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Rights of Trustee in Bankruptcy to Cash Surrender Value of Insurance Policies of a Bankrupt

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STUDENT NOTES

RIGHTS OF TRUSTEE IN BANKRUPTCY TO CASH SURRENDER VALUE OF INSURANCE POLICIES OF A BANKRUPT

The present statutory provisions relating in terms to the trustee's right to a bankrupt's life insurance policies are contained in Section 70a of the National Bankruptcy Act as amended. The material part of that section provides:

> "The trustee of the estate of a bankrupt shall be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition in bankruptcy ., except insofar as it is to property which is held to be exempt, to all (5) property including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him .. *Provided,* 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, within thirty days after the cash surrender value has been ascertained and stated to the trustee by the company issuing the same, pay or secure to the trustee the sum so ascertained and 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."[1]

Even under this provision, the trustee is not vested with title to "property which is held to be exempt," and moreover this section must be construed in connection with Section 6 of the Act which provides:

> "This Act shall not affect the allowance to bankrupts of the exemptions which are prescribed by the laws of the United States or by the State laws in force at the time of the filing of the petition in the State wherein they have had their domicile for the six months immediately preceding the filing of the petition "[2]

Since the amended sections as set out above differ in no material respect from those sections as they appear in the Bankruptcy Act of 1898,[3] the cases construing the quoted provisions since their original enactment may still be taken as authoritative.

Referring to Section 6, it would seem clear, since there are no laws of the United States providing exemptions as against creditors

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[1] U.S.C. sec. 110a (1940)

11 U.S.C. sec 24 (1940).

In Section 70a5 "who is a natural person" was added; other changes were made in those sections which are unimportant here.

in the case of insurance policies, that in determining the status in bankruptcy of insurance policies on the life of the bankrupt the laws of the State of the bankrupt's domicile must be examined and given effect. However, the courts early found it necessary to deal with the problem of construing Section 6 along with Section 70a5. Section 70a5, if read alone, might seem to contain the whole law and the prophets on the status of insurance policies of the type therein dealt with, and an argument to that effect was made in *Holden* v. *Stratton*, decided in 1905, where the Supreme Court, through Mr. Justice White, determined the matter in the following language: " the purpose of the proviso [70a5] was to confer a benefit upon the insured bankrupt by limiting the character of the interest in a *non-exempt* life insurance policy which should pass to the trustee, and not to cause such a policy when exempt to become an asset of the estate."[4] (Italics writer's.) And it is now firmly established that the law of the bankrupt's domicile as interpreted by the state courts is the determining factor as to whether or not a life insurance policy is exempt.[5] Therefore, it is readily discernible that the variance in result obtained in the various courts when the problem arises as to who is entitled to the cash surrender value is not attributable to diversities of interpretation of the Bankruptcy Act but rather to differences in state law.

For the purpose of determining the rights of the trustee and of the insured bankrupt in policies held by the latter, they may be classified in two groups—policies not exempt by state law, and policies exempt by state law

POLICIES NOT EXEMPT BY STATE LAW

If the policy has a cash surrender value and is payable to the bankrupt, his estate, or his personal representatives, the trustee is entitled to it as an asset of the estate by virtue of Section 70a5.[6] Of course, under the same section the bankrupt may avail himself of the opportunity to pay or secure to the trustee the cash surrender value of the policy and retain it free from the claims of creditors participating in the distribution of the estate under the bankruptcy proceedings. But if the insurance policy does not have a cash surrender value[7] available as a cash asset, the policy does not pass to the trustee in bankruptcy and is exempted from operation of the Bankruptcy Act.[8]

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[4] 198 U.S. 202, 213, 49 L. Ed. 1018, 1022, 25 Sup. Ct. 656 (1905) Legg v St. John, 296 U.S. 489, 80 L.Ed. 345, 56 Sup. Ct. 336 (1936), Cooper v Taylor, 54 F 2d 1055 (C.C.A. 5th 1932)

[6] Cohen v. Samuels, 245 U.S. 50, 62 L.Ed. 143, 38 Sup. Ct. 36 (1917)

Hiscock v Mertens, 205 U.S. 202, 51 L.Ed. 771, 27 Sup. Ct. 488 (1907). (It was held that the cash surrender value of a life insurance policy need not be provided for by the policy, but it is sufficient if the policy has such value by concession or practice of the company.)

Mercer National Bank of Harrodsburg v. White's Ex'r., 236 Ky 128, 32 S.W 2d 734 (1930)

Even if the proceeds of a policy be not made payable to the bankrupt, his estate, or his personal representatives, as for example where made payable to his wife, the trustee in bankruptcy may nevertheless, under certain circumstances, succeed in obtaining the surrender value as an asset of the estate.[9] Section 70a3 of the Bankruptcy Act, sometimes called the "power clause," provides that powers which the bankrupt might have exercised for his own benefit shall in turn be vested in the trustee;[10] hence, if the bankrupt has the right to change the beneficiary and to surrender the policy for the cash value thereof, it will pass to the trustee as an asset of the estate upon his exercise of the power to change the beneficiary.[11] But where the policy does not reserve to the insured the right to change the beneficiary without the latter's consent,[12] or where the insured cannot himself be made the beneficiary under the terms of the policy,[13] or by state law,[14] the proceeds of the policy are not assets of the bankrupt's estate.

In *Massachusetts Mutual Life Insurance Co.* v. *Switow*,[15] the court held that a consideration of Kentucky's exemption statute was unnecessary, stating that the trustee's claim to the policy could not in any event prevail because the assent of the beneficiary was necessary to obtain the cash surrender value and, by the terms of the policy, neither the bankrupt, nor his estate, nor personal representative could be designated as beneficiary Therefore, both fundamental elements were missing—(1) the right to change the beneficiary, and (2) the right of the insured to receive the cash surrender value.

POLICIES EXEMPT BY STATE LAW

When Congress drafted the Bankruptcy Act, it sought to avoid impingement upon state sovereignty As a consequence, the act provided in Section 6 that the allowances to bankrupts of exemptions provided by state law should remain inviolate. Moreover, as we have seen, Section 70a also made an exception for "property which is held to be exempt."

Since the courts of the several states, as a rule, construe their respective exemption statutes liberally, Section 70a5, in many cases,

[9] Cohen v. Samuels, 245 U.S. 50, 62 L.Ed. 143, 38 Sup. Ct. 36 (1917).

[10] 11 U.S.C. sec. 110a3 (1940)

[11] Cohen v. Samuels, 245 U.S. 50, 62 L.Ed. 143, 38 Sup. Ct. 36 (1917). (The courts have completely disregarded the argument that the power to change the beneficiary is thought to be a personal right and have said, in effect, that the beneficiary may be changed by a simple declaration under the power clause, Section 70a3 of the Act.)

[12] *In re* Fetterman, 243 Fed. 975 (N.D. Ohio 1917)

[13] Massachusetts Mutual Life Insurance Co. v. Switow. 30 F Supp. 809 (W.D. Ky. 1940).

[14] *In re* Miller, 74 F 2d 86 (C.C.A. 8th 1934)

[15] 30 F Supp. 809 (W.D. Ky. 1940)

has been rendered powerless to protect creditors. However, the courts justify their liberal interpretation upon the basis of "the humane purpose of preserving to the unfortunate or improvident debtor or his family the means of obtaining a livelihood and prevent them from becoming a charge on the public."[16]

Many of the states have insurance exemption laws.[17] The Kentucky statutes, exemplary of statutes in effect in those states which are most liberal in this respect, are as follows:

> "(1) A policy of insurance on the life of any person expressed to be for the benefit of, or duly assigned, transferred or made payable to, any married woman, or to any person in trust for her, or for her benefit, by whomsoever such transfer may be made, shall inure to her separate use and benefit and that of her children, independently of her husband or his creditors or any other person effecting or transferring the policy or his creditors.
>
> "(3) If the premium on any policy mentioned in this section is paid by any person with intent to defraud his creditors, an amount equal to the premium so paid, with interest thereon, shall inure to the benefit of the creditors, subject to the statute of limitations."[18]
>
> "(1) When a policy of insurance is effected by any person on his own life or on another life in favor of some person other than himself having an insurable interest therein, the lawful beneficiary thereof, other than the person effecting the insurance or his legal representatives, shall be entitled to its proceeds against the creditors and representatives of the person effecting the same.
>
> "(2) Subject to the statute of limitations, the amount of any premiums for such insurance paid in fraud of creditors shall inure to their benefit from the proceeds of the policy "[19]

The Kentucky Court of Appeals has held that these statutory provisions, being in the nature of an exemption law, are to be liberally construed for the benefit of the insured's family[20]

The federal courts in Kentucky have long taken a similar view of the matter, and two outstanding cases reflect the operation of the Kentucky statute in bankruptcy proceedings. In 1908, in a case where the bankrupt's wife was the beneficiary of a policy which contained a clause providing that the insured could at any time change the beneficiary with the consent of the company, the Western District Court held that the cash surrender value was not an asset

[16] Hickman v. Hanover, 33 F 2d 873, 874 (C.C.A. 4th 1929).
[17] 1 COLLIER, BANKRUPTCY sec. 6.16 n. 2 (14th ed., Moore 1940)
[18] KY. R. S. (1946) 297.140.
[19] KY. R. S. (1946) 297.150.
[20] *See* Parks v Parks' Ex'rs., 288 Ky. 350, 353, 156 S.W 2d 90, 92 (1941)

of the bankrupt's estate and would not permit the trustee to bring it into the estate through an exercise of the "power clause."[21] In 1923, under circumstances similar to those of the previous case, the Eastern District Court held that an insurance policy in which two infant children were designated as beneficiaries was exempt.[22]

Smith v. *Metropolitan Life Insurance Co.*,[23] which involved an interpretation of a New Jersey exemption statute very similar to Kentucky's, is in accord. There it was held that policies of insurance which are exempt under the law of the state of the bankrupt's domicile are exempt under Section 6 of the Bankruptcy Act, even though they have a cash surrender value and the insured has power to change the beneficiary.[24]

Since the Kentucky statutes provide that any beneficiary who has an insurable interest in the bankrupt may hold the policy to the exclusion of the bankrupt's creditors, it seems that the exemption provisions of the Bankruptcy Act are not limited, in their application in Kentucky, to the protection of members of the bankrupt's immediate family. Clearly, blood relationship is not essential to the existence of an insurable interest. For example, in *Sandlin's Adm'x.* v. *Allen*,[25] the court held that a person has an insurable interest in the life of another person, when the death of that other person will cause him probable pecuniary loss, and when the survival of that other person will likely be of pecuniary advantage to him.

In conclusion, for the purpose of determining the status of an insurance policy of a bankrupt, it is imperative first to determine whether and to what extent the particular type of policy is exempt from the claims of creditors under the law of the state of the bankrupt's domicile. In making such latter determination, the statutes of such state, as interpreted by its courts, must be given effect by the bankruptcy court.

If the particular policy is not exempt, then whether or not the trustee in bankruptcy can obtain its cash surrender value as an asset of the estate will depend upon the following considerations: If the policy is payable to the bankrupt, his estate or his personal representatives, the policy will pass to the trustee subject to the right of the bankrupt to retain it by paying or securing to the trustee the cash surrender value as provided in Section 70a5 of the Bankruptcy Act. If the policy is payable to someone other than the bankrupt, his estate, or personal representatives, and if the insured does not have the right to change the beneficiary, the policy will in no event pass to the trustee in bankruptcy. But if the insured does have the right to change the beneficiary the trustee may

[21] *In re* Pfaffinger, 164 Fed. 526 (W.D. Ky 1908)
[22] *In re* Renaker, 295 Fed. 858 (E.D. Ky. 1923)
[23] 43 Fed. 2d 74 (C.C.A. 3d 1930).
[24] *Accord, In re* Bendall, 28 F 2d 999 (E.D. Mich. 1928), *In re* La Tourette, 23 Fed. Supp. 631 (E.D. Mo. 1938)
[25] 262 Ky. 355, 90 S.W 2d 350 (1936).

exercise that right in his stead by virtue of the "power clause," thus making it payable to the bankrupt's estate and thereby bringing it in as an asset in bankruptcy.

On the other hand, if the particular policy or rather the cash surrender value thereof, is found to be exempt under state law, then such cash surrender value will not pass to the trustee in bankruptcy as an asset of the estate, nor can he obtain it by changing the beneficiary under the so-called power clause, even though the bankrupt himself has the power to change the beneficiary

The Court of Appeals has stated that Kentucky's exemption statutes relating to insurance policies are to be liberally construed. Speaking generally the result of these statutes is that policies payable to others than the insured, his estate, or his personal representatives, are exempt from the claims of creditors even though the insured has the power to change the beneficiary.

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