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THE TRUSTWORTHY ADVISOR

LIFE INSURANCE V. CREDITORS IN MASSACHUSETTS - WHO WINS?

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Asset protection has been one of the hot estate planning topics of the decade. Techniques to protect assets range from the familiar limited liability company to specially designed domestic trusts to offshore private foundations. In the rush towards sophistication, the estate planner can overlook the asset protection the client brings to the office door.

Take insurance products for instance. Many if not most of our clients have coverage in some form or another. And where the coverage originated may be very important. Some states have laws that expressly prohibit creditors of the owner and beneficiary of both life insurance and annuity contracts from reaching the proceeds without limitation (including cash value), so long as the payment of funds into the contract was not deemed a fraudulent transfer, while other states protect annuities in limited amounts while protecting life insurance policies without limitation. Massachusetts, of course, has its own special set of laws that don't exactly fit into any of the foregoing categories. And if you live in Massachusetts and purchased the product here, it is our law which will generally apply to your insurance.

Massachusetts law (Ch. 175 §125) provides that a creditor of an owner of a life insurance policy may not reach the proceeds of that policy – the beneficiary of the life insurance policy enjoys the proceeds at the insured's death regardless of whether the owner or the insured owes a debt. And case law protects the owner's cash value of the policy, too, which makes sense. This general rule of protection is subject to two important exceptions. First, amounts paid in to the policy that are deemed to be fraudulent transfers (together with interest on such transfers) are reachable by the creditor. Second, although the statute seems to expressly allow the owner to retain the right to change the beneficiary, and although there is no requirement under §125, as there is in a number of states, to name a spouse or dependent as the beneficiary, Massachusetts cases have nevertheless held that a change of beneficiary after the issuance of the policy can cause the §125 protection to be lost, illogical as that may be. Such a rule could very easily cause the important creditor protection to be inadvertently lost.

Regarding spouses or dependents as beneficiaries, there is another statute in Massachusetts Law (Ch. 175 §126) that provides protection for life insurance policies where the policy is made payable "to or for the benefit of a married woman", or to any person in trust for her or for her benefit. The §126 protection will apply even if the married woman was not the original beneficiary, and case law has held that the §126 protection can survive divorce with a properly worded settlement agreement. Despite the changes in the law and social attitudes regarding equal treatment of the sexes, married or otherwise, the Massachusetts legislature has yet to address the historical arrangement of §126, but in light of our Supreme Judicial Court's decision in the *Goodridge* case and the recent US Supreme Court decision in the *Windsor* case, it may be that the next Massachusetts court to look at §126 would broadly interpret it so that "married woman" means "spouse" or alternatively declare §126 unconstitutional. Remember, though, that even if the broader protection of §126 was applied to all married people, the restrictions of fraudulent transfer law would still apply.

Protection of the proceeds of annuity contracts in Massachusetts is somewhat simpler, in that briefly, it boils down to this: Single premium annuities or even multi-payment annuities that are "non-qualified" (not part of a qualified retirement plan) where the owner/annuitant has access to the cash value at any time, including the right to pledge or assign it, enjoy zero creditor protection in Massachusetts. But even those types of contracts, once annuitized (irrevocably converted to periodic payments), may enjoy some limited protection, because the annuitant has no access to the balance of funds in the contract nor the ability to anticipate or assign the payments. Once the payments are received, however, they are reachable the same as other non-protected assets of the owner.

With the foregoing in mind, here are a few basic practice tips to keep in mind if protection of a Massachusetts life insurance policy or annuity is an objective:

- Determine the domicile of the client and determine which state law will control the protection of the insurance product.

- Remember that premiums paid into the policy are subject to attack as a fraudulent transfer if the owner has claims that are pending, threatened or reasonably anticipated. If fraudulent transfers are an issue, check to see if the creditor has sent the insurance company a written claim against the proceeds.

- When reviewing a client's insurance portfolio, ask if the original beneficiary designation has been changed. If it has been changed, explain how this impacts asset protection. If protection is the paramount estate planning goal, consider naming the infamous married woman as the beneficiary (or a trust for her benefit), if this fits your facts.

- Do not advise a change in the original beneficiary designation without explaining the risk of losing the protection.

- Do not try to get the statutory protection by purchasing a policy on the life of a "straw" and stuffing it with cash, because the purchaser of the policy, if anyone other than the insured, must have an "insurable interest" in the person insured. (Typical examples are family members, business partners or co-shareholders.)

- Explain the difference in protection if an annuity is annuitized.