Life Insurance and State Laws on Creditor Protection

In addition to the income tax benefits of life insurance, life insurance may also receive creditor protection under state laws and the federal Bankruptcy Code. Although life insurance does not always provide creditor protection to the extent that a personal residence or a qualified plan is protected, life insurance still enjoys protection from creditors much more extensively than most other tangible or intangible property.

When combined with the other benefits provided by life insurance, this protection from creditors help to make life insurance an important tool for supplemental retirement planning (see Life Insurance in Retirement Planning on pages xxxx). This is especially true of those people involved with high-risk professions or just simply concerned with protecting their legacy from creditor claims.

For policyholders who file for protection under the federal bankruptcy laws, the federal Bankruptcy Code protects life insurance up to a specified amount of the debtor’s aggregate interest in any accrued dividend, interest, or loan value of an unmatured life insurance policy, provided that the insured is either the debtor, debtor’s spouse, or an individual of whom the debtor is a dependent. The federal Bankruptcy Code provides that debtors in bankruptcy may choose between either the federal exemptions provided in the Bankruptcy Code or the available state law exemptions for bankruptcy. However, some states do not allow the federal bankruptcy exemptions, in which case only the state law exemptions would be available in bankruptcy.

Many states provide more extensive exemptions of life insurance than federal law. In addition to the bankruptcy exemptions, many states provide protection for the cash value and death benefit of life insurance in a non-bankruptcy context. However, in many cases, state law exempts only the beneficiaries of the life insurance contract from claims by the creditors of the owner or insured of the contract in a non- bankruptcy context. In some states, the exemption for life insurance only covers the family members of the insured. Other states provide exemption from creditors’ claims for the insured and/or owner of the contract, in addition to the beneficiary of the contract.

In addition to protection directly afforded the life insurance contract cash value and death benefit, for additional creditor protection, a trust, partnership or limited liability company (LLC) may be an appropriate vehicle to own a life insurance contract. These entities can provide additional protection on their own and independent of the protection provided to the life insurance contract.

The following summary reviews the provisions of every state for exemptions of life insurance from attachment by creditors. The exemptions afforded life insurance generally do not apply (i) to the extent premiums were paid to defraud creditors or (ii) when policy is pledged/assigned to secure a debt.