RESOURCES

North Carolina Life Insurance Has Long Received Solid Protection From Creditors – But Only if You Follow the Rules

North Carolina has long provided its residents with special protection for life insurance policies against the claims of creditors. Recent cases, however, have made clear that the protection is only afforded if the rules are followed explicitly.

Creditors and sources of liability are everywhere these days. The most obvious targets for liability are physicians and celebrities, but anyone could be at risk for a terrible car accident ruled to be their fault. In the legal process, when someone is pursued by creditors, there are some assets that can be cordoned off from creditors. These assets are protected by statutory "exemptions", but most exemptions are severely limited to small amounts. Life insurance policies, on the other hand, are protected in unlimited amounts, both as to cash value and death benefit. This article will explain the exemption for life insurance and then review some recent cases explaining when and if the creditor protection is available and when it fails.

North Carolina's constitution (Article X, Section 5) provides as follows:

A person may insure his or her **own** life for the **sole use and benefit** of his or her **spouse or children or both**, and upon his or her death the proceeds from the insurance shall be paid to or for the benefit of **the spouse or children or both**, or to a guardian, **free from all claims** of the representatives or creditors of the insured or his or her estate. Any insurance policy which insures the life of a person for the sole use and benefit of that person's spouse or children or both shall not be subject to the claims of creditors of the insured during his or her lifetime, **whether or not the policy reserves to the insured during his or her lifetime any or all rights provided for by the policy** and **whether or not the policy proceeds are payable to the estate of the insured in the event the beneficiary or beneficiaries predecease the insured.** (Emphasis added.)

North Carolina also has a separate statute (N.C.G.S. 58-58-115) that generally protects, except in cases of fraud, life insurance against the claims of creditors **regardless of who is named as beneficiary of the policy**.

The federal bankruptcy rules provide certain exemptions from the claims of creditors, but give each state the right to choose the federal exemptions or to use their own. North Carolina, as a so-called "opt out" state, uses its own exemptions, and the relevant exemption here, N.C.G.S. 1C-1601(a)(6), exempts from the claims of creditors "Life insurance as provided in Article X, Section 5 of the Constitution of North Carolina."

So, life insurance is generally protected from the claims of creditors in North Carolina, but if a North Carolina resident files for or is forced into bankruptcy then the protection is limited to what is provided by the state's constitution.

Until recently, there were a number of unanswered questions about the extent of the constitutional protection of life insurance. Does it matter who the owner of the policy is? What is the "sole use and benefit" of the spouse, children or both? What if the policy is payable to a trust that benefits the spouse and children? What if grandchildren are also beneficiaries of the trust? The following Foster, Eshelman and Forgione decisions, all stemming from bankruptcy cases in North Carolina bankruptcy court districts, address some of these questions.

In In Re Foster, 2011 WL 5903393 (Bankr. E.D.N.C.), two cash value insurance policies were at issue. A husband

and wife had filed personal bankruptcy and claimed that the policies were exempt from the claims of creditors. The first policy insured the husband, was owned by the husband, and named the husband's revocable trust as the beneficiary. The second policy insured the husband, was owned by the wife, and named the husband's revocable trust as the beneficiary. The court concluded that neither policy was exempt since the policies were not for "the sole use and benefit" of the insured's wife and children. The stated basis for this conclusion was that the husband's revocable trust authorized the use of trust property to pay burial expenses, taxes and unsecured creditors of the trust. Because the insurance proceeds could have been used to pay debts of the trust, reasoned the court, the claim for exemption was improper. Note that the court suggested that it would likely not have permitted the exemption for the second policy in any event since it was not owned by the insured (and the constitution suggests that the exemption is only for policies owned by the insured).

In In Re Eshelman, 2012 WL 1945709 (Bankr. E.D.N.C.), a cash value policy owned by a bankrupt debtor was claimed as exempt in the bankruptcy proceeding. The debtor's bankruptcy application initially incorrectly listed his spouse as the beneficiary (when the named beneficiary was actually his revocable trust). The revocable trust included language requiring the trustee to use trust property to pay debts, expenses, and taxes. However, the trust included the following proviso: "my Trustee may in its sole discretion decline to pay to or otherwise make available for the benefit of my estate or my Executor life insurance proceeds, or any other assets, which would otherwise be exempt from the claims of creditors." The court concluded that the language regarding the use of trust property to pay creditors doomed the exemption. The court specifically stated that the trustee's discretion not to use insurance proceeds to pay creditors did not change the result. Note that the court acknowledged that after the beneficiary designation error was discovered the debtor changed the designation to his wife. The court completely ignored this change, presumably because it concluded that the determining factor was the designated beneficiary at the moment the debtor filed his bankruptcy petition.

In In Re Forgione, 2014 WL 4549004 (Bankr. M.D.N.C.), four cash value policies were at issue. One policy included the debtor's ex-wife as a beneficiary along with his children. The court quickly concluded that this policy was not exempt because it was not for the sole use and benefit of spouse and children. The other three policies named one or more of the debtor's children. The court allowed the exemption with respect to those policies. Significantly, the bankruptcy trustee also objected to the exemption claim on at least one of the other policies because it was alleged that the debtor's brother had been removed as a beneficiary within the four-year period prior to the petition date, and that in the event that a change of beneficiary was voidable under the bankruptcy statutes then the policies would not be exempt. The court did not address this further as the trustee apparently did not pursue that claim at the hearing. Moreover, the debtor did not try to claim that his ex-wife fit within the constitutional provisions, but instead that only ¼ of the cash value was exposed (which the court found unpersuasive). The court did note that the debtor did not assert that his ex-wife was a guardian of the children. That statement hints that the argument might have merit in the right circumstances.

From a review of the exemptions and case law, we can glean the following principles or guidelines:

1. Never, under any circumstances, should a life insurance policy lack a valid primary or contingent beneficiary. If there is no designation, the constitutional creditor protections will not be available and most insurance companies will pay the policy to the estate upon the insured's death, subjecting the proceeds to creditors and probate fees.
2. The insured should be the owner of the policy in order to qualify for the exemption. There may be tax or estate planning reasons for the insured's spouse or a trust to be the owner, but the insured should be the owner where creditors could be an issue down the road.
3. Where appropriate, name the spouse and/or children as the direct beneficiaries of the policy. Unless a revocable trust is drafted very carefully for this purpose it will be unlikely to meet the "sole use and benefit" standard required by the exemption from creditor claims. Most revocable trusts direct the trustee to satisfy the grantor's debts (and a stated exemption of life insurance from such direction was not significant to the bankruptcy courts who considered the issue).
4. The identity of the contingent beneficiary should not matter unless something happens to the primary

beneficiary. In other words, the fact that the insured names his revocable trust as contingent beneficiary should not be problematic as long as the primary beneficiary is living.

5. Policyholders should periodically review and update beneficiary designations. If you find yourself in financial difficulty that might end up in bankruptcy, consider whether the beneficiary designations meet the standard of the exemption (i.e., for the "sole use and benefit" of spouse and/or children). Although changing the ownership of a policy within a certain period prior to filing bankruptcy could be invalidated by creditors (under fraudulent transfer laws), changing the beneficiary is arguably not the transfer of an asset (which is what subjects a transaction to the fraudulent transfer laws). The Forgione court mentioned that as a potential issue, but it wasn't argued at the hearing stage.
6. Consider changing the ownership and beneficiary designation to an irrevocable life insurance trust ("ILIT"). Not only would this shield the proceeds from estate taxes, an ILIT should provide creditor protection (unless it is established too close in time to a bankruptcy or if the change in ownership to the ILIT constitutes a fraudulent transfer).
7. Don't overlook other important asset protection strategies such as obtaining a substantial umbrella liability policy, maximizing funding of retirement accounts, and using limited liability entities for business and real estate ventures.
8. The constitutional protection is aimed for creditors of the insured, not of the potential beneficiaries of the policy. If the potential beneficiaries are at risk of financial or legal trouble, then consider having their benefits pass into a protective trust rather than passing outright to them.

In conclusion, North Carolina has provided a powerful protection in its constitution for life insurance policies structured to benefit the insured's immediate family. However, recent bankruptcy cases show that unless the specific terms of the constitutional provision are followed exactly, then no protection is afforded and creditors of the insured can reach both the policy values and death benefit.

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