights of a beneficiary has been modified by many state statutes expressly exempting the proceeds of insurance up to a certain amount, declaring that any excess above such amount shall inure to the benefit of the creditors, and generally charging the proceeds of the policies with repayment of premiums paid in fraud of creditors.³

¹Metropolitan Life Insurance Co. v. Shalloway (C.C.A. 5th, 1945) 151 F. (2d) 548; Stolar v. Turner (1946) 237 Ia. 593, 21 N.W. (2d) 544; VANCE, INSURANCE (2d ed. 1930) §162, p. 616; 14 R.C.L. 545, p. 1376.

²Note, *Rights of Auditors of an insured insolvent against his wife and children as beneficiaries of a life policy*, 23 COLUM. L. REV. 771 (1923), and citations.

³VANCE, INSURANCE (2d ed. 1930) §145, p. 546.

At the present time insurance exemption statutes have been enacted in forty-seven of the United States. The only state in which such a statute has not been passed is Virginia, and even Virginia exempts proceeds of health and accident insurance and also protects the proceeds of group life insurance from attachment and garnishment.⁴

A number of states have statutes which permit a married woman to take out a policy of insurance upon the life of her husband (modeled after the original New York Verplanck Act), and in such case she may ordinarily recover the full amount of the policy where she survives her husband, free from the claim of her husband's creditors and, in some cases, free from the claims of her own. Still more common are statutes which permit a person to insure his own life and make the policy payable to his benefit or to his wife and children, free from the claims of his creditors, or exempt from the claims of creditors within certain limitations.⁵ These statutes, it has been said, are not declarative of any common law principle, but are enabling acts creating a new right and conferring a special privilege, and although the statute must be conformed to, a liberal construction will be given to secure the relief intended.⁶

Statutes exempting insurance may be broadly classified within three main categories: (1, those exempting a limited amount of insurance, in amounts varying from \$5,000 to \$10,000;⁷ (2) those exempting insurance purchased with a limited amount of annual premiums, in amounts varying from \$250 to \$500;⁸ (3) those exempting all insurance effected in favor of another from the claims of creditors, most of which also provide that premiums paid in fraud of creditors are recoverable.⁹ The "proceeds and avails" of a policy has been interpreted, in a recent decision, to include cash surrender and loan values,¹⁰ and accumulated dividends which, unless withdrawn, must be paid to the beneficiary.¹¹ The statutes have varying qualifications as to the beneficiaries who may take advantage of

⁴Va. Code of 1936 (Michie) §§4219, 4258j.

⁵2 COUCH, CYCLOPEDIA OF INSURANCE LAW (1929) §330, p. 936.

⁶McMullen v. Shields (1934) 96 Mont. 191, 29 P. (2d) 652; Lubke v. Vonnekold (1947) 250 Wis. 496, 27 N.W. (2d) 458; 35 C.J.S. **Exemptions, §39.**

⁷Ariz., Minn., Miss., S. Dak.

⁸Calif., Idah, Mo., Mont., Nev., S. Car., Utah.

⁹Ala., Ark., Colo., Conn., Dela., Fla., Ga., Ill., Ind., Ia., Kan., Ky., La., Me., Md., Mass., Mich., Nebr., N. Hamp., N. J., N. Mex., N. Y., N. Car., N. Dak., Okla., Ohio, Ore., Pa., R. I., Tenn., Tex., Vt., Wash., W. Va., Wis., Wyo.

¹⁰Schwartz v. Seldon (C.C.A. 2nd, 1945) 153 F. (2d) 334.

¹¹Duberstein v. Keil (1937) 301 U. S. 708, 81 L. Ed. 1362, 573 S. Ct. 941, 88 F. (2d) 7, 33 Amer. Bankr. Rep. (N.S.) 324.

the exemption (generally limited to the widow and children and, in some, to dependent relatives). In interpreting the Illinois statute, the court decided that it did not save the proceeds of a policy from garnishment by a holder of judgments rendered on a note executed by the insured and his wife, the beneficiary.¹² Some of the statutes limit the exemption to proceeds of insurance paid by insurance companies domiciled within the state, and a few exempt the proceeds from the claims of creditors of the beneficiary. However, except for such minor variations, the statutes within a given class are comparatively uniform.

There is apparently considerable difference of opinion among the courts as to what constitutes a fraud on the creditors. Generally speaking, the question comes up in one of three ways: (1) change of beneficiary after insolvency (usually from the insured or his estate to his wife, children or a dependent relative), (2) insolvent debtor takes out a policy payable to a third person or pays further premiums or (3) premiums are paid wholly or in part with embezzled money.

According to Vance, in the absence of a statute to the contrary, it is generally held that a voluntary transfer by the insured when insolvent is to be conclusively presumed to be in fraud of creditors, and will be set aside. Among the cases holding that a change of beneficiary after insolvency is a fraud on creditors, one of the most prominent is *Navasso Guano Co. v. Cockfield*.¹³ In that case, at the point of death, the insured changed the beneficiary of a policy on his life from his personal representative to his brother. The insured was insolvent at the time. In holding this to be a fraudulent conveyance, the court said:

"The insured was chargeable with the results of his action, even if he lacked the intention of defrauding his creditors. The transaction under review was fraudulent as to creditors and must be so adjudged."

In supporting of its position, the court declared this to be the law of England, citing *Stokoe v. Cowan*¹⁴ and *Freeman v. Pope*.¹⁵ The *Navasso* case is not without support, especially from the earlier cases, which readily found a fraudulent conveyance if an insolvent debtor who had built up a policy payable to his own estate should exercise the power reserved under the change of beneficiary clause by making a donee the beneficiary.¹⁶

¹²Roth v. Kaptowsky (1946) 393 Ill. 484, 66 N.E. (2d) 664.

¹³(1918) 165 C.C.A. 363, 253 F. 883, 6 A.L.R. 1173.

¹⁴29 Beav. 637, 54 Eng. Reprint 775.

¹⁵L.R. 9 Eq. 206, 39 L.J.Ch.N.S. 148, 21 L.T.N.S. 816.

¹⁶Atena Bank v. Manhattan Life Co. (C.C.S.D.N.Y., 1885) 24 F. 769; Friedman v. Fennell (1892) 94 Ala. 570, 10 So. 649; Reynolds v. Aetna Life (1889) 160 N. Y. 635, 55 N.E. 305; Gould v. Fleitman (1919) 188 App. Div. 759, 176 N.Y.S. 631.

A comparatively recent Michigan case held that a change of beneficiary in an insurance policy may be a "conveyance" within the fraudulent conveyance statute to the extent of the cash surrender value,¹⁷ and a federal court held that if a debtor borrows money on a pledge of the policy, leaving himself with an asset in the shape of the surplus value of the policy over the loan, and then gratuitously transfers to his wife the right of redemption under the pledge, it is a fraudulent conveyance, provided the policy has a cash surrender value.¹⁸ However, in both cases, the policy had no surrender value, so the creditors could not recover.

Seemingly contra, but distinguishable from the foregoing, are the following cases. In the face of the Uniform Fraudulent Conveyances Act, which had extended the Statute of Elizabeth¹⁹ to any property "liable for any debts of the debtor," the change of beneficiary was said to be not a transfer of "property" when the policy has no cash surrender value, hence not a fraudulent conveyance.²⁰ In *First Wisconsin National Bank of Milwaukee v. Roehling*,²¹ it was held that a change of beneficiary was not such a transfer of property as could be a fraudulent conveyance, except as to the cash surrender value of the policy, in spite of a statute which protects the proceeds of life insurance from creditors "except in cases of transfer with intent to defraud creditors."²² These results would be proper under the operation of the National Bankruptcy Act, as the trustee in bankruptcy is limited to cash surrender value. However, being state decisions they indicate a tendency in some states to reach the bankruptcy solution.

On the other hand, a directly opposite position has been taken by a number of courts. A North Carolina statute which provides that every life policy "after its issue assigned, transferred, or in any way made payable to a married woman" inures to her separate use and benefit was held controlling so as to make valid the transfer of a policy taken out by a husband, payable to his estate, and later changed by substituting his wife as beneficiary, while he was insolvent, the policy itself having given the insured an option to change the beneficiary.²³ To similar effect are other

¹⁷*Equitable Life Assurance Society of U. S. v. Hitchcock* (1935) 270 Mich. 72, 258 N.W. 214, 106 A.L.R. 591; Note, **Fraudulent Conveyances**, 33 MICH. L. REV. 1108 (1935).

¹⁸*Union Central v. Flicker* (C.C.A. 9th, 1939) 101 F. (2d) 857.

¹⁹13 Eliz. c. 5 (1571).

²⁰*Equitable Life Assurance Society of U. S. v. Hitchcock*, *supra*.

²¹(1936) 269 N.W. 677.

²²Note, **Change of Beneficiary of Life Insurance Policy as a Fraudulent Conveyance**, 47 YALE L. J. 128 (1937).

²³*Pearsall v. Bloodworth* (1927) 194 N. Car. 628, 148 S.E. 303.

cases.²⁴ The Indiana court said, in *State v. Tomlinson*,²⁵ that a transfer of a policy to one having an interest in the life of the insured will not be regarded as in fraud of creditors unless an actual fraudulent intent is proved. On this same theory, when at the time of assignment the policy had no pecuniary value available to creditors, the assignment to a wife was held valid.²⁶ These decisions reflect the movement in recent years to protect the debtor's family, even at the expense of creditors. However, the majority of courts now, and probably the better view, will not require an actual fraudulent intent to be shown, even in states in which the Uniform Fraudulent Conveyances Act has not been adopted.

There is also considerable controversy as to whether the circumstances of an insolvent debtor taking out a policy payable to a third person or paying further premiums while insolvent is a fraud on creditors. An early and influential case was *Central National Bank v. Hume*.²⁷ In this case, the Supreme Court refused to allow the creditor to recover either the proceeds of the policy or the premiums paid while the deceased was insolvent unless fraudulent intent of both parties to the transaction should be made out, on the theory that a debtor should be reasonably allowed to protect his family from destitution after his death.²⁸ The decision has a substantial following among the later cases. Vance and Couch agree that it is supported by the weight of authority, although a note in 21 *Michigan Law Review* 937 says that it is not followed by the majority of the cases in the United States. The decisions for and against it will be considered at greater length in a later part of the article, but in point are two recent cases in which it was held that mere payment of premiums by the bankrupt on a life insurance policy designating his wife beneficiary during a four-year period in which he was insolvent was not sufficient to constitute a fraud on creditors within the meaning of the exemption statute as to "premiums paid in fraud of creditors,"²⁹ and to the same effect is *Re Berman*.³⁰

²⁴*Cole v. Marple* (1881) 98 Ill. 58, 38 Am. Rep. 83; *Pulsifer v. Hussey* (1903) 97 Me. 434, 54 A. 1076; *Bailey v. Wood* (1909) 202 Mass. 562, 89 N.E. 149; *Borg v. McCroskery* (1936) 120 N.J.Eq. 80, 184 A. 187; *Lytle v. Baldinger* (1911) 84 Ohio St. 1, 95 N.E. 389; *White v. Pacific Mutual Life Insurance Co.* (1928) 150 Va. 849, 143 S.E. 340.

²⁵(1897) 16 Ind. App. 662, 45 N.E. 1116.

²⁶*Provident Life and Trust Co. v. Fidelity Insurance Co.* (1902) 203 Pa. 82, 52 A. 34.

²⁷(1888) 128 U. S. 195, 32 L. Ed. 370, 9 S. Ct. 41, 88 Am. Dec. 530.

²⁸Isadore H. Cohen, **Creditors' Rights to Insurance Proceeds as Determined by Premium Payments**, 40 COLUM. L. REV. 975 (1940).

²⁹*Doethloff v. Penn Mutual Life Insurance Co.* (C.C.A. 6th, 1941) 117 F. (2d) 582, 45 Am. Bankr. Rep. (N.S.) 435, (writ of certiorari denied in *Gardner v. Doethloff* (1941) 313 U. S. 579, 85 L. Ed. 1536, 61 S. Ct. 1100).

³⁰(D.C.N.Y. 1940) 31 F. Supp. 926, 46 Am. Bankr. Rep. (N.S.) 407.

There is more nearly unanimity of opinion as to disposition of the proceeds when the premiums were paid wholly or in part with embezzled money, the courts generally agreeing that the money can be followed into the hands of the beneficiary, the main question being simply the amount that can be recovered. However, even in this situation, the burden is on the defrauded person to trace his funds into premiums before he can claim any interest in the proceeds.³¹ The Georgia court is largely unsupported in its interpretation of the exemption statute in *Bennett v. Rosbrough*³² as permitting the widow to retain all the proceeds although the premiums were paid during insolvency and from money apparently stolen from the plaintiffs. The Oregon court, on the other hand, has expressly declared that the statute does not apply to insurance taken out by the insured with funds of another to which he was not entitled.³³

A number of different solutions have been adopted for determining the rights of the creditor in the proceeds of insurance where the beneficiary was changed or the insurance was purchased while the insured was insolvent (by those courts which consider this a fraud on creditors), and their rights in insurance in excess of the statutory exemption. The early courts, in the absence of statute, generally held that an assignment or change of beneficiary, depriving the insured's creditor of an asset, was a fraudulent conveyance without more ado,³⁴ and the creditors were thereby entitled to claim the whole policy as a "trust fund."³⁵ The constructive trust theory was also applied in the *Fidelity Trust Co. v. Union National Bank of Pittsburgh* case.³⁶ Among other cases holding that under such circumstances the creditors shall receive the entire proceeds are *Gould v. Fleitman* and *Navasso Guano Company, supra*. However the courts gradually became dissatisfied with this result and sought to protect the insured's dependents. A definite break was made in deciding *Central National Bank v. Hume, supra*. In that case the United States Supreme Court applied what they considered a sound rule of public policy. This rule validated the transaction of a debtor taking out life insurance upon his own life unless fraud of both parties to the transaction was made out. This amounted to a plain graft upon the body of the law, but it responded to a sentiment which proceeded to definite effect in statutory

³¹*Bromley v. Cleveland Ry. Co.* (1899) 103 Wis. 562, 79 N.W. 741.

³²(1923) 155 Ga. 265, 116 S.E. 788, 26 A.L.R. 1397.

³³*Jansen v. Tyler* (1935) 151 Ore. 268, 27 P. (2d) 969.

³⁴*Aetna National Bank v. Manhattan Life Insurance Co., Stokes & Son v. Coffey, Reynolds v. Aetna Life Insurance Co., all supra.*

³⁵Note, **Creditors' Rights in Exempt Proceeds of Life Insurance Purchased During Insolvency**, 25 VA. L. REV. 588 (1939).

³⁶(1933) 313 Pa. 467, 169 A. 209.

expression.³⁷ In the *Hume* case, Chief Justice Fuller expressed the attitude of the court in the following words:

"This argument in the interest of creditors concedes that the debtor may rightfully preserve his family from suffering and want. It seems to us that the same public policy which justifies this, and recognizes the support of wife and children as a positive obligation in law as well as morals, should be extended to protect them from destitution after the debtor's death, by permitting him . . . to devote a moderate portion of his earnings to keep on foot a security for support already, or which could thereby be lawfully obtained, at least to the extent of requiring that, under such circumstances, the fraudulent intent of both parties to the transaction should be made out."

This decision has been sharply criticized, among others, by Williston, who says that by the common law an insolvent debtor could not convey his property to a volunteer so as to free it from the claims of creditors, and if exceptions are to be made they should be created by statute. However, despite criticism, it has been followed by many courts,³⁸ and is said by some to represent the majority view—that the insured, though insolvent, may devote a reasonable part of his income to the purchase of life insurance for the benefit of his family, and that in the absence of proof of fraudulent intent of both parties, the beneficiaries may retain the entire proceeds of such insurance.³⁹

When the creditors are entitled to a share of the proceeds, a great many of the courts allow them only the amount of premiums fraudulently paid, with interest.⁴⁰ This has been approved by text-writers, too, as probably the best rule inasmuch as it fully reimburses the debtor's estate and at the same time protects his dependents against want. The rule has found expression in the statutes of many of the states, which specifically provide that the creditor shall receive the amount of such premiums.⁴¹ A late New York decision, in an action to set aside, as fraudu-

³⁷GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* (Rev. ed. 1940) §177a, p. 322.

³⁸*Johnson v. Alexander* (1890) 125 Ind. 575, 25 N.E. 706; *Ross v. Minnesota Mutual Life Insurance Co.* (1923) 154 Minn. 186, 91 N.W. 428, 31 A.L.R. 46; *Irving Bank v. Henrietta P. Alexander* (1924) 280 Pa. 466, 124 Atl. 634, 34 A.L.R. 834.

³⁹35 C.J.S., *Exemptions*, §39.

⁴⁰*Hendrie Manufacturing Co. v. Platt* (1899) 13 Colo. App. 15, 56 P. 209; *Cole v. Marple*, *supra*; *Tolman v. Crowell* (1934) 288 Mass. 385, 193 N.E. 60.

⁴¹Ala., Ark., Colo., Conn., Del., Ga., Ill., Ky., Me., Mass., Mich., N. Hamp., N. Y., N. Car., Ohio, Ore., Wash., W. Va., Wis., Wyo.

lent, a designation of beneficiaries, held that plaintiff could not succeed except on a showing of intent to defraud creditors, and any recovery would be the amount of premiums paid with actual intent to defraud creditors, with interest, since under the statute an action based on constructive fraud may not be maintained.⁴² This theory has a substantial following, and has also been said to represent the weight of authority.⁴³

Another rule which has been advanced is that the creditors are entitled to the cash surrender value of the policy at the time of the transfer, on the theory that an insolvent debtor cannot make a fraudulent conveyance of that which did not exist during his lifetime. A leading case which supports this proposition is *Equitable Life Assurance Society of U. S. v. Hitchcock*, *supra*. The court there held that a creditor's right of recovery should be limited to the cash surrender value of a policy fraudulently transferred rather than the face amount of the policy paid the beneficiary, relying upon the statute as indicating a general policy to protect from the claims of creditors insurance taken out for the benefit of an insured's wife and children, even though it does not expressly exempt the proceeds of a policy originally payable to the estate of the insured and later transferred. (Note: the Michigan statute was later amended to provide that such a transfer is *prima facie* evidence of an intent to defraud creditors if a debt existed at the time.) A similar approach has been taken by other courts.⁴⁴ There is some authority for allowing the creditor the amount of insurance purchased with the excess premiums, but this theory has not been very well received.

The question has arisen as to whether state exemption statutes create an exemption within the meaning of Section 6 of the Bankruptcy Act, declaring that the act shall not affect the allowance to bankrupts of the exemptions prescribed by state laws in force at the time of filing the petition.⁴⁵ According to the prevailing view, such a state law creates an exemption in favor of the insured within the meaning of the Bankruptcy Act, so that the cash-surrender value does not pass to the trustee.⁴⁶ The beneficiary may thus look to the exemption statutes of his state to resist

⁴²*Levine v. Grey* (1947) 271 App. Div. 891, 67 N.Y.S. (2d) 87, 271 App. Div. 928, 68 N.Y.S. (2d) 430.

⁴³106 A.L.R. 600.

⁴⁴*Davis v. Cramer* (1918) 133 Ark. 224, 202 S.W. 239; *Mahood v. Maynard* (1935) 114 W. Va. 385, 171 S.E. 884.

⁴⁵BANKRUPTCY ACT OF 1898, AS AMENDED, §6, 11 U.S.C.A. §24.

⁴⁶*Re Messinger* (C.C.A. 2d, 1928) 29 F. (2d) 158; *Re Pinals* (1930; D. C.) 38 F. (2d) 117.

the claims of the insured's creditors or his trustees in bankruptcy.⁴⁷ In the interpretation of these statutes, the federal courts are governed by the interpretations of the highest court of that state. It is generally assumed that, apart from the special provisions in the Bankruptcy Act relating to insurance policies, such policies would pass as other non-exempt property of the bankrupt⁴⁸ under the clause of the Act which provides that powers which might have been exercised by the bankrupt for his own benefit shall vest in the trustee.

In the absence of state exemption statutes, when the bankrupt had a policy payable to his estate, the trustee took the policy as an asset, but the bankrupt might redeem it by paying the cash surrender value within 30 days after such value had been ascertained.⁴⁹ But if the policy contained a "change of beneficiary clause" then the trustee might exercise the power thus reserved, and make the estate the beneficiary.⁵⁰ On that same principle, it was held in *Re Solomons*⁵¹ that a reservation to the insured of the right to change the beneficiary had the effect of retaining in him the beneficial ownership of the policy during his lifetime, so that, on his bankruptcy, policies or their surrender value constituted assets of his estate. For additional citations see 103 A.L.R. 243 and 169 A.L.R.1380. However, if such a policy is exempt under state law, the rule established in *Cohen v. Samuels* does not apply, and the trustee has no right to the policy.⁵² And state legislatures, running true to form, are closing this gap by exempting policies payable to beneficiaries whether or not the right to change the beneficiary is reserved or permitted.

Throughout the development of the law as to rights to the proceeds of insurance policies has been an unmistakable trend in favor of the beneficiary. This has been evidenced both by the decisions of the courts and by recent legislative enactments apparently based on the social policy of preserving the family even at the expense of creditors.

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⁴⁷*Holden v. Stratton* (1905) 198 U. S. 202, 49 L. Ed. 1018, 25 S. Ct. 656; *Re Johnson* (1910; D. C.) 176 F. 591; *Re Hammells* (1925; D. C.) 5 F. (2d) 879; *Re Erstine* (1930; D. C.) 41 F. (2d) 559, 16 Am. Bankr. Rep. (N.S.) 346; *Re Goodchild* (1935; D. C.) 10 F. Supp. 491, 28 Am. Bankr. R pe (N.S.) 81.

⁴⁸*Lincoln National Life Insurance Co. v. Scales* (C.A.A. 5th, 1933) 62 F. (2d) 582, 22 Am. Bankr. Rep. (N.S.) 333; *Re Wark* (D.C.N.Y. 1936) 14 F. Supp. 915, 35 Am. Bankr. Rep. (N.S.) 724.

⁴⁹BANKRUPTCY ACT OF 1898, AS AMENDED, §70a, 11 U.S.C.A. §110a.

⁵⁰*Cohen v. Samuels* (1917) 245 U. S. 50, 62 L. Ed. 142, 38 S. Ct. 36.

⁵¹(1932; D. C.) 2 F. Supp. 572.

⁵²*Turner v. Bovee* (C.C.A. 9th, 1937) 92 F. (2d) 791, 35 Am. Bankr. Rep. (N.S.) 265.