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CALU REPORT

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The Use of Insurance as Security for Family Law Support Obligations

In this latest edition of CALU Report, Debra Stephens, LLB, highlights a number of issues related to the use of life insurance to secure support obligations within the family law context, and offers some general comments on how to deal with those issues.

CALU wishes to thank Debra for her contribution.

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Introduction

by Debra Stephens, LLB[1]

The judgments of the Ontario Court of Appeal in *Turner v. DiDonato*,[2} and *Richardson (Estate Trustee of) v. Mew*[3] created anxiety (and perhaps a few sleepless nights) for some insurance advisors and many legal practitioners across the country.

> "It is possible, indeed commonplace, for a separation agreement to link the obligation to maintain life insurance to the obligation to pay support. This Agreement did not do so."[4]

These were sobering words for those who have been involved in negotiating separation agreements or have played a role in underwriting insurance for such arrangements. No doubt a number of legal counsel, after reading the decisions, pulled out their old agreements and precedents to see if the provisions they had drafted dealing with life insurance addressed the interpretation issues raised by the Court.

Attempting to craft life insurance provisions which meet the needs of clients, clearly express their intention, and comply with the provincial Insurance Acts[5] (herein collectively referred to as the "Insurance Act") is not an easy task. It is a balance involving detail, clarity of expression, and complex estate and trust issues.

Using insurance to secure spousal or child support is a relatively inexpensive, common sense option. Most payors already have life insurance, or have easy access to such coverage. However, when using such a vehicle to secure future support obligations, the client´s insurance and other advisors must navigate a number of minefields, including, but not limited to, concepts of irrevocability; proper designation of beneficiaries; insurance trust declarations; the appointment of trustees; insurance companies who create their own individual beneficiary designation forms but do not wish to become involved in insurance trusts; the powers of trustees; and termination of the insurance trust.

While it may not be much consolation to family law lawyers, estates and trust practitioners also struggle with many of the same issues. In particular, the specific wording of the *Insurance Act* and the designation of trustees as beneficiaries have been the subject of a number of court decisions and academic discourse.[6] This article is intended to highlight a

number of issues related to the use of life insurance to secure support obligations within the family law context and offer some general comments on how to deal with those issues.

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Why Life Insurance as Security?

There are a number of reasons why insurance is well-suited to secure support obligations in the family law context. Payors may not have sufficient assets which can be "segregated" or otherwise pledged as security for future support obligations. Even if there are such assets, they may not be sufficiently liquid nor can they be easily or irrevocably designated for the benefit of the payee spouse and/or children. Additionally, using an insurer´s beneficiary form or creating an Insurance Trust Declaration does not require the payor to include such provisions in his or her Will, which could for some reason be declared invalid or otherwise revoked or changed, thus providing little security for the payee spouse and/or children.

Many employed individuals have group insurance. This insurance might be used to secure future support obligations. However, the amount of such insurance is generally low and may not be sufficient to meet all support obligations. But of more concern for the person entitled to the support payments, the payor´s employment and thus the group insurance benefits could be terminated, resulting in no security for the support obligations.

Individual plans purchased by the payor can be quite affordable, assuming the payor is reasonably healthy. There is no significant capital outlay with respect to the acquisition of such policies and premiums can usually be absorbed in one´s budget. More important, however, is the tax-free treatment of life insurance proceeds. Accordingly, the entire death benefit of the policy is available to fund future support obligations, unlike RRSPs or RRIFs which may also allow for the designation of beneficiaries but may be fully taxable on the payor´s death depending on the recipient.

As well, if there is a designated beneficiary of an insurance policy (other than the insured´s estate), the proceeds are paid directly by the insurance company to the beneficiary and thus generally do not fall into and form part of the deceased´s estate.[7] If the life insured´s spouse and/or children are the designated beneficiaries, the policy is also generally protected from the deceased´s creditors while the insured is alive.[8] However, once the policy proceeds are paid to the spouse and/or children, they are not protected from the recipient´s creditors.

Many individuals simply designate beneficiaries of their insurance policies so that the insurance proceeds do not fall into the estate, and thus are not subject to provincial estate taxes or estate administration fees. As beneficiary designations need only be in writing (and thus do not have the same formal requirements as the execution of a Will) they can be more easily changed.

It is not preferred practice to designate the beneficiary of an insurance policy in a Will. First of all, there may be challenges based on the nature of the designation. A designation in a Will is effective only if it relates expressly to the insurance policy, either generally or specifically, and a revocation is only effective if it relates expressly to the prior designation, either generally or specifically.

With some exceptions a Will is revoked on marriage, or could be declared invalid for a number of reasons including lack of proper execution, undue influence or lack of capacity. The revocation of the Will will also result in the revocation of an insurance designation.[9] Especially in the family law context, where there is a desire to irrevocably designate a spouse and/or children as the beneficiary of the policy proceeds, it is not appropriate to put such a designation in a Will. As noted above, a Will can always be revoked and the insurer will not recognize the designation as irrevocable if it is in a Will.

Many separation agreements provide that support obligations will be a first charge against the payor´s estate. However, if there are other creditors of the deceased´s estate, they will have their claims paid first. Further, if the estate is extremely modest, this will not provide much comfort (or money) for the payee spouse and/or children.

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Key Questions with Using Life Insurance in the Family Law Context

It is very important that the parties who want to use insurance as security for support obligations fully define their expectations and intent. Are the proceeds of the insurance policy to be available to the recipient in any event? Are the proceeds only to fund future support obligations, and if so, for how long, and in what amount? If the insurance proceeds are greater than the support obligation, what is to happen with the remaining proceeds? Can the payor spouse designate alternative beneficiaries for the balance of the proceeds not used to fund the support obligation?

Support obligations are taxable in the hands of the spousal recipient[10] and deductible from the payor´s income during his or her lifetime. After the death of the payor such payments are not included or deducted for tax purposes. How do you determine the appropriate level of support after the death of the payor in light of this change?

What type of insurance is available to the payor spouse and how does the type of insurance affect the security? Are the policy proceeds simply to be paid over to the recipient or should there be a trustee who holds the proceeds in trust and applies them to or for the benefit of the individuals who are to be supported? If a trustee is to be chosen, who should that be? Should there be more than one trustee? How is the trustee to be compensated? If a trust is to be created, it is essential to ensure that the trust meets the three certainties, provides direction and powers to the trustee, and provides for a termination of the trust itself. Some possible responses to these issues are discussed below.

a) Control of the Insurance Proceeds

There is often tension between the payee and payor as to how the insurance proceeds are to be used to fund support obligations. The payee inevitably wants control over the proceeds of the insurance policy that will be payable at death to ensure that he or she can use the funds as he or she wants or as is necessary, in his or her sole discretion, to provide for spousal or child support. The payor, on the other hand, usually wants someone else to have control of the proceeds and ensure that there is no wind-fall for the payee spouse. Once the support obligations are either diminished or eliminated, the payor usually wants to retain the power to re-direct part if not all of the insurance proceeds to other beneficiaries.

It is often difficult for the payee to confirm that the insurance policy is in good standing and will always be available to meet future support obligations. He or she will want to be irrevocably designated as the beneficiary and will want proof on an ongoing basis that the policy is in force and the full face value can be accessed as security for future support obligations.

Conversely, the payor wants to have some ability to alter the designation of the insurance policy if his or her support obligations are reduced or terminated. Having an irrevocably designated beneficiary requires the recipient to provide his or her consent in writing to any change in the beneficiary designation. This can often be very difficult for the payor, as the payee has no incentive to provide such written consent.

b) Difference Types of Insurance Policies

Although insurance policies are an exceptionally valuable tool in estate planning, and often fund taxes and other obligations on death, individuals are sometimes careless in dealing with their policies. If is imperative that both parties confirm all details of the policy before negotiating the insurance clauses in a separation agreement. Often there is confusion over the face value of a policy, the policy number, the insurer, and even what type of insurance is in place. Unless the insurance is required for the payor´s personal estate planning, term insurance might be the more appropriate option. It can cover a specific time frame until the children reach a certain age or the support obligation otherwise ends. Then, if the policy is no longer required the policy can be allowed to lapse, or it can be converted to permanent coverage at this point in time.

However, for ongoing spousal support which is not limited in duration, or where the payor could require the insurance for his or her own estate planning needs, a permanent policy may be more appropriate.

If support is likely to be limited in duration, the payor may want to have the option to change the designated beneficiary to reflect the percentage reduction in the support obligation, and to designate a new beneficiary for a portion of the face amount of the policy. Again disputes can arise over how to deal with such an issue. In the family law context, separation agreements often provide for a resolution process to deal with many disputes including quantum of child or spousal support, custody and access issues, etc. This process should also be accessed to deal with any issues relating to the insurance policy and other issues.

c) Spouse Designated as both Beneficiary and Trustee

In a misguided effort to limit the payee spouse´s control over the insurance proceeds, some payors have chosen to designate the beneficiary as “my spouse Joan, as trustee for my children, Jim and Jean, beneficiaries”. This

presumably means that the payee spouse as trustee must somehow ultimately account to the children for the use of the insurance proceeds as they are being paid to him or her in trust.

There are many difficulties with such a designation. First, although the payee spouse receives the funds in “trust” or as “trustee”, the terms of the trust have not been stated. Presumably, the beneficiaries of the trust are the children, but there is nothing in writing to indicate that the payee spouse has the right to use the proceeds of the insurance policy to or for the benefit of the children. The trustee under most provincial *Trustee Acts* can invest and pay trust expenses, but little else, and certainly has no authority to use the funds to pay himself or herself the child support he or she was receiving before the payor died.

If the payee spouse is named as the trustee to receive the insurance proceeds and the monies are to be used for his or her support, the same problem exists. Technically the trustee has no power to use the funds for his or her own benefit. He or she would have to vary the trust to allow for direct payments of support. In reality this would never happen as the insurer would simply pay the funds to the spouse as trustee and he or she would likely place the funds in his or her own bank account. If no one else is designated to receive the balance of the insurance proceeds on the death or remarriage of the payee spouse, there is in effect no trust and it will likely be collapsed or wound up. In my experience it is quite unusual for the payee spouse to be designated as the trustee of the insurance policy if the proceeds are intended to fund spousal support obligations only.

I refer to these designations made without giving the trustee appropriate trust powers as being “directionless” trusts. Although the payee spouse is entitled to receive the insurance proceeds, he or she has no actual right to pay any of the monies out of that trust to meet the very child support obligations they were intended to secure. Instead, the only way that the payee spouse (trustee) can access those funds for the benefit of the children is to have the funds paid to the appropriate provincial Court, and then apply to have the monies paid out to or for the benefit of the children on either an ad hoc or periodic basis. Rather than leaving the funds sitting in a Court managed investment account, it is preferable for the surviving parent to have the use of the monies for the benefit of the children.

In many instances, of course, the payor spouse does not want the payee spouse to have total discretion on how the funds are to be used for the children. There is a lack of trust between the parties, or concerns about over-reaching. There is always a concern that the recipient spouse, who is to use the proceeds for the benefit of the children, will use them personally, or will not contribute as usual to the maintenance of the children and instead save and accumulate his or her own funds for personal use.

One solution is to name another individual as a trustee along with the surviving spouse. However, if specific trust terms are not created, then again the trustees will still be dealing with a “directionless” trust.

d) Termination of the Trust

The intent usually is that the insurance proceeds subject to the trust arrangement are to be used until such time as the support obligations end. The termination of support is usually set out within the separation agreement, but it can be subjectively interpreted. It is essential that the trustees be directed to wind up the trust upon the happening of a certain event or time frame, and that the final recipient of any remaining trust funds be designated.

As can be seen, there are a great many issues that must be addressed. It seems, however, that in situations where there is an ongoing and significant support obligation, the creation of an insurance trust could be a very helpful tool which would allow each of the payor and payee to maintain some control over the insurance proceeds, and allow those proceeds to be used for what they were intended: security for the payor´s actual support obligations and not as a lump sum “wind-fall” for either the payee spouse or the children when the support obligation ends.

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Insurance Trust Declarations – A Checklist

The balance of this paper provides a checklist of issues which professional advisors should review when trying to incorporate insurance terms within separation agreements and/or designating the beneficiary of an insurance policy. Standard insurance company designation forms do not really permit the creation of insurance trusts. Accordingly, it is often necessary to craft a unique Insurance Trust Declaration to meet the particular clients´ needs and circumstances. One must ensure that the designation is irrevocable, proper trustees are chosen, the trustees have sufficient powers and rights, know precisely when the trust is to be terminated, and what should happen with respect to any funds

remaining within the trust.

a) Naming Trustees
In creating an Insurance Trust Declaration, you should not name “Joe Doe, Trustee”. That is because the trustee will not receive the funds on a “creditor proof basis”. Instead the beneficiary should be named (i.e. Joe Doe, beneficiary to hold the proceeds of the Policy in trust…) on certain terms which are spelled out within the Insurance Trust Declaration.

If the beneficiary designation is to be irrevocable, that statement must appear in the beneficiary designation form or in the Insurance Trust Declaration and **must** be filed with the Insurer to be valid. This means that in some cases a portion of the separation agreement (dealing with the insurance) and the beneficiary form and/or Insurance Trust Declaration must actually be delivered to the Insurer. Prudent practice would be to receive written confirmation from the insurer that it has received all the relevant documents and will act in accordance with the beneficiary designation.

It is also essential to name an alternate trustee. (As noted earlier multiple trustees would be the preferred option). This will ensure that if the trustee dies or is unable or unwilling to act, the beneficiaries don´t have to apply to the Court to appoint someone else as a trustee. This is a costly and time-consuming exercise. It may also provide the payee spouse with the opportunity to state that he or she is the proper person entitled to receive the proceeds in trust, precisely what the payor spouse may have been trying to avoid.

If the trustee must make payments for an extended time, or may have to enter into negotiations with either the recipient spouse or children regarding quantum, cost of living adjustments or other expenses, he or she is going to have a significant and ongoing administrative obligation. It is essential that the payor confirm that the proposed trustee(s) will agree to act, and determine whether the proposed trustee(s) will act without compensation. If the trustee(s) requires compensation, such compensation should be set out within the Insurance Trust Declaration. Nothing is worse than appointing someone to assume responsibility as a trustee and then having them decline to do so upon the death of the payor.

b) Spousal Support
If the insurance trust is only designed to fund a limited duration spousal support obligation, then there should be a mechanism to quantify the obligation and an annuity or some other investment vehicle chosen to segregate the amount needed to provide for the spousal support, leaving the remaining insurance proceeds available to be transferred to another person. The Insurance Trust Declaration should designate the other beneficiary or beneficiaries.

c) Child Support
Where the insurance trust is to fund child support obligations, it will be necessary to consider segregating or apportioning the insurance proceeds between the children, taking into account their ages and stages of life. If there were three children and a $300,000 policy, then the trustee could be directed to create three separate trusts of $100,000 for each child. Each child´s trust would then terminate when the obligation to support that child ended, and any proceeds remaining in that child´s trust could be paid to this child when or she reached a certain age (such as 25 or 30), or could be paid out immediately. Again, it must be remembered that there should be an alternate beneficiary as that child could die before the support obligation ends. This other beneficiary could be either the child´s issue or his or her sibling(s).

An insurance trust for children should direct the trustee how to determine what payments should be made out of the trust to or for the benefit of the child. At first blush one would assume that the child support paid by the payor prior to his or her death would continue. However, as the cost of living increases, or as other expenses became known, the payor should consider giving the trustee the discretion to deal with these claims as well. The trustees should have the power to invest the funds and to require the production of certain information from the surviving parent/guardian of the child to substantiate the claimed expenses.

If the insurance proceeds are to fund both spousal and child support, this creates a more significant problem. Child support, as indicated, is usually of limited duration, whereas spousal support can continue indefinitely. Creative planning will have to be undertaken to determine the needs and quantum of insurance required for each group (children versus spouse), and careful drafting undertaken of the Insurance Trust Declaration to ensure that the expectations and intentions of the parties are addressed.

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Conclusions

The foregoing discussion highlights the conflicting expectations and desires of the payor and payee when using insurance to fund family law support obligations. There are fortunately a number of valid ways to address those conflicts and resolve them. Once a specific method has been chosen as to how insurance is to secure the support obligations, this method must be clearly and fully reflected in the insurance policy, beneficiary designations and other documents drafted by counsel.

In crafting Insurance Trust Declarations the language should be as clear and unequivocal as possible. The rights of the trustee and any discretion he or she has with respect to trust payments should be clearly set out. As drafting clauses providing for the proper termination of a trust can be somewhat complex it may be useful for the family law practitioner to get an estate or trust practitioner to review the Insurance Trust Declaration.

With the appropriate legal and insurance professionals at the table, life insurance can create a cost effective and timely solution to the ongoing need to fund support obligations on the death of the payor.

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Endnotes

[1] A version of this article was originally published as part of the OBA Annual Institute Programme, February 4, 2011 – Family Law; Family Law Boot Camp: Kicking it Up a Notch.

[2] (2009), 46 E.T.R. (3rd) 1, Ont. CA.

[3] (2009), 97 O.R. (3rd) 65 (Ont. C.A.).

[4] *Turner v. DiDonato*, ibid, at paragraph 38.

[5] For example, the Ontario Insurance Act, R.S.O. 1990, c. I-8. The Insurance Acts of the common law provinces are harmonized and therefore the comments in this article have general application to most provinces.

[6] For a sampling see: *Re: Carlisle*, 2007, Sask. Q.B. 425; *Sun Life Assurance Co. of Canada v. Taylor*, 2008, Sask. Q.B. 403. See also CALU *InfoExchange* 2010, v.4.

[7] See for example subsection 196(1) of the Ontario Insurance Act, supra note 5.

[8] See for example subsection 196(2) of the Ontario Insurance Act, supra note 5. In Quebec, it is the beneficiary´s relationship to policy owner that governs the creditor proof status of the policy.

[9] For example, refer to subsections 193(3) and (4) of the Ontario Insurance Act, supra note 5.

[10] Child support payments are generally not deductible under the Income Tax Act.

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