Volume 45 | Number 3 Article 14

4-1-1967

Bankruptcy -- Exemptions -- Life Insurance Policies With Reserved Right to Change Beneficiary

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claiming personal liability and seeking the clients express authority in this situation may be the stitch in time that saved nine.

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Bankruptcy—Exemptions—Life Insurance Policies With Reserved Right to Change Beneficiary

The issue in *In Matter of Wolfe*[1] was whether cash surrender values of insurance policies on the life of the bankrupt were exempt from the claims of a trustee in bankruptcy. Both policies named the wife as beneficiary, but reserved to the bankrupt husband the absolute right to change the beneficiary. In claiming that the cash surrender values of the policies were exempt, the bankrupt relied on both statutory[2] and constitutional[3] provisions. The court held that the statute was a void attempt to extend the insurance exemption fixed in the constitution and that "the cash surrender values of . . . [the] policies are not exempt property under the Constitution . . . of North Carolina . . . ."[4]

As of the date of the filing of a bankruptcy petition, the trustee acquires title to all propery of the bankrupt[5] except that which is held to be exempt.[6] An insurance policy is property that would

[1] 249 F. Supp. 784 (M.D.N.C. 1966).

[2] The relevant portion of the statutory provision reads as follows:

> If a policy of insurance is effected by any person on his own life . . . in favor of a person other than himself . . . the lawful beneficiary . . . thereof, other than the insured or the executor or administrator of such insured . . . shall be entitled to its proceeds and avails against creditors and representatives of the insured . . . whether or not the right to change the beneficiary is reserved or permitted . . . .

N.C. GEN. STAT. § 58-206 (1965).

[3] The relevant portion of the constitution provides as follows:

> The husband may insure his own life for the sole use and benefit of his wife . . . and in case of the death of the husband the amount thus insured shall be paid over to the wife . . . for her . . . own use, free from all the claims of the representatives of her husband, or any of his creditors. And the policy shall not be subject to claims of creditors of the insured during the life of the insured, if the insurance issued is for the sole use and benefit of the wife . . . .

N.C. CONST. art. X, § 7.

[4] 249 F. Supp. at 786.

[5] Bankruptcy Act § 70(a), 52 Stat. 879(a) (1938), 11 U.S.C. § 110(a) (1964).

[6] "This title shall not affect the allowance to bankrupts of the exemptions which are prescribed . . . by the State laws . . . ." Bankruptcy Act § 6, 52 Stat. 847 (1938), 11 U.S.C. § 24 (1964).

pass to the trustee absent some exempting provisions.[7] When the insured reserves the right to change the beneficiary at will and could name his estate or representative as beneficiary, there is property that vests in the trustee.[8] However, if the policy or any rights or proceeds under it are exempt from the claims of creditors, the policy is exempt from the claims of the bankruptcy trustee.[9] Thus even though the right to change the beneficiary is reserved, the policy is not subject to the claims of the trustee if such a policy is exempt under state law.[10]

Prior to 1932 the North Carolina constitutional provision exempting insurance provided that on the death of the husband, the amount of insurance on his life payable to his wife should be paid to her free from the claims of the husband's creditors.[11] The constitution did not contain the provision that a policy issued for the benefit of a wife should be exempt from the claims of the husband's creditors during his life. However, the legislature had enacted a statute providing that when a policy was made payable to a married woman, it inured to her separate use and benefit.[12] In 1925 the

[7] Burlingham v. Crouse, 228 U.S. 459 (1913). See generally, Annots., 68 A.L.R. 1215 (1930), 103 A.L.R. 239 (1936), and 169 A.L.R. 1380 (1947).

The bankrupt may keep the policy alive and free from the claims of creditors by paying to the trustee an amount equal to the cash surrender value of the policy. The saving clause provides as follows:

> That when any bankrupt, who is a natural person, shall have any insurance policy which has a cash surrender value payable to himself, his estate, or personal representatives, he may . . . pay or secure to the trustee the sum . . . stated, and continue to hold, own, and carry such policy free from the claims of the creditors participating in the distribution of his estate under the bankruptcy proceedings, otherwise the policy shall pass to the trustee as assets . . . .

Bankruptcy Act § 70(a) (5), 52 Stat. 879(a) (5) (1938), 11 U.S.C. § 110 (a)(5) (1964). See Hiscock v. Mertens, 205 U.S. 202 (1907) (defining cash surrender value for purposes of this section).

[8] Cohen v. Samuels, 245 U.S. 50 (1917). The Bankruptcy Act gives the trustee title to powers which the bankrupt could exercise for his own benefit. Bankruptcy Act § 70(a)(3), 52 Stat. 879(a)(3) (1938), 11 U.S.C. § 110(a)(3) (1964).

[9] Holden v. Stratton, 198 U.S. 202 (1905). The bankrupt may commit acts that affect the insurance exemption. See Comment, 1961 DUKE L.J. 569.

[10] *In re* Messinger, 29 F.2d 158 (2d Cir. 1928).

[11] N.C. CONST. art. X, § 7 (1868). For a historical analysis of the North Carolina insurance exemption provisions and the cases thereunder, see Faris, *Exemption of Insurance and Other Property in the Virginias and Carolinas,* 17 WASH. & LEE L. REV. 19, 32-36 (1960) [hereinafter cited as Faris].

[12] N.C. GEN. STAT. § 58-205 (1965).

United States Court of Appeals for the Fourth Circuit in *Whiting v. Squires*[13] considered whether these provisions exempted from the claims of the trustee the cash surrender value of an insurance policy naming the bankrupt's wife as beneficiary, but reserving to the husband the absolute right to change the beneficiary. The court in *Squires* felt that such a construction of the statute[14] would confer an exemption beyond that allowed by the North Carolina constitutional provision. Thus the court held:

> The limit of the constitutional exemption . . . is that the wife or the wife and children take the benefits of a policy payable to her or them as beneficiaries at the death of the insured. The exemption may cover a policy payable to the wife and children with no power of the insured to change the beneficiaries, because in such a policy the wife or the wife and children have a vested interest, and the policy, if paid at all, must be paid to them at the death of the husband. But the exemption does not embrace the surrender value, the property of the husband, of a policy in which he can change the beneficiary at will.[15]

Subsequent to *Squires,* the constitutional provision was amended by adding a provision exempting the policy from the claims of the husband's creditors during his life if the policy was issued for the sole benefit and use of the wife.[16] At the same time the legislature added a statutory provision exempting the proceeds and avails of insurance policies, regardless of whether the right to change the beneficiary was reserved.[17]

It seems that the subsequent amendment and statute were intended to overcome the result in *Squires.*[18] Thus the basic issue before the court in the *Wolfe* case was whether this outcome was achieved. In the absence of a conflict with the constitutional provision, the statute would exempt the policy from the claims of the

[13] 6 F.2d 100 (4th Cir. 1925), *cert. denied,* 269 U.S. 587 (1925).

[14] Statutes similar to the one in question have been construed to exempt the cash surrender value even though the right to change the beneficiary is reserved. *E.g., In re* Reiter, 58 F.2d 631 (2d Cir. 1932); Magnuson v. Wagner, 1 F.2d 99 (8th Cir. 1924); *In re* La Tourette, 23 F. Supp. 631 (E.D. Mo. 1938); Brown v. Home Life Ins. Co., 3 F.2d 661 (E.D. Okla. 1925); Slurszberg v. Prudential Ins. Co., 192 Atl. 451 (N.J. 1936).

[15] Whiting v. Squires, 6 F.2d 100, 01-02 (4th Cir. 1925), *cert. denied,* 269 U.S. 487 (1925).

[16] N.C. CONST. art. X, § 7. See note 3 *supra.*

[17] N.C. Sess. Laws 1931, ch. 179, § 1, N.C. GEN. STAT. § 58-206 (1965). See note 2 *supra.*

[18] Faris at 36. See note 21 *infra.*

trustee.[19] However, the statutory provision must be considered in light of the North Carolina view that the legislature cannot by statute add to an exemption specified in the constitution.[20] The trustee's claim is ultimately resolved by determining whether the present constitutional provision allows exemption during the husband's life when the right to change the beneficiary is reserved. In reaching its result, the court in *Wolfe* concluded that the constitutional amendment did not overrule *Squires*.[21] It held that the wives and children are protected from the claims of the husband's creditors during his life only when the policies are for their *sole* benefit and that the provision does not exempt the policies when the bankrupt has the power to change beneficiaries.[22]

It seems the court felt that insurance is not for the sole benefit of the wife when the husband has the right to change the beneficiary.[23] In reaching the result in the *Wolfe* case, the court apparently assumed that this was the basis of the *Squires* decision. The true basis of the *Squires* decision, however, is that the exemption was granted only for the amounts to be paid over to the wife in the case of the husband's death.[24] The constitutional provision interpreted provided that *on the death of the husband,* "the amount thus insured shall be paid over to the wife . . . free from all claims of . . . creditors."[25] It appears that the cases relied on[26] by the

[19] *E.g., In re* Messinger, 29 F.2d 158 (2d Cir. 1928); *In re* Beckman, 50 F. Supp. 339 (N.D. Ala. 1943).

[20] Wharton v. Taylor, 88 N.C. 230 (1883). The case involved the validity of an attempt by the legislature to expand the homestead exemption beyond the limits specified in the state constitution. See Aycock, *Homestead Exemption In North Carolina,* 29 N.C.L. REV. 143, 144 (1951).

[21] 249 F. Supp. at 786.

> By reading the 1931 statutory amendment and the constitutional amendment together, there is reason to believe that the legislature did intend to limit the effect of the *Squires* case. So far as the constitutional amendment alone is concerned, however, the wording clearly falls short of overruling *Squires.* At the same time the statutory amendment seems to be just another unconstitutional attempt . . . at expanding the insurance exemption.

Faris at 36.

[22] 249 F. Supp. at 786.

[23] In determining the extent of the exemption granted by the amended constitutional provision, "the principal problem will be in determining what policies are for their *sole* benefit." Faris at 36.

[24] See text accompanying note 16 *supra.*

[25] N.C. CONST. art. X, § 7 (1868).

[26] Morgan v. McCaffrey, 286 F. 922 (5th Cir. 1923) (whenever any person shall die); *In re* Morgan, 282 F. 650 (S.D. Fla. 1922) (when person dies); *In re* Long, 282 F. 383 (S.D. Fla. 1918) (whenever any person dies).

Squires court involve construction of the scope of provisions purporting to exempt proceeds payable *at the death of the insured,* rather than a determination that insurance is not for the sole benefit and use of the beneficiary merely because the right to change is reserved.

It is submitted that the 1932 amendment does overrule the *Squires* decision. This is because the amendment purports to grant exemption during the life of the insured husband and, in addition, applies to the *policy* rather than the proceeds payable at death. Exemption of the policy itself should exempt the cash surrender value from the claims of the bankruptcy trustee.[27] Thus the result in *Wolfe* seems to be founded on the idea that the policy is not issued for the sole benefit of the wife if the husband retains the right to change the beneficiary. Such a restrictive construction, coupled with the modern practice of reserving the right to change beneficiaries,[28] would make the constitutional provision a virtual nullity. The insurance is for the benefit of the wife if, at the time of the bankruptcy, she is named as beneficiary and the power to change has not been exercised,[29] and reservation of the power to change the beneficiary should not deprive the policy of the characteristic of

[27] See *In re* La Tourette, 23 F. Supp. 631 (E.D. Mo. 1938). And where the provision purports to exempt the "proceeds and avails," the courts hold the cash surrender value is exempt. *E.g.,* Pearl v. Goldberg, 300 F.2d 610 (2d Cir. 1962); *In re* Messinger, 29 F.2d 158 (2d Cir. 1928); *In re* Beckman, 50 F. Supp. 339 (N.D. Ala. 1943).

[28] In refusing to hold that exemption is precluded by reservation of the right to change the beneficiary, courts have specifically referred to the prevalent tendency to include such reservations in modern insurance policies. See, *In re* Reiter, 58 F.2d 631 (2d Cir. 1932), Slurszberg v. Prudential Ins. Co., 192 Atl. 451 (N.J. 1936).

Very few of the policies now issued would qualify for exemption under the rule established in the instant case.

> [A]ll . . . policies as now issued contain provisions which, in effect, state that unless otherwise provided by endorsement to the policy, the insured is the *owner* of the policy. The *owner* of the policy possesses the right to change the beneficiary without the consent or approval of the beneficiary. . . . [I]t is believed that the *overwhelming majority* . . . of the policies issued in which the husband is the insured and the wife is named beneficiary, are those in which the insured—husband is the owner (rather than the beneficiary—wife). . . .

Letter From Robert H. Koonts to David S. Orcutt, March 13, 1967. (Mr. Koonts is Associate General Counsel for Jefferson Standard Life Insurance Company, Greensboro, N.C.)

[29] See *In re* Pittman, 275 Fed. 686 (E.D.N.C. 1921). Although Judge Connor was mistaken as to the power of the trustee to require the bankrupt to exercise a change of beneficiary, his test for determining if insurance is for the benefit of the wife seems to be the proper one.

being for the benefit of the wife.[30] Construction of the exemption provision should be such that it accomplishes its paramount purpose, the protection of the wife.[31] The decision of the district court in *Wolfe* defeats that purpose and is contrary to repeated holdings of bankruptcy referees in the state since the constitutional amendment and statute were added.[32] It has been suggested that the constitutional amendment only assures that policies of insurance on the life of the husband are exempt during his life if there is no reservation of the right to change the beneficiary.[33] Such a restrictive interpretation of the effect of the constitutional amendment credits the legislature with drafting and submitting to the people a constitutional amendment, and simultaneously enacting a statute in violation of that amendment.

While a decision of the North Carolina Supreme Court[34] could definitely establish the scope of the constitutional exemption, it is unpredictable when the court would be called upon to decide that question. A more immediate and effective way to overcome the unfortunate decision in *Wolfe* would be to amend the constitutional provision, making the insurance exemptions available in North Carolina similar to the exemptions allowed in other jurisdictions.[35] This could easily be accomplished by replacing the present language of the constitutional provision with the wording of North Carolina General Statute § 58-206.[36]

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[30] *E.g., In re* Reiter, 58 F.2d 631 (2d Cir. 1932); *In re* La Tourette, 23 F. Supp. 631 (E.D. Mo. 1938); Brown v. Home Life Ins. Co., 3 F.2d 661 (E.D. Okla. 1925); Slurszberg v. Prudential Ins. Co., 192 Atl. 451 (N.J. 1936).

[31] *E.g., In re* Reiter, 58 F.2d 631 (2d Cir. 1932); Slurszberg v. Prudential Ins. Co., 193 Atl. 451 (N.J. 1936).

[32] See the order of Referee Rufus W. Reynolds in the principal case. In his conclusions of law, the referee stated:

> The undersigned Referee for over nineteen years has been consistently and regularly recognizing the cash surrender of life insurance policies on the bankrupt to be exempt where the beneficiary is the wife or children of the bankrupt even though there is a reservation for a change of beneficiary.

Order of Rufus W. Reynolds, Referee in Bankruptcy, In Matter of Wolfe, Nos. B-35-65 & B-36-65 (M.D.N.C. 1965).

[33] Brief for Appellant, p. 4, In Matter of Wolfe, 249 F. Supp. 784 (M.D.N.C. 1966).

[34] The North Carolina court apparently has not considered the effect of the constitution and the statute in a situation where the creditor is seeking to attack the policy during the life of the insured husband.

[35] See Riesenfeld, *Life Insurance and Creditors' Remedies in the United States*, 4 U.C.L.A. L. REV. 583 (1957).

[36] (1965).