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Suplementary Insurance Contracts: Are They Testamentary

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SUPPLEMENTARY INSURANCE CONTRACTS: ARE THEY TESTAMENTARY?

RECENT decisions in states outside of the Southwest have focused attention on the validity of beneficiary designations contained in contracts issued after maturity of life insurance policies, whether such contracts mature by the death of the insured, by an election of the insured to surrender the policy, or otherwise in accordance with policy provisions. Although the question apparently has never been before the Texas courts, it is a matter of great practical importance and worthy of consideration.

A typical case arises when the insured under a life insurance policy dies without having specified that the beneficiary is to receive the proceeds under one of the optional methods of settlement. Most policies provide under such circumstances that the beneficiary may elect one of these settlement options, or possibly a combination of options which will best meet his or her particular needs. Realizing that the person electing to receive periodic payments under the settlement options may die before the entire proceeds have been paid, the insurance company may permit the payee to specify who is to receive unpaid proceeds after his or her death, with the right reserved to change this designation. Quite often a provision may be included permitting the payee to withdraw the unpaid proceeds at any time due to changed circumstances. This typical arrangement seems altogether proper from the standpoint of the payee, who will receive a guaranteed income, with the right to change the arrangement if necessary, reserving also the right to dispose of unpaid proceeds as simply and easily as did the insured originally. From the standpoint of the insurance company the arrangement is satisfactory, for the better life insurance can fulfill human needs, the more desirable it will be.

To the insurer it is simply a matter of marketing the best possible product.

But now the assertion must be reckoned with that this arrangement is a testamentary disposition and therefore invalid. The attack is made because the payee under the contract issued after maturity of the insurance policy reserves the right to change the beneficiary who will finally receive any unpaid proceeds. The attackers argue that since the designation becomes effective only when death has removed the possibility of a change, the designation is of no legal significance until death and is therefore testamentary. Even if the right to change the designation is not reserved, the theory then becomes that reservation of a right of withdrawal by the payee provides the same effective control over the proceeds until death.

At this point it is appropriate to point out that these questions may arise in three instances. The person making the election may be (1) the beneficiary in a life insurance policy which has matured by the death of the insured, (2) the insured under an endowment policy which has matured according to its terms, or (3) the insured who has surrendered a policy and elected to have the cash surrender value paid under one of the settlement options. The same principles would seem to apply in all three situations.

Before analyzing the problem further, it may be helpful to consider two recent decisions on the question. On January 7, 1952, a New York supreme court handed down its decision in *Hall v. Mutual Life Insurance Company of New York.*[1] This was an interpleader case, the issue being whether the contingent payee named by the payee in a supplementary contract (the beneficiary in the life insurance policy) issued after the death of the insured should be permitted to receive the unpaid proceeds after the death of the payee, or whether the attempted designation by the payee was a testamentary disposition and therefore invalid. The executors of the deceased payee claimed the proceeds, contending that

[1] 109 N. Y. S. 2d 646 (1952). The case has been appealed.

the supplementary contract, insofar as it sought to direct payment of the proceeds to a contingent payee, was an attempted testamentary disposition and therefore void as a violation of the Statute of Wills. This contention was based on the theory that the supplementary contract was not an insurance contract but a new and independent contract because of certain variations between the basic policy provisions and the income settlement agreement ultimately issued to the beneficiary-payee. These differences were that the payee was to receive interest on the unpaid proceeds quarterly, where the policy provided only for annual interest payments, and that the payee was to be permitted to withdraw the proceeds, while no withdrawal provision was included in the basic policy of insurance.

The trial court (supreme court) held that the policy, as a contract of insurance, terminated with the death of the insured and that all that remained was the obligation to pay the proceeds. Since the insurance was no longer in force, the court reasoned that the income settlement agreement was not a contract of insurance or a supplementary contract. By holding that there was no supplementary insurance contract, application of rules generally recognized as controlling because of the *sui generis* nature of life insurnce policies and supplementary contracts providing for payment of insurance proceeds was prohibited.[2] Thus, the executors of the deceased payee recovered the unpaid proceeds because the payee's direction to the insurer was testamentary and a violation of the Statute of Wills. The court sought to support its holding primarily because the deferred payment agreement issued to the deceased payee was not in accordance with the guaranteed provisions of the basic policy, including certain provisions requested by the payee and permitted by the insurer as an additional service to the payee.

Since the decision was rendered, an addition to Section 24-A of the New York Personal Property Law has been enacted to make

[2] Gurnett v. Mutual Life, 356 Ill. 612, 191 N. E. 250 (1934); *In re* Brotherhood of Locomotive Firemen, 9 La. App. 74, 119 So. 79 (1928); see 1 SCOTT, TRUSTS (1939) § 57.3.

it clear that where the insured has not specified who shall be contingent payee, the beneficiary named in the policy can designate who should receive unpaid proceeds, and that such action shall not be questioned as possibly being a testamentary disposition and subject to the Statute of Wills. Although this declaration of legislative intent may have considerable weight when the case is heard in the appellate division, it is not controlling, for the transaction considered in the *Hall* case took place long before the passage of this statute. The terminology of the statute and legislative note at its end indicate that the Legislature did not intend to change the pre-existing law, but sought only to avoid having the same question arise in the future.

The most recent decision covering a similar situation was handed down by the Supreme Court of the State of Washington on June 11, 1952, *Toulouse v. New York Life Insurance Company.*[3] In that case the executor of the insured's estate challenged the validity of an agreement between the insurer and the insured. The insured had exercised one of the optional methods of settlement offered by an endowment policy upon its maturity, deciding to leave the proceeds of the policy with the insurer, subject to withdrawal on demand. Any amount in the insurer's possession at the insured's death was to be distributed to designated third parties.

The executor contended that the portion of the agreement designating third parties to receive the unpaid proceeds after the insured's death was void as an attempted testamentary disposition in violation of the Statute of Wills. The insurer took the position that the agreement constituted a supplementary insurance contract and was a valid third-party donee-beneficiary contract.

The supreme court affirmed the trial court's holding that the original insurance policy, the form letter or acceptance certificate signed by the insured, and the supplementary contract constituted the agreement between the insured and the company. In the major-

[3] 245 P. 2d 205.

ity opinion Justice Hill pointed out that the right to take advantage of optional methods of settlement provided in an insurance contract is a valuable one and will be protected. The beneficiary (or, as in the case under consideration, the insured) acquired "a vested interest in the company's performance of that part of its contract of insurance. Such an interest is in the nature of a property right. The species of property is neither money nor real property, but a contractual obligation."[4] The court then determined that to benefit from it a compliance with the Statute of Wills was not necessary. The court pointed out that, while the validity of such contracts as the one being considered had seldom been passed upon, the validity of such provisions was assumed without question in several cases.[5]

A reading of the several opinions in the *Toulouse* case establishes that three justices found the contract designating third parties to receive the unpaid proceeds at the death of the insured to be a supplementary contract, valid under *sui generis* principles applicable to life insurance, and also that it was valid as a third-party donee-beneficiary contract. Two justices concurred solely on the latter ground, deciding that the insurer was the promisor, the insured the promisee, and the designated payees were third-party beneficiaries. The fact that the contract was conditional because the promisee had a right to withdraw the proceeds at any time did not render it invalid, since the rights of the donee-beneficiaries were merely subject to that limitation. Four dissenting justices chose to take a narrower view that the law of gifts must apply, partly, it is submitted, because of a failure to understand the actuarial significance of some language used in the insurance policy.

Having posed the problem by a review of the contrary positions taken by these two recent cases, let us now consider the

[4] *Id.* at 208, citing Latterman v. Guardian Life Insurance Company, 280 N. Y. 102, 19 N. E. 2d 978 (1939), noted, 127 A. L. R. 450 (1940).

[5] Smith v. Smith, 172 F. 2d 399 (8th Cir. 1949); Aetna Life Insurance Company v. Bartlett, 53 F. Supp. 1005 (D. Mass. 1944).

matter on the basis of fundamental principles and policy. To eliminate some apparently extraneous matter, one can safely say that if the person to receive the payment is named irrevocably and there is no right of withdrawal, there is a present creation of a right in the person. In those cases there seems to be no doubt that the named third party has a vested right and is clearly a third-party donee-beneficiary.[6] Likewise, it seems to be generally agreed that if the insured elects an option exactly as guaranteed by the insurance policy, or if the beneficiary makes such an election when the policy matures by the death of the insured, a supplementary insurance contract results and the *sui generis* principles historically applied to the anomalous situations presented by life insurance contracts are recognized.[7] The problem which has caused most discussion, however, arises when a supplementary contract is issued after maturity or surrender of a policy and it provides for payment to a beneficiary named by the person making the election, which person also reserves the right to change the beneficiary or withdraw all or a portion of the proceeds.

It is submitted that the most realistic approach to the problem is to recognize that in any case the election to have the proceeds of an insurance policy paid in a certain manner is not an isolated act; it is always an integral part of one transaction, beginning with the issuance of the insurance policy and terminating only after the insurance company has paid the last dollar due under the contract. In line with this view, it would seem proper to use a very liberal interpretation in determining whether a contract is a supplementary contract and therefore to be considered according to *sui generis* insurance principles. One possible solution would be to define a supplementary contract as one which is:

1. either a part of a life insurance policy or separate instrument,

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[6] Kansas City Life Insurance Company v. Rainey, 353 Mo. 477, 182 S. W. 2d 624 (1944).

[7] Mutual Benefit Life Insurance Company v. Ellis, 125 F. 2d 127, 138 A. L. R. 1478 (2d Cir. 1942), *cert. denied*, 316 U. S. 665 (1942).

which may or may not be designated a trust agreement, referring to the proceeds of a policy,

2. made between a life insurance company and the policyholder or the beneficiary,

3. made before the maturity or surrender of the policy, or after the policy has matured by reason of the death of the insured, or after it has matured as an endowment, or upon surrender of the policy.

4. by which the company agrees to make definite future payments, but which does not require the company to segregate or hold any particular fund for the payees,

5. such payments to be made to the person with whom the company contracts, or to some other person, or both, as may be provided in the contract,

6. in consideration of the payment of premiums to the company or in consideration of the company's not making a payment presently due under the terms of the policy.[8]

Some such definition would provide a much more practical method for deciding cases than the one used by the court in the *Hall* case, where the contract was held not to be a supplementary contract because of a variation in the provisions from guaranteed rights under the terms of the insurance policy itself. Tested by ordinary principles of common sense and fairness, it certainly should not be determined that a designation of a contingent payee is valid when the option selected is exactly as guaranteed, yet is invalid if some liberalization is granted by the company to permit it better to serve the insuring public. Indeed, it would seem most unusual for a court to appear to censure the company for such generosity and in effect punish the proposed recipient. Such a view would prevent life insurance companies from extending to policyowners and beneficiaries more liberal and flexible settlement option privileges, although they are included in policies currently being issued, without possibly invalidating the agreement elected.[9] The unusual result would be that a policyowner or

[8] Cox, Berkeley, *Corollary Legal Aspects of Supplementary Contracts* in THE BENEFICIARY IN LIFE INSURANCE (David McCahan ed. 1948) 156.

[9] For an excellent description of the social usefulness and *sui generis* nature of life insurance policies and agreements concerning disposition of their proceeds see *In re* Haedrich's Estate, 134 Misc. 741, 746, 748, 236 N. Y. Supp. 395, 402, 404 (1929), *aff'd*, 230 App. Div. 763, 243 N. Y. Supp. 896 (1930), *aff'd*, 256 N. Y. 608, 177 N. E. 160 (1931).

beneficiary would have to be watchful lest the insurer grant some privilege not guaranteed in the policy. Clearly such a situation is contrary to the public interest.

Another basis now frequently used by courts to uphold contracts like that in the *Hall* case is that the payee is a third-party donee-beneficiary. A trend in this direction probably exists, although the writer has been unable to find any case offering a sound reason why *sui generis* principles should not apply from the time a life insurance policy is issued until all proceeds have been paid.

A leading case[10] has held that failure to elect one option *as provided in the contract,* while preventing the ensuing contract from being a supplementary contract, did not invalidate the agreement as being testamentary. The court reasoned that enforcement of the agreement would not violate the Statute of Wills because the beneficiary's right to enforce "is based upon a contractual obligation and not on any interest in the property of the decedent."[11] Since a withdrawal right was reserved to the beneficiary under the insurance policy involved, the court held that the right of the last taker specified in the agreement, "though subject to be divested in the manner provided in the contract, is a vested right arising when the contract is made and enforceable unless and until terminated pursuant to the provisions of the instrument of settlement."[12]

Further support for this theory is to be found in another leading case, *Kansas City Life Insurance Company v. Rainey.*[13] The court in that case enforced a contract providing for payment of remaining principal to a person designated in an "Investment Annuity Policy" after the death of the owner of the policy who had been receiving the income, despite the fact that the right to

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10 Mutual Benefit Life Insurance Company v. Ellis, 125 F. 2d 127, 138 A. L. R. 1478 (2d Cir. 1942), *cert. denied,* 316 U. S. 665 (1942).

11 *Id.* at 131.

12 *Ibid.*

13 353 Mo. 477, 182 S. W. 2d 624 (1944).

change the beneficiary was reserved. Without determining whether *sui generis* principles would apply as they do when a beneficiary is designated by the insured in a life insurance policy, the court held that so far as the person designated to receive the unpaid proceeds was concerned, "any disposition as to her was effected at the time she was designated as beneficiary. Her enjoyment of the fund was merely postponed until Hall's death, subject to the right of revocation retained by Hall."[14]

After these aspects of the problem have been reviewed, certain conclusions can be drawn. First, by the weight of authority, from the standpoint of carrying out the wishes of the policyowner, and because of the great interest of the public in the validity of thousands of such agreements now outstanding, the decision in the *Hall* case is wrong.

Second, permitting agreements between the insured and insurer that are advantageous to the insured and acceptable to the insurer, although not guaranteed in the insurance policy, should be encouraged as a matter of public policy. When the policy has matured by the death of the insured, the same privilege should be extended to the beneficiary who elects an optional method of settlement. As stated in the *Rainey* case, the "contract [was] made and in force during Hall's lifetime. Hence there would be no reason to surround it with formalities which safeguard a will."[15]

Third, although contracts such as those discussed above can be enforced as third-party donee-beneficiary contracts, it is submitted that another valid basis perhaps equally good exists. *Sui generis* principles long applied to permit designation of a beneficiary in a life insurance policy, with a right to change reserved, should apply also to income agreements issued as a direct result of the maturity of a life insurance policy.[16]

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[14] 182 S. W. 2d at 626.
[15] *Ibid.;* see Krell v. Codman, 154 Mass. 454, 28 N. E. 578, 14 L. R. A. 860 (1891).
[16] See authorities cited *supra* note 2.