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Pledging Life Insurance: Interest of the Beneficiary as Against the Estate of the Insured

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PLEDGING LIFE INSURANCE: INTEREST OF THE BENEFICIARY AS AGAINST THE ESTATE OF THE INSURED

An interesting problem arises out of a situation common to most present day life insurance loan transactions. The common situation in such transactions is briefly this: X is insured under a life insurance policy having a maturity value of $1,000.00. His wife, Y, is the beneficiary of the policy. X goes to his bank and borrows $500.00. As collateral security for the loan X assigns the life insurance policy to the bank. The policy contains the usual provisions giving the insured the right to assign the policy and to change the beneficiary. X then dies. The proceeds of the policy are paid to the bank which deducts the $500.00 due it, and pays the balance left over to Y, the beneficiary. As between the creditor-assignee and the beneficiary, the law seems well fixed in most jurisdictions that the beneficiary is entitled to only such amount of the proceeds of the policy as remain after the claim of the assignee has been satisfied (that is to say, the balance due, at the time of the insured's death, on the debt to secure which the policy had been assigned).[1] That is the common situation; it is after this point that the problem arises which is the subject of this article.

Let us return again to the hypothetical situation above. Y, the beneficiary, disappointed (especially so where the insured's estate is solvent and well able to pay all his debts) by reason of having received only $500.00 when she had reasonably expected to receive $1,000.00, now files claim against the estate of her deceased husband for the sum of $500.00. The disposition of this claim is the problem which is to be considered below.

At first blush the answer seems obvious, for even a mere cursory search of the leading text authorities discloses: "The beneficiary of an insurance policy takes no vested interest; that which he has is a mere expectancy"[2] (quotes mine). Ergo—the wife-beneficiary cannot recover on her claim against the estate of her husband since said claim is based on nothing more than a disappointed hope. However the answer is not as simple as it at first appears, a fact which will be amply demonstrated by the cases to be examined herein below. Suffice it now to point out that, first, there is not a great deal of case authority directly in point; second, the case authority which exists is of comparatively recent origin; and third, said case authority is widely split into opposing views.

The first point of departure from what has been alluded to above as the obvious answer to the problem is to be found in the situation where a suretyship relation exists between the insured, as principal, and the beneficiary, as surety.

[1]Davis vs. Modern Industrial Bank, 279 N. Y. 405; Landreth vs. 1st. National Bank (1943), 346 Pa. 551; Smith vs. Coleman (Va. 1945), 35 S. E. 2d. 107.
[2]Appleman: Insurance Law and Practice, Vol. II, p. 309; Richards: Law of Insurance, p. 564.

In such a case some courts have permitted the beneficiary to recover from the estate of the insured all of the policy proceeds which had been applied to the payment of the debts of the insured for which the policy had been pledged. Such recovery has been predicted upon the beneficiary's special right of subrogation which accrued to him by virtue of the suretyship relation. The case of *Russell vs. Owen* (1932), 203 N. C. 262, 165 S. E. 687 is illustrative of the principles involved. In this case the decedent, D. S. Owen, borrowed $6,000.00 from the Equitable Life Assurance Society of the United States, for which said Owen and his wife executed their bond, he as principal debtor, and she as surety. In order to secure this bond D. S. Owen and his wife executed a deed of trust covering certain lands owned by Owen. The Equitable Life Assurance Society of the United States issued a policy of insurance upon the life of D. S. Owen in the sum of $6,000.00. As additional security for the loan this policy was immediately assigned to the Society by the insured and his wife who was the beneficiary named therein. The policy contained the usual provisions giving the insured the right to change the beneficiary and to assign the policy. Upon the death of the insured the proceeds of the policy were applied to discharging the debt of $6,000.00 owed by the insured to the Life Assurance Society. The wife then sued to recover the $6,000.00 from the estate of the insured, claiming that she was subrogated to the rights of the creditor. In disposing of this case the appellate court sustained the theory advanced by the wife-beneficiary in the following language:

> "In the instant case, no change of beneficiary having been made by the insured while the policy was in force, the interest of Violet Owen, as beneficiary named in the policy, ceased to be contingent upon the death of the insured; upon his death it ripened into a vested interest, with the result that, subject only to the rights of the creditor . . . under the assignment . . . the proceeds of the policy became and were the property of Violet Owen, free from all claims of the representatives of her husband or any of his creditors.
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> The policy was assigned as *additional security* (italics mine) for the bond executed by the insured as principal, and the beneficiary as surety . . . The bond was paid out of the proceeds of the insurance. Thus the property of the surety . . . was applied to the payment of the bond on which the insured was liable as principal. By reason of these facts Violet Owen became a creditor of the estate of her husband in the amount paid out of her property. As such creditor she is entitled to be subrogated to all the rights of the Equitable Life Assurance Society."[3]

It is further to be noted in this case, that, even though the court recognized the generally accepted rule that the beneficiary of this type of insurance policy

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[3]Accord: Katz vs. Ohio National Bank (1934), 127 Ohio 531, 191 N. E. 782.

takes not a vested interest but only a mere expectancy therein, still, this was held not to be a bar to recovery by the wife-beneficiary in this particular fact-situation.

There are other cases which depart even farther from the obvious answer to the problem which was alluded to early in this discussion. These cases do not limit recovery by the beneficiary to situations where a suretyship relation exists between the insured as principal, and the beneficiary as surety. The New Hampshire case of *Barbin vs. Moore* (1932), 159 A. 409 will serve as an illustration. In this case one George Leclerc had taken out two policies of insurance upon his life. His daughters were named as the beneficiaries in the policies. Each policy contained the usual provisions for change of beneficiary and assignment of the policy. Sometime later the insured assigned both policies to a bank as additional collateral security, in the event of his death, for a loan of $9,000.00, which was also secured by a mortgage on his real estate. Afterwards Leclerc made payments on the loan, so that at the time of his death there was due the bank the sum of $7,762.94. The insurance company paid that sum to the bank, and the bank discharged the mortgage. The administrator of the insured's estate sold the real estate for $9,025.00. The guardian of the daughter-beneficiaries then sued on their behalf to recover $7,762.94 from the insured's estate. The Supreme Court of New Hampshire in a very able opinion pointed out that the problem finally resolves itself into a question of intent. What was the intent of the insured when he assigned the policy as collateral security? Was it his intent to thereby make the proceeds of the policy the primary fund from which the debt should be paid? The court points out the improbability of this result in the following language:

> "The root of the defendant's claim is that in some way the decedent made the insurance policies payable for the benefit of his estate to the extent of the mortgage debt. The improbability of the existence of such a purpose is a fact to be considered in determining the extent to which the execution of the power of disposal goes. He desired to borrow money, and evidently had to furnish more security than the mortgaged real estate would afford. More security to the lender was all he needed, and apparently all he undertook to appropriate. There is no evidence of any purpose to change the relation between his estate and the insurance money. There can hardly be any doubt that if the real estate security had been ample the policies would not have been pledged. . . . *Collateral means secondary or subsidiary* (italics mine). Such security is to be resorted to only in the event that the pledgor fails to perform the principal contract. A pledge as collateral security *ex vi termini* excludes the idea that the thing pledged is designed as the primary source from which payment is to be made. . . . If he had wished to have the insurance go to pay the debt in any event and to the enrichment

of his estate, he could have made his creditor the designated beneficiary to the extent of its claim. His failure to do this is significant of his purpose in the execution of the power. It evidences his design to secure his prospective creditor, and at the same time not to impair the beneficiaries' title beyond what was necessary to protect the lender."

Having found that it was not the insured's intent, by a mere assignment of the policy as collateral security, to make the policy proceeds primarily liable for the insured's debt, the court then proceeds to examine the nature of the beneficiaries' rights in the policy. The findings on this point are based, to a considerable degree, upon the New Hampshire Insurance-Proceeds Exemption Statute.[4] The pertinent part of that statute is as follows:

> "When a policy of insurance is effected by a person on his life, or the life of another, expressed to be for the benefit of a third person or his representatives, the party for whose benefit such policy is so expressed to be made shall be entitled to the sum so insured, against the claims of the creditors or representatives of the party effecting the same."[5]

The court then defines the rights of the beneficiaries in the following language:

> "The right to assign or pledge is superior to the right of the named beneficiaries, but the latter may be called the residuary right, and it constitutes a legal claim upon all of the title that has not been disposed of in the exercise of the superior right. . . . A right of present enjoyment accrued to the beneficiaries upon the death of the insured. The right extended to the entire sum due under the policies. It had never been cut down in amount. The only incumbrance upon it was the pledge as collateral for the debt of the insured. . . . A fundamental error in the defendant's argument is the assumption that the assignment as collateral was an extinguishment, pro tanto, of the beneficiaries' rights. It was not that, but only an incumbrance of these rights. By force of the statute they (the rights of the beneficiaries)[6] are superior to the rights of his estate and creditors."

Needless-to-say the beneficiaries were permitted to recover in this case, even though their recovery made the estate of the insured insolvent. Assignment of the policies as collateral security did not indicate an intent to make the policy proceeds the primary fund for the payment of the debt, nor did such assignment destroy pro tanto the rights of the beneficiaries. Therefore, as between the estate of the insured and the beneficiaries, it was the obligation of the estate to pay the debt of the insured. The property of the beneficiaries having been

[4]New Hampshire P. L. C. 277 Sec. 2.
[5]Ibid.
[6]Parenthetical phrase my addition.

used to discharge this debt, they were subrogated to all the creditor's rights against the estate of the insured.

Further support for the principles laid down in *Barbin vs. Moore* can be found in equally lucid expression in the New York case of *Chamberlin vs. The First Trust & Deposit Company* (1939), 15 N. Y. Supp. 2d. 168, 172 Misc. 472. The facts here were substantially those of our hypothetical situation so there is no need to recount them in detail. However the acuity with which the court looks thru the facts to the fundamental issues involved is worthy of specific notice. First, on the question of the insured's intent, the court had the following to say:

> "I do not think that the mere assignment of the policies in this case constituted a direction to the insurance company to pay the note to the lender trust company. Chamberlin could very easily have accomplished that, had he so desired. He could have made the lender trust company the beneficiary of the policies. He could have indicated in some way that the insurance money should be the primary fund from which the note was to be paid. He could have revoked the designation of his wife as beneficiary, and re-designated her the beneficiary of the policies subject to the assignments, thereby diminishing her interest in the policies pro tanto, in which case . . . the lender trust company would have been constituted the primary beneficiary and the wife the secondary beneficiary."

Second, on the question of the beneficiary's interest, and of the effect of the pledge on that interest; the court says:

> "Collateral security in bank phraseology means, some security additional to the personal obligation of the borrower.[7] . . . The effect of the assignment was to place a pledgee's lien against the proceeds of the policies. The purpose of this lien was to stand behind the insured's primary obligation to pay his note. The expectant or inchoate interest of the wife became absolute at the death of the insured, subject only to the pledgee's lien. The insured's death did not affect the nature of this lien. *If it was a pledge as collateral only during the insured's lifetime, it was no more than that after his death.*"[8]

Having thus resolved the two main issues in the case the court phrased its conclusion in the following terms:

> "If, then, the insured pledged these policies for security additional to the primary obligation which was his promise to pay, and if it be held that the collateral could not be used unless and until there was default in performing the primary

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[7]The court quoting Black's Law Dictionary, 3rd. Edition, p. 349.
[8]Italics mine.

obligation, it follows that the primary fund from which the note should be paid was his estate, in the absence of a clear and unequivocal direction to the contrary."[9]

It may be observed, then, at this point, that all of the foregoing cases would solve our hypothetical problem by permitting the beneficiary to recover from the estate of the insured whatever amount of the insurance proceeds had been applied to the payment of the insured's debt.

This, however, is apparently not the view which would be taken in Pennsylvania. The very few cases which purport to declare the Pennsylvania Law in regard to our problem seem to hold that an assignment of a policy as collateral security has the effect of extinguishing pro tanto the rights of the beneficiary in the proceeds of the policy. A clear statement of this view is to be found in the case of *Cassel vs. Bigler* (1934), 22 D. & C. 125. Here a bill in equity was filed by the creditor-assignee to compel the widow-beneficiary and the administrators of the insured to interplead for the purpose of determining the ownership to certain collateral in the hands of the creditor-assignee, the loan having been paid out of the proceeds of the life insurance. The facts here were again substantially those of our hypothetical situation.

The court (Clearfield County), although it recognized the authority of the cases set forth above in detail, found that the Law of Pennsylvania was otherwise. Its statement of that Law is as follows:

> "As we construe this decision,[10] it evidences the view of the Supreme Court that when once the insured takes away from the expectancy previously granted to his beneficiary some part or all of it and conveys it, even though by way of lien rather than absolutely, to another person, his action must be held to bar the expectancy to that extent; or, to state it otherwise, when he resorts to the insurance policies and makes them assets for the payment of his debts, he has in effect made them an asset of his estate for all purposes to the extent so charged, the measure of that extent being the amount of the loan. . . . In our opinion, therefore, when A. Wright Bigler added his life insurance to the collateral securities which he had already pledged with the bank, he made it a part of his estate to the extent of the loan and the act of the pledgee in obtaining payment of the loan out of the insurance proceeds would not by subrogation divest the ownership of the decedent in the collateral securities still held, but they would remain as before the property of A. Wright Bigler, now vested by reason of his death in his administrators."

[9]Accord: Smith vs. Coleman (Va. 1945), 35 S. E. 2d. 107.
[10]Fidelity Trust Co., Administrator vs. Union National Bank of Pittsburgh (1933), 313 Pa. 467.

The sole authority on which the County Court based the sweeping and unequivocal decision quoted above is the case of *The Fidelity Trust Co., Administrator vs. The Union National Bank of Pittsburgh* (1933), 313 Pa. 467. The County Court in the *Cassel* case recites the facts of the *Fidelity Trust Co.* case to be substantially these:

The insured had created a life insurance trust, the trustees of which were the beneficiaries of certain life insurance policies. These particular policies were found to have been so deposited and the beneficiaries so designated at a time when the insured was solvent, and the question of a conveyance in fraud of creditors which was involved in some of the other items in the same case was held not to apply to the policies in question. Subsequently, after becoming insolvent, the insured made an agreement with an Ohio bank which required the trustees to purchase certain notes, upon which he was indebted to it, after his death, this agreement being found by the court to be in effect, though not in form, an assignment of the proceeds of the policies. The Ohio bank held other collateral securities for the payment of its indebtedness of $200,000.00 and sold these securities realizing thereon sufficient to reduce the indebtedness to the bank to $57,494.20. The administrators sued to recover the $200,000.00 as against the trustees and the wife and children of the insured, who were the beneficiaries of the insurance trust. The lower court gave $57,494.20 to the administrators of the insured, and the balance to the beneficiaries of the policies. The Supreme Court gave the entire $200,000.00 to the administrators of the insured.

In the *Cassel* case the court was presented with the argument that the result reached in the *Fidelity Trust Co.* case was based upon the fact that a fraudulent conveyance was involved there. In order to bolster its decision the court rejected this view of the *Fidelity Trust Co.* case, and in its statement of the facts of that case, as set out above, sought to preclude any objections along those lines. For several reasons the writer of this article is unable to agree with the County Court in its construction of the *Fidelity Trust Co.* decision. First of all, the editor of the State Reports, in his syllabus of the *Fidelity Trust Co.* case, definitely states that the assignment to the Ohio bank was held to be a fraudulent conveyance. Though it is admitted that this can be no authority, still it is evidence that one mind not unfamiliar with the law and the interpretation of decisions took a different view from that of the County Court. Secondly, the Supreme Court expressly cites, at two places in its opinion, the finding of the chancellor that the deal with the Ohio bank was a fraudulent conveyance. At no point in the opinion is this finding overruled, nor does the Supreme Court say anywhere that its opinion is not based upon this finding. And thirdly, with the exception of the *Cassel* case, the *Fidelity Trust Co.* case has never been cited by any subsequent cases as standing for the proposition which the Cassel case says it does. All the cases which Shepards list as citing the *Fidelity Trust Co.* case are cases where a fraudulent conveyance was involved.

Let us examine more closely the opinion in the *Cassel* case. The court says that when the insured assigns the proceeds of the policy as collateral security he in effect makes such proceeds assets of his estate to the extent so charged, the measure of that extent being the *amount of the loan.* Suppose that the insured had originally borrowed $1000.00, pledging as collateral his life insurance policy in the amount of $1000.00. During his lifetime he pays back $900.00, so that at the time of his death only $100.00 is still owing. According to the language of the *Cassel* opinion the estate of the insured would be entitled to the $900.00 in preference to the beneficiary named in the policy. What could be farther from the intent of the insured when he pledged his insurance than this result? The word 'collateral' by definition and connotation is absolutely irreconcilable with the result that must inevitably follow the view taken by the court in the *Cassel* case. If the insured had changed the beneficiary in the policy then the result reached in the *Cassel* case can be defended, but not so where all that the insured did was to assign the policy as collateral security. This rule is recognized universally: That the excess of the proceeds of the policies over and above the *indebtedness* belongs to the beneficiary named in the policies and not to the estate of the insured.[11] Thus it becomes apparent that the language of the *Cassel* case is unduly broad, and even goes beyond what would be required to justify the disposition of the insurance money in that case.

Let us turn now to the language of the Supreme Court of Pennsylvania in the *Fidelity Trust Co.* case on which the *Cassel* case based its result.

> "The right of the wife and children to participate in the insurance was an expectancy measured by the policies and the insurance trust agreements. One of the conditions of the donor's gift was that, by exercise of the power expressly reserved, he might destroy altogether the expectancy of his wife and children."

Quite true; moreover, all the cases referred to in the early part of this article would agree with this statement by the Pennsylvania Court. But, a destruction of the expectancy is accomplished by a change of beneficiary, not by a mere assignment. Most courts which run afield at this point do so by reason of their failure to distinguish between these two alternate acts of the insured. Assignment is purely a contract act. Change of beneficiary is the exercise of a power to appoint.[12] To treat an assignment as having the same effect as a change of beneficiary is to ignore the facts and make a fundamental error. This amounts to conforming the facts to jibe with a predetermined result, rather than permitting the result to be determined by the facts.

Let us look further at the language of the Supreme Court.

> "By the Ohio bank agreement, he diminished the con-

11Landreth vs. First National Bank, 346 Pa. 551; Penn Mutual Life Insurance Co. vs. Meguire, 13 Fed. Supp. 967; Allen vs. Home National Bank, 120 Conn. 306, 180 A. 498; Chamberlin vs. First Trust & Deposit Co., 15 N. Y. Supp. 2d. 168.

12Katz vs. Ohio National Bank (1934), 127 Ohio 351, 191 N. E. 782.

> tingent benefiicial interest theretofore conferred on his family, and subordinated that interest in the insurance proceeds to the extent of the loan and interest."

This language is entirely consistent with the view taken by the cases set forth in the early part of this article. Diminished and subordinated certainly do not mean extinguished and wiped out completely, but they are harmonious with the view that the residuary rights of the beneficiary remained, subordinate only to the rights of the assignee. The Superior Court of Pennsylvania has said this very thing in a later case:

> "Whatever interest the beneficiary may have, he or she is not completely deprived thereof by an assignment, but is subject to the right of the creditor until the debt is paid."[13]

The opinion in the *Fidelity Trust Co.* case concludes with the following words which further belie the view taken by the County Court in the *Cassel* case:

> "The record shows that the donor did not intend to deprive his family of the benefit of the insurance except as to the interest granted to the Ohio bank. . . here the evidence is conclusive that he sought to keep as much of the proceeds as possible within the statutory exemption from creditors and separate from his estate which was not exempt."

If all that the insured took away from his family's interest in the insurance proceeds was the interest that he gave to the Ohio bank how can he be said to have given any interest to his estate? The two propositions cannot be reconciled.

In conclusion the writer submits that, after a study of the *Fidelity Trust Co.* case, it cannot be said with conviction that said case is in fact an ajudication of the insurance problem which has been considered herein. Though it is admitted that there is ample language in the case seemingly in point, it is earnestly believed that the case was disposed of solely on the basis of the fraudulent conveyance involved therein. It then must follow that the answer to our problem is still an open question in Pennsylvania, and one which might well be submitted to the Supreme Court for their express determination. Keeping in mind the public policy behind our insurance proceeds exemption statute,[14] looking closely at the intent of the insured in these transactions, and not forgetting the distinct nature of *collateral* security, it is urged that the answer to this insurance problem might well be determined in Pennsylvania along lines similar to the view taken in the New York and New Hampshire cases discussed at the beginning of this article. It is the writer's confirmed opinion that these cases reach not only the most equitable result, but also the result best sustained by the logic of good law.

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[13]Lemley vs. McClure (1936), 122 Pa. Super 225.
[14]Act of June 28, 1923. P. L. 884, No. 335 Sec. 1; 40 P. S. 517.