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Protecting Assets Through Insurance and Annuities

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Lawyers and other advisors are constantly being called upon to counsel clients on protecting assets, and while asset protection planning involving onshore and offshore trusts, corporations, limited liability companies, etc. has become a subspecialty of the law, there are some basics that attorneys and advisors should know about the special protection offered by insurance and annuity contracts, which in certain instances could help clients as much as all those sophisticated entities. Since the various state laws discussed in this article differ (materially in some cases) between life insurance and annuity contracts, and since annuity contracts offer somewhat greater planning flexibility, the two will be discussed separately, but the discussion will focus primarily on asset protection offered by annuities.

Overview of State Laws Protecting Life Insurance

Every state has laws protecting to some extent the value and proceeds of life insurance policies from creditors of the owner/insured. Some states restrict protection to policies where the insured's spouse and/or dependants are the named beneficiaries (e.g., Hawaii, Illinois, Ohio, Tennessee), while others extend total protection regardless of the beneficiary's dependence on the insured (e.g., Florida, Kansas, Michigan, Texas), and still others limit protection of cash value to a specified amount (e.g., Alaska, $10,000, Connecticut $4,000, Arizona $25,000). Thus, the laws vary considerably from state to state, and one desiring to protect assets through the purchase of life insurance must carefully select the state law he wishes (and is able) to apply before he goes to the trouble of moving to the state in order to avail himself of the applicable protection.[1] Even at that, it should be noted that a move for the sole purpose of availing oneself of increased protection on the purchase of a policy could backfire. In one case, for instance, where it was apparent that a debtor had moved to a state for the primary purpose of obtaining creditor protection under the new state's increased exemptions, the bankruptcy court held that the debtor's exemptions should be limited to those which would have applied in his former state of residence.[2]

Overview of State Laws Protecting Annuities

Annuity protection through state laws is not quite as universal as it is with life insurance. There are a few states, for instance, which offer no protection at all for annuities outside of an ERISA-qualified retirement plan (e.g., Connecticut, Massachusetts, New Hampshire, Virginia). Interestingly, some of these very same states (e.g., Connecticut and New Hampshire) offer unlimited protection to a beneficiary's interest in a life insurance policy. In many states protection of annuity proceeds or value is limited to amounts determined by the state to be reasonably necessary for the support of the owner or his dependants, but then there are several states which offer unlimited protection of amounts placed in annuities (e.g. Florida, Texas, Colorado, Illinois, Michigan), regardless of having dependants as beneficiaries.

An interesting possibility in planning with annuities, especially in those states with unlimited protection, stems from the fact that typically the protective laws apply not only to commercial annuities, but to <u>private</u> annuities as well. In an illustrative case, an individual entered into a $350,000 private annuity agreement with his daughter-in-law, as trustee of an irrevocable trust for other family members. At the time of the private annuity agreement the individual was solvent and no suits were pending. Thirteen months later the individual filed for bankruptcy, claiming an exemption for the annuity as allowed under Florida law. The individual's creditors objected to the exemption on the basis that the private annuity agreement is not what was contemplated by the Florida statute; that the debtor exercised total control over the construction and implementation of the entire arrangement; and that if this qualified as an exempt annuity, "any debtor can go to his cousin and give him all of his property in return for a promised stream of income," and protect the funds. The court agreed that the exemption when applied to a private annuity could invite abuse, but noted, in overruling the creditor's objections, that on all the facts it found that there was no intent to defraud creditors, that the annuity was purchased 13 months prior to bankruptcy and at a time when the debtor was solvent, that the debtor's financial downfall was due to defalcations of another and not of his own business ventures, and that he did not anticipate insolvency or contemplate bankruptcy when the annuity was established.[3]

Special Protection Where an Annuity is Annuitized

For asset protection purposes, the annuity (whether private or commercial) offers still a further benefit that is not available with life insurance policies, which could be extremely valuable in those states, such as Massachusetts, Virginia, or Connecticut, which offer limited or no creditor protection for annuities. To illustrate, assume that the purchase of an annuity is not a fraudulent conveyance, and funds or property is used to acquire the annuity. Once the annuity is annuitized, the asset used to fund the annuity is no longer an asset of the transferor; he is <u>only</u> entitled to a "stream of income" (the annuity payments) based on the terms of the contract. And as to the stream of payments, since under the typical contract the transferor/debtor cannot accelerate these, neither could a judgment creditor or a trustee in bankruptcy.[4] Depending on the amount of the annuity payments and the transferor/debtor's life expectancy, it may be possible to arrange a settlement of the debt; otherwise the creditor will have to undergo the expense and the effort to collect each payment as it comes due over the years.

Federal Law Protecting Insurance and Annuities

The federal bankruptcy code provides some limited exemptions from the bankruptcy estate for life insurance policies and annuity contracts owned by or accessible to the debtor, but these exemptions are so nominal that they are ignored for purposes of this discussion.[5]

Using and Losing the Protection – The Fraudulent Conveyance Issue

With all these protective statutes, particularly where the protection is unlimited, one might conclude it is a relatively easy matter for a debtor or potential debtor to simply purchase a large, single premium life insurance policy (including a private placement policy) or a single premium annuity and secure immediate protection of the funds.[6] While it may be a relatively easy matter to make the purchase, the answer to the question of whether protection will necessarily follow is an unequivocal "maybe".

Overriding all of the protective statutes and exemptions from the reach of creditors is the issue of fraudulent conveyance. If the debtor or potential debtor purchases or funds the life insurance policy or annuity with the intent to "hinder, delay or defraud" his creditors, or if the purchase or funding renders the transferor insolvent, then it is quite likely that the protective law or exemption will not apply. Whether an individual in such a case has made a fraudulent conveyance is always a question of fact to be decided by a court, and this in itself may offer the debtor an opportunity to negotiate with his creditors, but it may nevertheless be of little help where there are determined creditors. If a creditor persists and is successful in having the purchase or funding of a policy or contract declared a fraudulent conveyance, the court may, among a number of other remedies, order the insurance company to liquidate the policy or contract and pay the proceeds to the creditor (or to the debtor's trustee in bankruptcy).

It is also important to address the common misconception that in order to have a fraudulent conveyance the transfer must have rendered the transferor insolvent, or the transfer must have been for less than adequate consideration. This is not so. Any transfer made with intent to hinder, delay, or defraud a creditor could be considered fraudulent. In fact, Florida and Texas have enacted laws covering this very type of transaction. The Florida law, to illustrate, provides that a <u>conversion</u> of assets that results in the new asset being exempt by law from creditors can be a fraudulent conveyance, even though the transfer was by definition for fair value.[7] This is especially noteworthy, if not puzzling, when one considers that Florida and Texas are two of the states with the most liberal statutory protection for life insurance and annuities.

There are a considerable number of cases in virtually every state where substantial statutory protection is offered, illustrating both sides of the fraudulent conveyance issue, most of them coming up in a bankruptcy setting. Bankruptcy laws allow a debtor to conduct what is called "pre-bankruptcy planning", through which a debtor, in the very face of a bankruptcy petition, may intentionally and directly avail himself of state protective laws with a view towards protecting some of his assets, despite the bankruptcy proceeding. This is because federal bankruptcy laws allow a debtor to elect to apply state laws regarding certain exemptions, and the property covered by such exemptions will be excluded by law from the bankruptcy estate.[8] Utilizing this approach, a debtor should be able, for example, to take all available funds, perhaps even liquidate other assets to raise funds, and put all of these funds into a protected (exempt) asset such as a Florida annuity (for a Florida debtor) and then immediately file bankruptcy. After the bankruptcy proceeding, the debtor's debts would be discharged and he is then free to liquidate the exempt asset (here, the annuity) and get a "fresh start". From a planning standpoint, the problem is that sometimes it works, and sometimes it doesn't. Witness the Florida and Texas fraudulent conversion statutes noted above, and witness further, two cases on substantially the <u>same point,</u> appealed to and heard in the <u>same circuit court of appeals,</u> on the <u>same day</u>, <u>with opposite results.</u>

In case no. 1 (we'll refer to as the "Hanson" case), Mr. and Mrs. Hanson had a farm which was doing poorly and they defaulted on bank loans. They decided to file bankruptcy and just a couple of weeks before filing, on the advice of counsel, they sold some non-exempt assets and used the funds to purchase two life insurance policies having a cash value of just under the allowable state exemption (South Dakota exempted cash value of up to $20,000 in this case). They then filed for bankruptcy and the creditor bank objected to the exemption of the policies on the basis that it was a fraudulent conveyance.

The bankruptcy court held there was no evidence of fraudulent intent; the insurance policies were exempt and protected from the Hanson's bankruptcy proceedings. The creditor bank appealed, and on June 2, 1988, the 8th Circuit Court of Appeals affirmed the decision of the bankruptcy court, allowing the Hansons to keep the policies and receive a discharge of their debts.[9]

In case no. 2 (we'll refer to as "Tveten"), Dr. Tveten got involved in a number of huge real estate developments along with some fellow physicians for investment. The developments were highly leveraged and Tveten was one of the guarantors of the debts. The developments went sour and Tveten became personally liable for debts of about $19 million. This was many times over Tveten's net worth so he decided to file for bankruptcy. Like the Hansons he sought legal counsel, and like the Hansons he was advised to conduct some pre-bankruptcy planning. Like the Hansons he liquidated almost all of his non-exempt property and like the Hansons used the proceeds, in this case about $700,000, to purchase life insurance and annuity contracts from the Lutheran Brotherhood. He did this because under Minnesota law, such benefits, without limitation, could not be reached by creditors and thus would be exempt in the bankruptcy proceedings.

The bankruptcy court found that although the exemptions claimed by Tveten were technically permissible, Tveten had "abused" the permitted protection, and it further found that Tveten acted with the intent to hinder and delay his creditors. Accordingly, the court denied the discharge of his debt in bankruptcy. Tveten appealed, and on June 2, 1988, the 8th Circuit Court of Appeals ultimately affirmed the decision of the bankruptcy court (and the federal district court).[10]

A concurring opinion in the Hanson case was written by the same justice who wrote a dissenting opinion in the Tveten case, Justice Arnold, in an attempt to address the very puzzling question of how the same court could render two effectively opposite results on the same day on two virtually identical fact situations. In the Hanson concurring opinion Justice Arnold basically observed that Tveten suffered the denial because of the amount of money involved. His concurring opinion was in fact a thinly camouflaged strong dissent of the Tveten case and warned that such decisions unfortunately may boil down to whether the particular bankruptcy court judge involved feels the debtor tried to protect "too much".[11]

And to make the issue even more puzzling, consider this incredible coincidence: a friend of Tveten's, another physician, named Johnson, also got involved in Tveten's real estate venture, and also personally guaranteed millions of dollars of the entity's debt. (For those who don't know the legal definition of guarantor, it is: "A fool with a pen.") As it happened, Johnson and Tveten went to and were counseled by the <u>same</u> prominent bankruptcy attorney, who gave both men the <u>same</u> advice, and who represented <u>both</u> in their respective bankruptcy hearings in the <u>same</u> circuit. Tveten lost and Johnson won.[12] Was it because Tveten's plan involved $700,000, while Johnson's plan "only" $240,000 of annuities? Perhaps the unfortunate answer is that it depends on the evidence, how aggressive the debtor was, and the judges hearing the case.

In short, there are cases of courts taking the same perspective as Tveten, and it appears that although such tactics are technically within the law, the courts are very sensitive to what may look like an abuse of the privilege and they clearly have the right to override it. Therefore, from a planning standpoint it seems the wiser approach in large cases would be to go for something less than the "full Monte". In fact, in Justice Arnold's dissenting opinion in Tveten, he says, "One is tempted to speculate what the result would have been in this case if the amount of assets converted had been $7,000 instead of $700,000." And he comments further, "But sitting as a judge, by what criteria do I determine when this pig becomes a hog? If $700,000 is too much, what about $70,000?….I submit that Tveten did nothing more fraudulent than seek to take advantage of a state law of which the federal courts disapprove."[13]

Not a very satisfactory answer in any respect. Perhaps a much better answer, as virtually all asset protection planning attorneys will attest, lies in the timing of the plan. In all of the above cases and numerous others like them, such planning that is literally last minute is like shooting dice. This is not to say that last minute pre-bankruptcy-type planning should never be done, since, in most cases, the worst that happens is that the debtor is returned to his position before the plan, and the costs associated with the plan would have gone to his creditors anyway. If it is at all possible, however, a plan carried out more than a year from a bankruptcy petition will be far stronger and more likely to stand up. And of course the further the plan is away from bankruptcy (or a creditor's claim) the better.

Protection Through Life Insurance Trusts

It is fairly well-recognized that the typical irrevocable life insurance trust (ILIT) offers protection not only from the debtor's creditors but also from the creditors of the discretionary beneficiaries. Since the typical ILIT containing a spendthrift provision qualifies as a "spendthrift trust" (not reachable by the creditors of a non-settlor/beneficiary) under the laws of most states,[14] the state protection has little or nothing to do with the fact that the trust may hold life insurance or that life insurance may be protected under the laws of the particular state. In fact, it does not matter what asset is held by the trust; to the extent protection of the trust asset is offered by the spendthrift arrangement, the asset will be protected. Of course, if the transfer of the asset or funds to the trust constitutes a fraudulent conveyance, then the transfer may be voided, but this result, per se, has nothing to do with the protection offered by the trust. Similarly, if the individual transferor was also a beneficiary of the trust, the spendthrift protection would not extend to him (with the possible exceptions of qualified spendthrift trusts established in Alaska, Delaware, Nevada, Utah, or Rhode Island) and so his creditors could reach those trust assets.[15] Thus, an ILIT would not normally be the first choice for an individual seeking to protect assets through the special exemptions offered for owners of life insurance and annuities.

Conclusion

Although every state has laws providing creditor protection for the cash value and proceeds of life insurance policies ranging from complete unlimited protection to protection only under certain circumstances or protection limited in amount, and although almost all states have laws protecting to a greater or lesser extent the value and proceeds of annuities, the protection offered by such laws, while potentially valuable, is by no means absolute. In fact, reported decisions indicate that protective laws in all cases are subordinate to the overriding law of fraudulent conveyance, so that, as a general rule, the laws do not protect the annuities or insurance policies of a debtor who acts with fraudulent intent.

It appears, then, that the extent of the protection offered by the states' protective laws will depend upon such subjective issues as the transferor's motive in the acquisition of the insurance product; the timing of the acquisition; the transferor's circumstances surrounding the acquisition (e.g., did the transfer render him insolvent? Was there any other reason for the acquisition?); the amount of the acquisition in relation to the transferor's entire estate; and of course, the state in which the transferor resides. Despite all of the variables, however, not all individuals have the luxury of waiting for or planning for just the right circumstances, or the luxury of time to acquire the protected asset a year or two before trouble strikes. In such situations they may not have a choice other than to seek "emergency" protection under the laws but perhaps in a way that avoids the mistakes of those who have gone before them.

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[1] For an excellent and thorough review of the pertinent law of all states relating to insurance and annuities, see Gideon Rothschild & Daniel Rubin, *Creditor Protection for Life Insurance and Annuities*, Asset Protection Strategies, Alexander A. Bove, Jr., ed. (American Bar Association 2002).

[2] *In re Coplan,* 156 Bankr. 88 (M.D. Florida 1993).

[3] *In re Mart,* 88 Bankr. 436 (S.D. Florida 1988), and *see* Fla. Stat. sec. 222.14 (2001).

[4] *In re Grossman*, 259 Bankr. 708 (N.D. 2001).

[5] 11 U.S.C. § 522(d)(7) and § (8) (2001) life insurance, and 11 U.S.C. § 522(d)(10)(E) (2001) annuity payments.

[6] *Goldenberg v. Sawczak*, 791 S.2d 1078 (Florida, 2001)

[7] Fla. Stat. Ann. Sec 222.29 (West 2001); Tex. Prop. Code Ann. Sec. 42.004 (Vernon 2002); *but see In re Kimmel*, 131 Bankr. 223 (S.D. Fla. 1991).

[8] 11 U.S.C. §522(b)(2) (2001).

[9] *In re Hanson,* 848 F.2d 866 (8th Circuit 1988).

[10] *In re Tveten,* 848 F.2d 871 (8th Circuit 1988).

[11] *Supra*, note 9, concurring opinion at 870.

[12] *In Re Robert Johnson*, 80 Bankr. 953 (D. Minn. 1987).

[13] *Supra,* note 10, dissenting opinion at 878-880.

[14] Austin Scott & William Fratcher, *The Law of Trusts* sec. 155 (4th ed. Little Brown 1987).

[15] Id at § 156.