Life Insurance Policies in Bankruptcy Proceedings

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LIFE INSURANCE POLICIES IN BANKRUPTCY PROCEEDINGS

An analysis of the reports of the Attorney General of the United States with respect to bankruptcy proceedings, as well as the recent discussions with respect to the enactment of the Chandler Act \(^1\) before the various Judiciary Committees of both the House of Representatives and the Senate, reveals that there has been a tremendous increase within recent years of the filing of petitions in bankruptcy, not only by professional men, but also by those not actually engaged in the conduct of business, such as wage earners, housewives, and others. In the bankruptcy proceedings of these individuals, as well as those engaged in business, the sole possible asset, in innumerable instances, has been life insurance policies of the bankrupt. Consequently, considerable litigation has arisen with respect to the status of the bankrupt's policies of insurance.

Since 1927 many states, undoubtedly motivated by the recent depressions and economic debacles, have enacted statutes for the purpose of exempting policies of insurance so as to place the same beyond the reach of the creditors of the insured.

The adoption of Section 55a and its corollary provisions—Sections 55 (b) and (c) of the Insurance Law—by the State of New York, has been followed by the passage of similar laws by many other states, including New Jersey, Pennsylvania and Massachusetts.

Sections 55a, 55b and 55c of the New York Insurance Law provide as follows:

Section 55a. Rights of creditors and beneficiaries under policies of life insurance.

If a policy of insurance, whether heretofore or hereafter issued, is effected by any person on his own life or on another life, in favor of a person other than

\(^{1}\) Enacted June 22, 1938, effective Sept. 22, 1938. The Chandler Act is a complete revision of the Bankruptcy Act and all amendments thereto since its adoption in 1898.
himself, or, except in cases of transfer with intent to defraud creditors, if a policy of life insurance is assigned or in any way made payable to any such person, the lawful beneficiary or assignee thereof, other than the insured or the person so effecting such insurance, or his executors or administrators; shall be entitled to its proceeds and avails against the creditors and representatives of the insured and of the person effecting the same, whether or not the right to change the beneficiary is reserved or permitted, and whether or not the policy is made payable to the person whose life is insured if the beneficiary or assignee shall predecease such person; provided, that, subject to the statute of limitations, the amount of any premiums for said insurance paid with intent to defraud creditors, with interest thereon, shall enure to their benefit from the proceeds of the policy; but the company issuing the policy shall be discharged of all liability thereon by payment of its proceeds in accordance with its terms, unless before such payment the company shall have written notice, by or in behalf of a creditor, of a claim to recover for transfer made or premiums paid with intent to defraud creditors, with specification of the amount claimed.2

Section 55b. Exemption of disability insurance from execution.

No money or other benefit paid, provided or allowed or to be paid, provided or allowed by any stock or mutual life, health or casualty insurance corporation on account of the disability from injury or sickness of any insured person shall be liable to execution, attachment, garnishment, or other process, or to be seized, taken, appropriated or applied by any legal or equitable process or operation of law, to pay any debt or liability of such insured person whether such debt or liability of such insured person was incurred before or after the commencement of such disability, but this

2 In effect March 31, 1927.
section shall not affect the assignability of any such
disability benefit otherwise assignable, nor shall this
section apply to any money income disability benefit
in an action to recover for necessaries contracted for
after the commencement of the disability covered by
the disability clause or contract allowing such money
income benefit. 3

Section 55c. Rights of creditors and beneficiaries
under annuity contracts.

If under an annuity contract, whether heretofore or
hereafter issued, the person who paid the considera-
tion for such contract shall be entitled to any benefits,
rights, privileges, or options, such benefits, rights,
privileges or options shall not be subject to legal proc-
есс, nor shall such person be compelled to exercise any
such rights, privileges or options, except where such
consideration has been paid with intent to defraud
creditors. But where such person is actually receiv-
ing periodic payments under such annuity contract,
such periodic payments shall be subject to garnishee
execution pursuant to the provisions as to such execu-
tion contained in the civil practice act, and the sur-
plus of such periodic payments beyond the sum neces-
sary for the education and support of such person,
shall be liable for the claims of his creditors in the
same manner as other such property which cannot be
reached by execution. The creditors of the person who
paid the consideration for any such annuity contract
shall have no right to subject to legal process the bene-
fits, rights, privileges or options accruing thereunder
to any beneficiary or assignee, other than the person
who paid such consideration, nor shall they compel
such beneficiary or assignee to exercise any such rights,
privileges or options, except where such consideration
has been paid or such assignment made with intent to
defraud creditors. The benefits, rights, privileges or
options accruing under such contract to such benefi-

3 In effect May 14, 1934.
ciary or assignee shall not be transferable, nor subject to commutation, nor to legal process by the creditors of such beneficiary or assignee, except in an action to recover for necessaries, if the parties to such annuity contract so agree.

An annuity contract within the meaning of this section shall be any obligation to pay certain sums at stated times during life or lives, or for a specified term, or terms, issued for a valuable consideration, regardless of whether or not such sums are payable to one or more persons, jointly or otherwise, regardless of whether or not such consideration is payable in one amount or in installments, and regardless of whether or not, in addition to, or in lieu of, such certain sums payable at stated times, further sums shall be payable at the end of such life or lives, or term or terms, or any other time or times. 4

As a result of these statutes, as well as the similar statutes in the other states, numerous questions have arisen as to the status of the bankrupt's policies of insurance in bankruptcy proceedings.

I.

RIGHTS OF TRUSTEE IN BANKRUPTCY.

The rights of a trustee in bankruptcy in and to the policies of insurance of a bankrupt are fixed and limited by the provisions of Section 70a, subdivisions 3 and 5, of the Bankruptcy Act, the provisions of which were unaffected by the Chandler Act.

Section 70a, subdivisions 3, 5, provides as follows:

Section 70a: "The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of

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4 In effect April 25, 1935.
the bankrupt as of the date of the filing of the petition in bankruptcy or of the original petition proposing an arrangement or plan under this Act, except insofar as it is to property which is held to be exempt, to all

“(3) Powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person;

“(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, or otherwise seized, impounded, or sequestered: Provided, That rights of action ex delicto for libel, slander, injuries to the person of the bankrupt or of a relative, whether or not resulting in death, seduction, and criminal conversation shall not vest in the trustee unless by the law of the State such rights of action are subject to attachment, execution, garnishment, sequestration, or other judicial process: And provided further, 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; * * *.”

In the absence of exemption statutes, the trustee in bankruptcy succeeds to all the rights of the bankrupt-insured in his policies of insurance, and these rights are the same whether the policy is payable to the insured, his estate or to
a third party beneficiary where he reserves the right to change the beneficiary.\(^5\)

In *Cohen v. Samuels*\(^5\)a the trustee sought to obtain the cash surrender value of the policies of insurance of the bankrupt as of the date of adjudication. The policies were payable to third parties as beneficiaries, reserving to the bankrupt the right to change the beneficiary. Upon the question as to the right of the trustee to obtain the cash surrender value of the policies, the court said:

"* * * The policies had a cash surrender value at the time Samuels was adjudicated a bankrupt which the companies were willing to pay to him, and in all of them he had the absolute right to change the beneficiaries.

"The question in the case is the simple one of the construction of § 70a. By it the trustee of the bankrupt is vested by operation of law with title to all property of the bankrupt which is not exempt * * *.

"* * * The declaration of subdivision 3 is that 'powers which he might have exercised for his own benefit' 'shall in turn be vested' in the trustee, and there is vested in him as well all property that the bankrupt could transfer or which by judicial process could be subjected to his debts, and especially as to insurance policies which have a cash surrender value payable to himself, his estate or personal representative. It is true the policies in question here are not so payable, but they can be or could have been so payable at his own will and by simple declaration. Under such conditions to hold that there was nothing of property to vest in a trustee would be to make an insurance policy a shelter for valuable assets, and, it might be, a

\(^5\) Cohen v. Samuels, 245 U. S. 50, 38 Sup. Ct. 36 (1917); Cohn v. Malone, 248 U. S. 450, 39 Sup. Ct. 141 (1919); In re Messinger, 29 Fed. 158 (C. C. A. 2d, 1928) (though the policies were not payable to the bankrupt, the Supreme Court had, held the cash surrender value of the same was an asset passing to the trustee, as the bankrupt had the power, by reason of the reservation in the policies, to make them payable to himself); Hickman v. Hanover, 33 F. (2d) 873 (C. C. A. 4th, 1929); In re La Tourette, 23 F. Supp. 631 (E. D. Mo. 1938).

\(^{a}\) 245 U. S. 50, 38 Sup. Ct. 36 (1917).
refuge for fraud. And our conclusions would be the same if we regarded the proviso alone.

"This court has been careful to define the interest of bankrupts in the insurance policies they may possess. In Hiscock v. Mertens, 205 U. S. 202, we gave a bankrupt the benefit of the redemption of a policy from the claims of creditors, though a cash surrender value was not provided by it, but was recognized by the insurance company. In Burlingham v. Crouse, 228 U. S. 459, 473, we said that it 'was the purpose of Congress to pass to the trustee that sum which was available to the bankrupt at the time of bankruptcy as a cash asset, otherwise to leave to the insured the benefit of his life insurance.'"

However, in view of the enactment of the exemption statutes by the various states and the prevailing custom of making the policies of insurance payable to a named beneficiary, which, in most instances, is either the spouse or the children of the insured, the foregoing decision has been rendered ineffective. The decision can only be invoked when no exemption statute exists, or if there is such a statute, when the policy of insurance is payable to the insured or his estate. In the event the decision is applicable, the trustee in bankruptcy is vested with title only to the cash surrender value of the policy of insurance as of the date of the filing of the petition in bankruptcy. However, irrespective of whether any exemption statute exists, no rights pass where the bankrupt does not reserve the right to change the third

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8 Burlingham v. Crouse, 238 U. S. 459, 33 Sup. Ct. 564 (1913); Cohen v. Samuels, 245 U. S. 50, 38 Sup. Ct. 36 (1917); Frederick v. Fidelity Mutual Life Ins. Co., 256 U. S. 395, 41 Sup. Ct. 503 (1921); In re Gannon, 247 Fed. 932 (C. C. A. 2d, 1917), wherein the court held that industrial insurance, without cash surrender value, did not pass to the trustee in bankruptcy, even in the absence of exemption statutes; In re Samuels, 254 Fed. 775 (C. C. A. 2d, 1918), where it was held that the test of "surrender value" was whether the policy had a present cash value available to the insured bankrupt in accordance with the fixed method and by the exercise of his own unassisted will; In re Greenberg, 271 Fed. 258 (C. C. A. 2d, 1918); In re American Range & Foundry Co., 14 F. (2d) 308 (D. C. Minn. 1926) (where the policy was not exempt, the trustee was entitled to the cash surrender value, even though the premiums upon the policy had been paid by the wife as beneficiary); In re Weisman, 10 F. Supp. 312 (S. D. N. Y. 1934); In re Brecher, 19 F. Supp. 283 (S. D. N. Y. 1937).
party beneficiary, since the latter has a vested interest in the policy which is exempt from the claims of the trustee and creditors.\(^7\)

The trustee’s rights cannot be enlarged by any act or change of circumstances after the filing of the petition in bankruptcy. If the bankrupt, with policies of insurance payable to himself or his estate, or to a third party beneficiary, dies after the filing of the petition but before the adjudication of bankruptcy, the trustee is nevertheless only entitled to the cash surrender value of the policies at the time of the filing of the petition.\(^8\) If at the time of the filing of the petition in bankruptcy, the policy of insurance had no cash surrender value either because of outstanding loans, extended insurance or the pledge of the same with some creditor, no interest in the policy passes to the trustee in bankruptcy, notwithstanding the bankrupt’s subsequent death or the redemption and reinstatement of the policy by the bankrupt.\(^9\)

The bankrupt, the beneficiary, the assignee or pledgee of the policy have the absolute right to preserve the policy by paying to the trustee the cash surrender value to which the trustee is entitled, and on such redemption to hold the policy free of all claims of the trustee in bankruptcy.\(^10\) However, where a policy is owned or held by a bankrupt as assignee, it is not exempt, and the policy itself, and not merely its cash surrender value, passes to the trustee in bankruptcy.\(^11\)

It is important to note that by reason of the express language of Section 70a, subdivision 5, of the Bankruptcy Code.

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\(^7\) Central National Bank of Washington v. Hume, 128 U. S. 195, 9 Sup. Ct. 41 (1898); In re Samuels, 254 Fed. 775 (C. C. A. 2d, 1918); In re Majors, 241 Fed. 538 (D. C. Ore. 1917); In re Fetterman, 243 Fed. 975 (N. D. Ohio 1917); In re Weish, Dudley & Bracker, 2 Am. B. R. (n. s.) 258 (S. D. N. Y. 1923).


Act, if creditors do not participate in the distribution of the assets of the bankrupt estate by not filing or by withdrawing their claims, they may subject the proceeds of a non-exempt policy in the hands of the beneficiary to the payment of their claims.\textsuperscript{12}

Where the beneficiary of the policy is the bankrupt and the insured does not have the right to change the beneficiary, the vested interest of the bankrupt passes to the trustee. This interest includes not merely its cash surrender value, but also the right to the proceeds of the policy, as the policy itself passes to the trustee.\textsuperscript{13} The same right passes to the trustee where the policy is on the life of an officer of a bankrupt corporation and the corporation is the beneficiary. Such a policy is not exempt under the state laws.\textsuperscript{14}

Where a policy of insurance is not exempt, the insurance company cannot refuse to consent to the surrender value being paid to the trustee in bankruptcy.\textsuperscript{15}

The bankruptcy court has summary jurisdiction over the trustee’s application to determine whether the bankrupt’s policies are exempt and the beneficiary cannot be heard to object to the summary jurisdiction of the referee to determine the issues.\textsuperscript{16}

II.

EXEMPTION STATUTES AND RIGHTS OF TRUSTEE THEREUNDER.

The exemption statutes, the rights granted thereunder to the bankrupt, and the status of his policies of insurance

\textsuperscript{15} Cohen v. Samuels, 245 U. S. 50, 38 Sup. Ct. 36 (1917); In re Samuels, 245 F. Supp. 775 (C. C. A. 2d, 1918); In re Greenberg, 271 Fed. 258 (C. C. A. 2d, 1918); In re Reiter, 58 F. (2d) 631 (C. C. A. 2d, 1932).
must be determined by the state laws and the construction placed thereon by the highest state court, which construction is binding upon the bankruptcy court.\(^1\) In *Harrison v. Miller*\(^2\) the court upon the question of the effect and interpretation of the state statute exempting policies of insurance, said:

“The matter of exemption is to be determined by the State laws, and in determining what construction is to be placed upon a state statute, this Court will be guided by the construction placed thereon by the Supreme Court of the State.”

The bankruptcy courts afford recognition to the state exemption statutes by reason of the provisions of Section 6 of the Bankruptcy Act, which now provides as follows:

Section 6: “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, or for a longer portion of such six months than in any other State: Provided, however, That no such allowance shall be made out of the property which a bankrupt transferred or concealed and which is recovered or the transfer of which is avoided under this Act for the benefit of the estate, except that, where the voided transfer was made by way of security only and the property recovered is in excess of the amount se-
cured thereby, such allowance may be made out of such excess."

In *Matter of Messinger*, which is probably the leading case upon the construction and effect of exemption statutes, and particularly the status of the bankrupt's policies of insurance under Section 55a of the New York Insurance Law, the Circuit Court of Appeals for the Second Circuit laid down the general rules to be applied. In that case the bankrupt had two policies of insurance payable to his wife as beneficiary, in which he had reserved the right to change the beneficiary. The trustee sought to obtain the cash surrender value of the policies as of the time of the filing of the petition, and the bankrupt claimed the policies were exempt under Section 55a. In holding the policies were exempt the court said:

"Section 70a of the Bankruptcy Act (11 U. S. C. A., § 110a) determines the disposition of life insurance policies, so far as they may not come within the exemptions under state laws which are permitted by section 6, supra. * * *

"The statute does not exempt the bankrupt if he exercises his reserved power to change the beneficiary for his personal advantage, and, indeed, precludes an exemption in such case by saying that the 'beneficiary * * * other than the insured' shall be entitled to the proceeds and avails. But it plainly does attempt to exempt the 'proceeds and avails' so far as beneficiaries, other than the bankrupt, may have an interest in the policy. It does not protect the insured against his creditors, and only seeks to prevent them from affecting the rights of the beneficiaries other than himself. While the insured may still change the beneficiary, and appoint to himself under the reserved power, by reason of the New York Insurance Law, he cannot be compelled to do this, as he would have been

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2. Id. at 159.
prior to the enactment of Section 55a, because, to do so would deprive the beneficiaries of their interest. Thus there is an allowance of an exemption to the bankrupt to the extent of the right of the trustee to compel him to exercise the reserved power. While the benefit inures directly to the beneficiary and not to the bankrupt, yet it is an exemption of the bankrupt himself to the extent indicated. * * *

"** Section 55a of the State Insurance Law took effect March 31, 1927. It is unlikely that there were not creditors existing at that time, seeing that bankruptcy followed so soon after. To the creditors whose claims arose prior to the passage of the law, it would not apply.

"In view of the foregoing considerations, the order of the District Court is modified, so as to provide that the trustee in bankruptcy shall be entitled to the cash surrender value of the policies to the extent of the proved claims of creditors, if any, which existed on March 31, 1927, and also so as to provide that, if the bankrupt shall at any time exercise his power to change the beneficiary for his personal advantage, the cash surrender value shall constitute unadministered assets of the bankrupt estate. As thus modified, the decree is affirmed."

This case has been followed in all subsequent decisions of the Circuit Court of Appeals for the Second Circuit and by the other Circuit Courts of Appeal and District Courts.21

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As a result, exemption statutes have been construed so as not to operate retroactively.\textsuperscript{22}

The rights of the insured and beneficiary under a policy of insurance must be determined as of the date the policy was issued,\textsuperscript{23} and the effective date of the policy is the one stipulated therein.\textsuperscript{24} However, where the policy is ante-dated, but on issuance it provides that it relates back to the time of the application and is so dated, that is the effective date of the policy.\textsuperscript{25}

Prior to the decision \textit{In re Gordon},\textsuperscript{26} there was considerable doubt as to whether policies of insurance of the bank-
rupt issued after the enactment of the state exemption statute, were exempt as to creditors whose claims antedated the enactment of such statute. The Gordon decision resolved many of these open questions with respect to the status of policies of insurance and the rights of creditors therein. The bankrupt had four policies of insurance, of which his wife was the beneficiary, but in all of which the right to change the beneficiary had been reserved. Three of the policies were issued on March 31st, 1927, prior to the enactment of Section 55a of the New York Insurance Law. One of the policies was issued on January 8, 1930. The claims of the creditors of the bankrupt had accrued prior to the enactment of the statute and the lower court held that by reason thereof the policies issued prior to its enactment were not exempt, and that the cash surrender value of said policies passed to the trustee in bankruptcy as assets of the bankrupt estate. The lower court held, however, that the policy issued subsequent to Section 55a was exempt. On appeal, the bankrupt urged that all the policies were exempt, as the claims of creditors were based upon notes executed after the statute in payment of obligations that arose prior to its enactment. In holding all policies not to be exempt, the court said: 27

"There was evidence sufficient to justify the District Court in finding that the note held by the creditor for $23,847.65 succeeded earlier notes given for indebtedness which accrued prior to the enactment of Section 55a. The fact that these prior notes, except to the extent of $5,150 were marked 'paid' does not require us to hold that the earlier indebtedness represented by these notes was extinguished. No agreement to cancel it was established, nor was such an agreement at all probable. Indeed we think it was disproved. All the notes were simply evidence of loans, and the creditor was, therefore, entitled to take the position that the claim it relied on existed prior to the enactment of Section 55a. * * *

"A creditor may resort to the cash surrender value of any life insurance policies of his debtor merely by

27 Id. at 585.
proving that he was a creditor before any exemption statute was enacted. ** **.

"But we find no decisions of the Supreme Court or of the highest courts of the state distinguishing between policies issued prior to the passage of exemption laws and those issued after. In Nelson v. McCrary, 60 Ala. 301, such a distinction was repudiated in respect to a homestead exemption where the land in question was purchased after the enactment of the statute creating the exemption. ** **.

"If the distinction between policies taken before the enactment of the exemption statute and after it were tenable, we should expect that in the former contingency the courts would have allowed trustees in bankruptcy to reach only the cash surrender value at the date of the enactment and not the value accrued to the date of bankruptcy. Yet we believe that the value at the time of bankruptcy has always been payable in those cases to the trustee.

"** ** Many a man who becomes insolvent has little or nothing except the cash surrender value of an insurance policy, often of substantial worth. A distinction between policies issued before and after the passage of an exemption act is not tenable if in either case there are preexisting creditors. Such a distinction would be based upon mere speculation and, if indulged in, to justify an exemption would seem to involve a result against the general weight of authority. Indeed, it is hard to distinguish between an investment in life insurance and a deposit in a savings bank." 28

Under the Pennsylvania statutes, when a policy is exempt, a loan made against the cash surrender value by the bankrupt after the filing of the petition, is exempt and free

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28 Associated Indemnity Corp. v. Chais, 161 Misc. 763, 293 N. Y. Supp. 280 (1936), holding Section 55b applicable to policies written before as well as after statute enacted, but not to impair constitutional rights of creditors. Contra: Cecilian Operating Corp. v. Berkwit, 151 Misc. 814, 272 N. Y. Supp. 291 (1934); In re Beach, 8 F. Supp. 910 (D. C. Mass. 1934), holding that policies issued after the enactment of the exemption statute are exempt.
from the claims of the trustee. 29 The Florida statutes have been construed in accord with those of Pennsylvania. 30

The Pennsylvania and Florida cases are contra to the New York decisions, which hold that where the bankrupt avails himself of the cash surrender value by a loan upon the policy after the filing of the petition, the cash surrender value of the policy (as of the date of filing of the petition in bankruptcy) passes to the trustee in bankruptcy. 31 The courts of New York have also held that where the policy was issued originally payable to the bankrupt or to his executors, administrators or assigns, it cannot subsequently be converted into an exempt policy by changing the beneficiary to a third party. 32 It is submitted that this rule is too harsh for there is no logical reason why a policy cannot be claimed to be exempt if the change in beneficiary is made while the bankrupt-insured has no creditors. 33 This suggestion would give the protection of the statute to the bankrupt, and would not be in conflict with the rule pronounced in In re Gordon and In re Messinger (that a creditor has a right to resort to any present and future property of his debtor), 34 since, if

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33 Cf. In re Phillips, 7 F. Supp. 807 (D. C. Pa. 1934), wherein it was held that under the Pennsylvania statute, policies of insurance originally payable to executors, administrators and assigns of the bankrupt, where the bankrupt changed the beneficiary to a trust company as trustee under a trust agreement for the benefit of his family, the cash surrender value of such a policy was exempt from all claims of creditors; Hays v. Harris, 78 F. (2d) 66 (C. C. A. 8th, 1935) (where a policy of insurance was exempt as against the trustee in bankruptcy of partnership though policy was issued on life of a partner and partnership was the beneficiary, where the beneficiary was changed to the partner's wife, long prior to the bankruptcy and while partnership was solvent). But see Navassa Guano & Co. v. Cockfield, et al., 253 F. 883 (C. C. A. 4th, 1918) (holding that a change in beneficiary in anticipation of approaching death was in fraud of creditors so that the policy was not exempt).
the change is made while the bankrupt-insured has no creditors, none of their rights can be impaired.

As has heretofore been indicated, policies of insurance are not exempt with respect to debts existing at the time of the enactment of the exemption statutes. Hence, the cash surrender value of policies of insurance, at the time of the filing of the petition in bankruptcy, passes to the trustee in bankruptcy where the claims of creditors antedated the enactment of the state exemption law. However, in such instances the cash surrender value passes to the trustee to be distributed solely to those creditors whose claims arose prior to the exemption statute, and not to the general body of creditors.

If the policies of insurance are surrendered by the bankrupt prior to the filing of the petition in bankruptcy, the right to retain the cash surrender value of the policies will depend upon the manner of its disposition. "Proceeds and avails" of a policy has been defined to include its cash surrender value, and where the same is paid directly to the beneficiary of the policy, it is exempt and free from the claims of the trustee and creditors. Where, however, the cash surrender value is paid to the bankrupt-insured, it is not exempt and the proceeds pass to the trustee in bankruptcy. If the cash surrender value is turned over directly to the beneficiary, either by the insured or the company, it is exempt; if it is availed of by the bankrupt even for the purpose of buying property or shares of stock in the name of the beneficiary,

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35 In construing when the claims of creditors accrued and when they attained their status as pre-existing obligations, the rule has been laid down that the claim of a creditor secured by collateral or mortgage prior to March 31, 1927, but based upon an obligation that arose prior thereto, was a pre-existing obligation as to which the policy of insurance was not exempt. Kest v. Bassin, 78 F. (2d) 705 (C. C. A. 2d, 1935); In re Jeroloman, 6 F. Supp. 430 (S. D. N. Y. 1934); In re Gordon, 90 F. (2d) 584 (C. C. A. 2d, 1937).


it is not exempt. Even though the trustee in bankruptcy has obtained the cash surrender value of the policy from the company, the beneficiary can collect upon the policy where it is exempt.

III.

DISABILITY INSURANCE.

Disability insurance (ordinarily a supplementary contract to the life insurance policy) and the benefits payable thereunder, have been held to pass to the trustee in bankruptcy, unless the same are specifically exempted by the law of the state of the domicile of the bankrupt. This question was authoritatively settled in Legg v. St. John, where the United States Supreme Court said:

"* * * As Legg had become totally and permanently disabled before the adjudication, the company’s obligation to make benefit payments monthly thereafter was property of the bankrupt which passed to the trustee, unless specially exempted by the law of Tennessee, or by § 70a of the Bankruptcy Act (11 U. S. C. A. § 110a). It was not exempted by § 70a, because the obligation to pay disability benefits is not ‘insurance’ within the meaning of that section. The term ‘insurance’ as there used referred only to legal reserve...

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life insurance, the kind of insurance to which a case surrender value was a common incident. * * *

"* * * The obligation of the company to pay disability benefits in the future is not after-acquired property. It is property which was acquired by Legg long before the adjudication, and fully paid for by the premiums paid before the adjudication. Nor are the benefits payable after the adjudication in any sense future earnings. They are not the fruit of anything to be done by Legg after the adjudication. The right to receive disability benefits in the future does not differ from any other right acquired before adjudication to receive money thereafter. It is in essence an annuity purchased and paid for prior to the adjudication. Like other property, it passed to the trustee, unless exempted by the law of the bankrupt's domicile."

In New York the disability benefits payable under a policy of insurance were likewise held not to be exempt under Section 55a of the Insurance Law. Upon the enactment of Section 55b the courts construed that section similarly to Section 55a, holding that the exemption granted thereunder applied solely to claims of creditors arising after the enactment of the statute and had no retroactive effect upon the claims of creditors.41

The analysis of the cases indicates that it is only where the disability arose so that the right to payments under the disability clause of the contract became effective or invoked prior to the filing of the petition in bankruptcy, that the disability benefits pass to the trustee in bankruptcy. It would seem, therefore, and it has been so held, that where the bankrupt was not disabled at the time of the filing of the petition


in bankruptcy and no claim for disability benefits had been presented, the independent or separate contract of disability insurance does not pass to the trustee in bankruptcy.\textsuperscript{42}

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\textbf{IV.}

\textbf{Annuity Insurance.}

Where the state statute specifically exempts annuity contracts of insurance from the claims of creditors, as in ordinary life insurance policies, the annuity contract is exempt and does not pass to the trustee in bankruptcy even though the beneficiary's rights might be divested by the bankrupt by change of beneficiary, by the surrender of the policies or by his survival to the maturity of the policy.\textsuperscript{43}

In some jurisdictions annuity contracts have been held not to be exempt.\textsuperscript{44} The status of this type of policy must be determined by the state exemption statute. In Ohio, it was held that a group annuity contract is not life insurance, and unless specifically exempted by the state statute, the cash surrender value of such a policy passed to the trustee in bankruptcy, upon the ground that such a contract was in effect nothing more than an investment and savings plan, and was not life insurance nor an annuity upon life.\textsuperscript{45} In Minnesota, where the exemption statute is similar to Section 55a of the New York Insurance Law, it was held that if the statute exempts in whole or in part the avails of the annuity policies, the court is required to give the bankrupt the benefit of the statutory exemption. In \textit{In re Walsh},\textsuperscript{46} a very well-considered opinion, a retirement annuity insurance contract, in which the primary purpose was to provide annuity for the bankrupt-insured after attaining a specific age, and which contained merely incidental provisions for payments to a named beneficiary under certain circumstances, was held not

\textsuperscript{43} Bowers v. Reinhard, 78 F. (2d) 776 (C. C. A. 3d, 1935).
\textsuperscript{44} \textit{In re Baxter} (D. C. Ohio) C. C. H. 4687; \textit{In re Walsh} (D. C. Minn.) 34 Am. B. R. (N. s.) 238.
\textsuperscript{45} See note 43, supra.
\textsuperscript{46} 34 Am. B. R. (N. s.) 238.
exempt as life insurance, and that a mere savings plan annuity contract in which the insurance feature was nothing more than the return of the cash surrender value, did not come within the purview of the state exemption statutes with respect to insurance.

However, under Section 55c of the New York Insurance Law, an annuity contract, including retirement annuity insurance, is specifically exempted from claims of creditors and, therefore, would be exempt from the claims of a trustee in bankruptcy.

V.

ENDOWMENT INSURANCE.

While it has been held that endowment policies of life insurance with a third party beneficiary are within the scope of the state exemption statutes and that the cash surrender value thereof does not pass to the trustee in bankruptcy, several courts have limited the exemption by holding that in the event the bankrupt, after the filing of the petition in bankruptcy, changes the beneficiary to his personal advantage, or survives to the maturity of the policy, the cash surrender value of the policy, as of the date of adjudication, passes to the trustee in bankruptcy.

VI.

DIVIDENDS.

Dividends upon a policy of insurance either applied towards the payment of premiums for purchase of paid-up additions, or even left to accumulate at interest, have been held

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to be exempt under the state exemption statutes. In *In re Keil*, the bankrupt, under the options expressed in the policy, specifically instructed the company to accumulate the dividends at interest. After the filing of the petition in bankruptcy, the trustee sought to obtain the accumulated dividends. In holding the accumulated dividends were exempt, the court said:

"The insured's power to withdraw on the anniversary date dividends standing to the credit of his policy when the bankruptcy petition was filed would clearly pass to his trustee under Section 70 of the Bankruptcy Act as amended (11 U. S. C. A. § 110). Therefore the question is whether such dividends are exempted by section 55a of the New York Insurance Law. This statute has been construed to exempt the cash surrender value of policies on the bankrupt's life payable to his wife, and to prevent his trustee in bankruptcy from compelling him to exercise the reserved power to change the beneficiary for his own advantage. If the cash surrender value of a policy is 'proceeds and avails' of the policy, it is difficult to see why accumulated dividends should be treated otherwise. Unless decisions of the state courts compel a different construction we cannot doubt that section 55a was intended to exempt these accumulated dividends so long as the bankrupt refuses to withdraw them for his own advantage. Decisions relating to disability payments, which are in the nature of an annuity payable to the bankrupt, are entirely beside the mark."

The New York courts are in disagreement upon this subject. The trend of the decisions is to the effect that the

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41 *Id.* at 8.
dividends accumulated at interest upon policies of insurance are exempt, and may not be reached by creditors or the trustee in bankruptcy of the bankrupt-insured. 52

VII.
PREMIUMS PAID IN FRAUD OF CREDITORS.

Section 55a of the New York Insurance Law, and the exemption laws of other states with the exception of New Jersey and Pennsylvania, specifically provide that policies of insurance are not exempt as to premiums paid with the


In Phoenix Mutual Life Insurance Co. v. Felig, 254 App. Div. 360, 5 N. Y. Supp. (2d) 170 (1st Dept. 1938), the Appellate Division of the First Department reversed the Supreme Court, which had held that accumulated dividends left on deposit with the company were exempt from the claims of creditors under the authority of In re Keil, 88 F. (2d) 7 (C. C. A. 2d, 1937). The policies involved in the case were issued prior to the enactment of Section 55a and became fully paid up in 1925. After that date and up to the death of the insured in 1936, the dividends were allowed to accumulate on the policies. The accumulated dividends were claimed both by the administrator of the estate of the insured and the committee of the beneficiary, an incompetent. There were no provisions in the policies for the payment of the dividend accumulations to the beneficiary. The policies provided that the accumulated dividends were to be paid to the insured where no premiums were due. The policies also provided for the payment of their face amount to the beneficiary. Although it was contended that dividends were exempt from the claims of creditors, the court held the statute did not affect vested rights nor alter the effect of express provisions in policies issued prior to its passage. It was further held that Section 55a did not apply to accumulated dividends upon a policy issued prior to its enactment under which the dividends were the property of the insured. The court, in reviewing cases, approved of the holding in Manufacturers Trust v. Equitable Life Assurance Society, supra, that the accumulated dividends were the property of the insured, payable to his estate rather than to the beneficiary upon the death of the insured. Likewise approved was the holding in 242 W. 38th Street v. Meyerowitz, supra, that dividends accumulated at interest under the option selected by the insured were not exempt from the claims of creditors, upon the ground that the contract provisions of the policy prevailed when not in conflict with the statute. The court distinguished New York Plumbers Specialty Co. v. Stein, supra, in that the policies in that case provided that the dividends were to be applied towards the purchase of additional insurance if the insured made no other election, and that the additional insurance or accumulated dividends unpaid at the maturity of the policy were to be payable to the beneficiary. Under such circumstances the dividends were exempt and passed to the beneficiary in accordance with the policy requirement as well as those of the statute.

52 See cases cited supra note 51.
intent to defraud creditors, and that these premiums may be recovered by the creditors from the proceeds of the policy. The courts in construing this part of Section 55a, have limited the recovery by creditors and the trustee in bankruptcy to the extent of the cash surrender value of the policy as is traceable to the premiums paid in fraud of creditors. This result was reached in Matter of Goodchild, where it was held that the trustee cannot recover the premiums paid in fraud of creditors out of the proceeds of the policy, but only so much of the cash surrender value as was created by such premiums. This rule would appear to be an unwarranted limitation upon the language of Section 55a, which provides that the amount of the premiums paid in fraud of creditors should inure to their benefit out of the proceeds of the policy. In Matter of Rosenthal, it was held that the provisions of the statute demonstrated that the recovery was measured by the premium fraudulently paid and not limited to the cash surrender value created thereby. A similar interpretation was impliedly stated in In re Yaeger.

In construing similar statutes and provisos, the courts of other states have held that the trustee in bankruptcy can recover the amount of premiums paid in fraud of creditors out of the proceeds and avails of the policy, and to the extent that premiums have been paid in fraud of creditors, the policy is not exempt. This holding appears to be the more logical and reasonable rule, as the statute itself would indicate that the creditors and the trustees in bankruptcy have a right to recover out of the cash surrender value or the proceeds of the policy the full amount of the premiums paid in fraud of creditors.

In the courts of New Jersey and Pennsylvania, by reason of the particular wording of their state exemption stat-

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56 21 F. Supp. 324 (W. D. N. Y. 1937) (where the court denied recovery upon the ground fraud was not established); cf. In re Hirsch, 4 Supp. 708 (S. D. N. Y. 1937).
utes, a trustee in bankruptcy can not recover from the cash surrender value the amount of premiums paid in fraud of creditors. In New Jersey, in Greiman v. Metropolitan Life Insurance Co., the court held that the premiums so paid could be recovered only from the “proceeds” of the policy, which right did not arise until the death of the assured. Recognizing that its decision differed from that of In re Goodchild the court sought to reconcile it by reason of the difference of language in the exemption statutes of the states.

In Pennsylvania, in Matter of Silansky, it was held that payments of premiums as well as repayment of policy loans, even though made with the intent to defraud creditors, were exempt, as the Pennsylvania statute did not restrict the exemption to policies not procured in fraud of creditors. The court stated that the stipulation would be otherwise in New York. There, under the decision of In re Hirsch, money repaid on policy loans by a bankrupt while insolvent with the intent to hinder, delay and defraud creditors, might be recovered out of the proceeds and avails of a policy of insurance which would otherwise be exempt under the provisions of Section 55a of the New York Insurance Law. In such case the trustee could recover the fraudulent payments out of the cash surrender value.

The courts have consistently held that the policies of insurance of a bankrupt should not be made a shelter for valuable assets and a refuge for fraud. Obviously it would be unconscionable for the courts to condone and even encourage the bankrupt’s fraudulent concealment of assets by permitting the repayment of policy loans which do not constitute an enforceable obligation against the bankrupt, or by sanctioning the prepayment of premiums.

The principle announced in New York and in Washington is the more logical and sound rule. The trend of the decisions is that while the courts will endeavor to afford the protection granted by the statutes in holding policies exempt,
they will not permit the perpetration of a fraud on creditors where the insured, while insolvent and with the intent to hinder, delay and defraud his creditors, repaid policy loans or prepaid insurance premiums. Such payments should not and will not be deemed to have been converted into exempt property, and the recovery of the same will be permitted by the courts out of the cash surrender value of the policies.

IN GENERAL.

There are various other policies of insurance, which the courts, by reason of statutory provisions, have always recognized to be exempt as to claims of creditors and the trustee in bankruptcy.

Thus the proceeds of a policy of group insurance, whether payable directly to the employee or a beneficiary, are exempt.64

Similarly the benefits and proceeds payable to an employee, officer or agent of any firm or corporation maintaining a retirement or pension fund, whether payable to the insured or a beneficiary, are exempt from the claims of the trustee in bankruptcy and the creditors.65

The proceeds and benefits payable under a policy of fraternal insurance to the insured or a beneficiary are likewise exempt,66 as are the proceeds or benefits payable to the insured or his beneficiary under a policy of an employee's mutual benefit association.67

The general trend, both legislative and judicial, is to extend the benefit of exemptions to policies of insurance, wherever possible. The only limitation imposed is where the policy is made payable to the insured, his estate or legal representative, in which event the court will be bound by reason of the statutory provisions and judicial interpretation to recognize the rights of creditors and the trustee in bankruptcy.

Max Schwartz.

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64 N. Y. Ins. Law § 101d.
65 Id. § 229.
66 Id. §§ 240.
67 Id. §§ 212.