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TOPIC: Arizona Law Protects Life Insurance Death Proceeds Against Bankruptcy Claim Made by Creditors

CITES: [ML Servicing Co. Inc. v. Coles](#), No. 1 CA–CV 13–0282, 2014 WL 4627462 (Ct App AZ Sep 16, 2014); [Arizona Revised Statutes Section 20–1131](#).

SUMMARY: An Arizona appeals court ruled that state law protected a life insurance policy beneficiary’s death proceeds even where the insured allegedly paid for the policy with funds that weren’t his.

BACKGROUND: Mortgages, Ltd. was one of Arizona’s largest and oldest private mortgage lenders. Its CEO was Scott Coles, who was also—through his revocable trust—the sole owner of the company.

In 2008, Mortgages, Ltd. was forced into bankruptcy by its creditors. During the bankruptcy proceeding, Scott died. After Scott’s death, the bankruptcy court ordered that the business assets be managed, gathered and collected for the benefit of the bankruptcy creditors.

Scott owned multiple policies insuring his life. Following his death, some of the insurance proceeds, believed to be in excess of \$60 million, were paid to Ashley, Scott’s widow. The creditors sued Ashley and alleged the policies’ premiums, believed to be in excess of \$130,000 per year, were paid with funds Scott improperly distributed from the business immediately prior to or during the bankruptcy proceeding—at a time when the company was insolvent.

FACTS: Ashley filed a motion to dismiss the creditors’ claim. She argued that the creditors were not entitled to the policies’ proceeds because Arizona Revised Statutes § 20–1131 bars any creditor of a decedent from recovering life insurance proceeds from a beneficiary.

If a policy of life insurance is effected by any person on the person's own life ... the lawful beneficiary ... is entitled to its proceeds against the creditors and representatives of the person effecting the insurance.

In granting Ashley's motion, the court noted that the language of the statute was unambiguous in its protection of the beneficiary's right to the death benefit.

The trial court further reasoned that:

The crux of [the creditors'] claims is based on the allegation that Scott paid insurance premiums in fraud of creditors; it is the premiums, not the proceeds, which Scott allegedly misappropriated. As such, [the creditors'] remedy is a return of premiums ... a claim for which [the creditors] do not plead.

The creditors appealed to the Arizona appellate court, arguing that:

1. they were not really creditors of the insured, but actually had an ownership interest in the policy due to a theory of constructive trust of the allegedly misused premium money, and thus were entitled to the death proceeds;
2. because Scott did not buy the life policy with lawfully obtained funds, he could not name a lawful beneficiary—and hence the statute did not protect Ashley; and
3. the insured would be getting away with fraud with regard to creditors unless the court paid the death proceeds to the creditors.

RESULT: The appellate court rejected all the arguments of the creditors. It concluded:

1. The creditors really were just creditors, and not constructive owners of the life policies.
2. The Arizona statute's requirement that Ashley be a lawful beneficiary had to do with insurable interest, and not with any of the facts relevant to this case.
3. The creditors had the statutory right to recover the misused premium amounts plus interest. That right was specified in the same Arizona statute which protected the beneficiary's death proceeds from creditors.

With regard to the first point, the creditors argued that other jurisdictions impose constructive trusts on misappropriated funds in similar circumstances to those in this case. The court refused to recognize a constructive trust in this case, finding that the creditors' statutory right to premium recovery was the proper (and adequate) alternative remedy.

The court noted that the creditors *chose not* to pursue the premium recovery remedy; instead they banked on the court deciding to award the creditors *all* the death proceeds. When the appellate court refused to do so, the creditors were left without any available remedies.

RELEVANCE: The *Coles* case raises a recurring question: In what kinds of circumstances should courts overrule the asset protection rules created by statute? In this case, the creditors alleged the insured took money out of his business in violation of bankruptcy rules and in fraud of its creditors, and then used the money to buy a life insurance policy on his life payable to his wife. The issue here was—is it fair under those circumstances for the insured’s family—and not the creditors—to get the death benefit? The Arizona court said “Yes”, although a different court might have reached a different result.

General asset protection rules may not protect every life insurance policy owner or beneficiary in all situations. The *Coles* decision deals with a relatively unusual set of circumstances in which the Arizona statutory death benefit creditor protection rule was called into question. Even though the case was decided in favor of the insured’s wife, it took a lawsuit, an appeal, and an eventual court decision to protect the death benefit against creditor claims.

The *Coles* case reminds us that financial professionals should be careful when describing the asset protection characteristics of life insurance to clients, given the different state or federal bankruptcy statutes that could apply.

WRNewswire #14.9.26 was written by Linas Sudzius of [Advanced Underwriting Consultants](#).

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